

# OJSC PASHA Bank Financial Statements

Year ended 31 December 2008 Together with Independent Auditors' Report

Ernst & Young

S. Commercial

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## Independent Auditors' Report

To the Shareholders and Board of Directors of OJSC PASHA Bank:

We have audited the accompanying financial statements of OJSC PASHA Bank, which comprise the balance sheet as at 31 December 2008 and the statement of operations, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

## Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of OJSC PASHA Bank as at 31 December 2008, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Erust four Holdings (III) B.V.
13 March 2009

### **BALANCE SHEET**

# As of 31 December 2008

(Figures in Tables are in Thousands of Azerbaijani Manats)

|  | Notes  | 2008    | 2007       |
|--|--------|---------|------------|
| Assets   |        |         |            |
| Cash and cash equivalents                                | 5      | 38,711  | 14,146     |
| Amounts due from credit institutions                     | 6      | 5,475   | 10,773     |
| Securities purchased under agreements to resell          | 7      | 6,202   | , <u>-</u> |
| Trading securities                                       | 8      | 598     | -          |
| Investment securities available-for-sale                 | 9      | 92,681  | 10,003     |
| Loans to banks   | 10     | 7,800   | · _        |
| Loans to customers                                       | 11     | 44,207  | 10,316     |
| Property and equipment                                   | 12     | 1,002   | 731        |
| Intangible assets  | 13     | 239     | 169        |
| Deferred tax assets                                      | 14     | -       | 61         |
| Other assets   | 15     | 722     | 79         |
| Total assets   |        | 197,637 | 46,278     |
| Liabilities  |        |         |            |
| Amounts due to financial institutions                    | 16     | 28,918  | _          |
| Amounts due to customers                                 | 17     | 55,113  | 11,416     |
| Current income tax liability                             | 14     | 2,508   | ,<br>-     |
| Deferred tax liabilities                                 | 14     | 450     | -          |
| Other liabilities  | 15     | 137     | 116        |
| Advances from shareholders for increase in share capital | 18     | -       | 25,000     |
| Total liabilities  | -<br>- | 87,126  | 36,532     |
| Equity   |        |         |            |
| Share capital  | 18     | 100,000 | 10,000     |
| Retained earnings (accumulated loss)                     | 18     | 10,511  | (254)      |
| Total equity   | -<br>- | 110,511 | 9,746      |
| Total liabilities and equity                             | =      | 197,637 | 46,278     |

Signed and authorised for release on behalf of the Management Board of the Bank:

Munday CI Chairman of the Management Board

Olga Rachko

13 March 2009

Chief Accountant

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## STATEMENT OF OPERATIONS

## For the year ended 31 December 2008

(Figures in Tables are in Thousands of Azerbaijani Manats)

|   |            | Year ended 31<br>December<br>2008 | Period from 18<br>June 2007 (date<br>of inception) to<br>31 December |
|---|------------|-----------------------------------|--|
|   | Notes      |                                   | 2007   |
| Interest income                                   |            |                                   |  |
| Amounts due from credit institutions              |            | 7,484                             | 202  |
| Loans to customers                                |            | 6,129                             | 20   |
| Investment securities available for sale          |            | 3,126                             | 23   |
| Loans to financial institutions                   |            | 999                               | -  |
| Other   |            | 901                               |  |
|   |            | 18,639                            | 245  |
| Interest expense                                  |            |                                   |  |
| Amounts due to customers                          |            | (1,513)                           | (3)  |
| Other   |            | (53)                              |  |
|   |            | (1,566)                           | (3)  |
| Net interest income                               | ·          | 17,073                            | 242  |
| Impairment charge for interest-bearing assets     | 11         | (2,018)                           | -  |
| Net interest income after loan impairment charge  | -          | 15,055                            | 242  |
| Net fee and commission income                     | 20         | 1,074                             | 2  |
| Net losses from trading securities                |            | (368)                             | -  |
| Net gains from foreign currencies                 |            | ` ,                               |  |
| -dealings   |            | 433                               | -  |
| -translation differences                          | _          | (3)                               | 2  |
| Non-interest income                               |            | 1,136                             | 4  |
| Salaries and other employee benefits              | 21         | (1,176)                           | (269)  |
| Depreciation and amortisation                     | 12, 13, 21 | (247)                             | (29)   |
| General and administrative expenses               | 21         | (984)                             | (263)  |
| Non-interest expenses                             |            | (2,407)                           | (561)  |
| Profit (loss) before income tax (expense) benefit |            | 13,784                            | (315)  |
| Income tax (expense) benefit                      | 14         | (3,019)                           | 61   |
| Net profit (loss) for the year/period             | •          | 10,765                            | (254)  |
| I (-saa) Janet Kansan                             | •          |                                   |  |

The accompanying notes on pages 5 to 32 are an integral part of these financial statements.

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# STATEMENT OF CHANGES IN EQUITY

# For the year ended 31 December 2008

(Figures in Tables are in Thousands of Azerbaijani Manats)

| _                                   | Share capital | Retained earnings<br>(accumulated loss) | Total equity |
|-------------------------------------|---------------|---|--------------|
| 18 June 2007 (date of inception)    | -             | -                                       | •            |
| Issuance of share capital (Note 18) | 10,000        | -                                       | 10,000       |
| Net loss for the period             |               | (254)                                   | (254)        |
| 31 December 2007                    | 10,000        | (254)                                   | 9,746        |
| Issuance of share capital (Note 18) | 90,000        | -                                       | 90,000       |
| Net profit for the year             |               | 10,765                                  | 10,765       |
| 31 December 2008                    | 100,000       | 10,511                                  | 110,511      |

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## CASH FLOW STATEMENT

# For the year ended 31 December 2008

(Figures in Tables are in Thousands of Azerbaijani Manats)

|   | Notes | Year ended 31<br>December<br>2008     | Period from 18<br>June 2007 (date<br>of inception) to<br>31 December<br>2007 |
|---|-------|---------------------------------------|--|
| Cash flows from operating activities  |       | · · · · · · · · · · · · · · · · · · · |  |
| Interest received   |       | 17,128                                | 175  |
| Interest paid   |       | (1,564)                               | _  |
| Fees and commissions received   |       | 1,527                                 | 35   |
| Fees and commissions paid   |       | (453)                                 | (13)   |
| Realised gains less losses from dealing in foreign currencies                                     |       | 433                                   | 3  |
| Salaries and other employee benefits paid   |       | (1,176)                               | (269)  |
| Administrative expenses paid  |       | (984)                                 | (198)  |
| Cash flows from (used in) operating activities before changes in operating assets and liabilities |       | 14,911                                | (267)  |
| Net (increase) decrease in operating assets   |       |                                       |  |
| Amounts due from credit institutions  |       | 5,545                                 | (10,733)   |
| Securities purchased under agreements to resell   |       | (6,202)                               | -  |
| Trading securities  |       | (966)                                 | _  |
| Loans to banks  |       | (7,800)                               | -  |
| Loans to customers  |       | (35,519)                              | (10,316)   |
| Other assets  |       | (643)                                 | (76)   |
| Net increase (decrease) in operating liabilities  |       |                                       |  |
| Amounts due to financial institutions   |       | 28,918                                | -  |
| Amounts due to customers  |       | 43,695                                | 11,414   |
| Other liabilities   |       | 18                                    | _  |
| Net cash from (used in) operating activities  |       | 41,957                                | (9,978)  |
| Cash flows from investing activities  |       |                                       |  |
| Purchase of investment securities available-for-sale  |       | (413,969)                             | (14,494)   |
| Proceeds from sale and redemption of investment securities available-for-sale                     |       | 332,167                               | 4,499  |
| Purchase of property and equipment  |       | (493)                                 | (708)  |
| Acquisition of intangible assets  |       | (94)                                  | (173)  |
| Net cash used in investing activities   |       | (82,389)                              | (10,876)   |
| Cash flows from financing activities  | ,     |                                       |  |
| Advances from shareholders for increase in share capital  | 18    | _                                     | 25,000   |
| Proceeds from issuance of share capital   | 18    | 65,000                                | 10,000   |
| Net cash from financing activities  |       | 65,000                                | 35,000   |
| Effect of exchange rates changes on cash and cash equivalents                                     |       | (3)                                   | -  |
| Net increase in cash and cash equivalents   |       | 24,565                                | 14,146   |
| Cash and cash equivalents, beginning  | 5     | 14,146                                | -  |
| Cash and cash equivalents, ending   | 5     | 38,711                                | 14,146   |
|   |       |                                       | · <del></del>  |

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### NOTES TO FINANCIAL STATEMENTS

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 1. Principal activities

OJSC PASHA Bank (the "Bank") was established on 18 June 2007 as an open joint stock company under the laws of the Republic of Azerbaijan. The Bank operates under a banking licence issued by the National Bank of the Republic of Azerbaijan ("NBA") on 28 November 2007.

The Bank accepts deposits from the public and extends credit, transfers payments, exchanges currencies and provides other banking services to its commercial and retail customers.

The Bank's registered legal address is 15 Yusif Mammadaliyev street, Baku, AZ1005, Azerbaijan.

As of 31 December 2008 and 2007 the shareholders of the Bank are as follows:

| Shareholder                         | 31 December 2008 (%) | 31 December 2007 (%) |
|-------------------------------------|----------------------|----------------------|
| Mr. Arif Pashayev                   | 10                   | 10                   |
| Pasha Holding Ltd.                  | 60                   |                      |
| ADOR Ltd.                           | 30                   | <u>.</u>             |
| Glasgow Investments Ltd. Azerbaijan | -                    | 30                   |
| Selmer Investments Ltd. Azerbaijan  | •                    | 30                   |
| Gusting Consulting Corp.            | -                    | 30                   |
| Total                               | 100                  | 100                  |

The Bank is ultimately controlled by Mr. Arif Pashayev.

### 2. Basis of preparation

#### General

These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS").

The Azerbaijani Manat is the functional and presentation currency of the Bank as the majority of the transactions are denominated, measured, or funded in Azerbaijani Manats. Transactions in other currencies are treated as transactions in foreign currencies. These financial statements are presented in thousands of Azerbaijani Manats ("AZN"), except per share amounts and unless otherwise indicated.

The Bank is required to maintain its records and prepare its financial statements in Azerbaijani Manats and in accordance with IFRS.

The financial statements have been prepared under the historical cost convention except as disclosed in the accounting policies below.

The Bank's operations are in Azerbaijan and constitute a single industry segment - commercial banking. Accordingly for purposes of IAS 14 "Segment Reporting" the Bank is treated as one business and geographical segment.

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# NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 3. Summary of significant accounting policies

#### Changes in accounting policies

The Bank applied the same accounting policies with those in prior year, except for the adoption of the following new IAS and IFRS amendments during the year:

Reclassification of Financial Assets – Amendments to IAS 39 'Financial instruments: Recognition and measurement' and IFRS 7 'Financial instruments: Disclosures'

Amendments to IAS 39 and IFRS 7 were issued on 13 October 2008 and allow reclassification of non-derivative financial assets out of the held for trading category in particular circumstances. The amendments also allow transfer of certain financial assets from the available for sale category to loans and receivables category. The effective date of those amendments is 1 July 2008. Any reclassification made in periods beginning on or after 1 November 2008 shall take effect only from the date when the reclassification is made.

If a non-derivative financial asset classified as held for trading is no longer held for the purpose of selling in the near term, it may be reclassified out of the fair value through profit or loss category in one of the following cases:

- a financial asset that would have met the definition of loans and receivables above may be reclassified to loans and receivables category if the Bank has the intention and ability to hold it for the foreseeable future or until maturity;
- other financial assets may be reclassified to available for sale or held to maturity categories only in rare circumstances.

A financial asset classified as available for sale that would have met the definition of loans and receivables may be reclassified to loans and receivables category of the Bank has the intention and ability to hold it for the foresecable future or until maturity. There were no reclassifications made during 2008 in relation to the above.

#### Financial assets

### Initial recognition

Financial assets in the scope of IAS 39 are classified as either financial assets at fair value through profit or loss, loans and receivables, held-to-maturity investments, or available-for-sale financial assets, as appropriate. When financial assets are recognised initially, they are measured at fair value, plus, in the case of investments not at fair value through profit or loss, directly attributable transaction costs. The Bank determines the classification of its financial assets upon initial recognition.

### Date of recognition

All regular way purchases and sales of financial assets are recognised on the trade date i.e. the date that the Bank commits to purchase the asset. Regular way purchases or sales are purchases or sales of financial assets that require delivery of assets within the period generally established by regulation or convention in the marketplace.

## Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They are not entered into with the intention of immediate or short-term resale and are not classified as trading securities or designated as investment securities available-for-sale. Such assets are carried at amortised cost using the effective interest method. Gains and losses are recognised in the statement of operations when the loans and receivables are derecognised or impaired, as well as through the amortisation process.

### Financial assets at fair value through profit or loss

Financial assets classified as held for trading are included in the category 'financial assets at fair value through profit or loss'. Financial assets are classified as held for trading if they are acquired for the purpose of selling in the near term. Derivatives are also classified as held for trading unless they are designated and effective hedging instruments. Gains or losses on financial assets held for trading are recognised in the statement of operations.

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# NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thousands of Azerbaijani Manats)

# 3. Summary of significant accounting policies (continued)

### Financial assets (continued)

Available-for-sale financial assets

Available-for-sale financial assets are those non-derivative financial assets that are designated as available-for-sale or are not classified in any of the preceding categories. After initial recognition available-for sale financial assets are measured at fair value with gains or losses being recognised as a separate component of equity until the investment is derecognised or until the investment is determined to be impaired at which time the cumulative gain or loss previously reported in equity is included in the statement of operations. However, interest calculated using the effective interest method is recognised in the statement of operations.

Determination of fair value

The fair value for financial instruments traded in active market at the balance sheet date is based on their quoted market price or dealer price quotations (bid price for long positions and ask price for short positions), without any deduction for transaction costs.

For all other financial instruments not listed in an active market, the fair value is determined by using appropriate valuation techniques. Valuation techniques include net present value techniques, comparison to similar instruments for which market observable prices exist, options pricing models and other relevant valuation models.

Offsetting

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

### Cash and cash equivalents

Cash and cash equivalents consist of cash on hand, amounts due from the NBA, excluding obligatory reserves, and amounts due from credit institutions with no maturity and that are free from contractual encumbrances.

### Repurchase and reverse repurchase agreements

Sale and repurchase agreements ("repos") are treated as secured financing transactions. Securities sold under sale and repurchase agreements are retained in the balance sheet and, in case the transferee has the right by contract or custom to sell or re-pledge them, reclassified as securities pledged under sale and repurchase agreements. The corresponding liability is presented within amounts due to credit institutions or customers. Securities purchased under agreements to resell ("reverse repo") are recorded as separate account on the balance sheet if material or as cash and cash equivalents or loans to customers as appropriate. The difference between sale and repurchase price is treated as interest and accrued over the life of repo agreements using the effective yield method.

## Amounts due to customers

Issued financial instruments or their components are classified as liabilities, where the substance of the contractual arrangement results in the Bank having an obligation either to deliver cash or another financial asset to the holder, or to satisfy the obligation other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of own equity instruments. Such instruments include amounts due to the NBA and Government, amounts due to credit institutions, amounts due to customers and debt securities issued. After initial recognition, borrowings are subsequently measured at amortised cost using the effective interest method. Gains and losses are recognised in the statement of operations when the borrowings are derecognised as well as through the amortisation process.

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# NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thonsands of Azerbaijani Manats)

# 3 Summary of significant accounting policies (continued)

### Impairment of financial assets

The Bank assesses at each balance sheet date whether there is any objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that has occurred after the initial recognition of the asset (an incurred 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or the group of financial assets that can be reliably estimated. Evidence of impairment may include indications that the borrower or a group of borrowers is experiencing significant financial difficulty, default or delinquency in interest or principal payments, the probability that they will enter bankruptcy or other financial reorganisation and where observable data indicate that there is a measurable decrease in the estimated future cash flows, such as changes in arrears or economic conditions that correlate with defaults.

Amounts due from credit institutions and loans to customers

For amounts due from credit institutions and loans to customers carried at amortised cost, the Bank first assesses individually whether objective evidence of impairment exists individually for financial assets that are individually significant, or collectively for financial assets that are not individually significant. If the Bank determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risks characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is, or continues to be, recognised are not included in a collective assessment of impairment.

If there is an objective evidence that an impairment loss has been incurred, the amount of the loss is measured as the difference between the assets' carrying amount and the present value of estimated future cash flows (excluding future expected credit losses that have not yet been incurred). The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognised in the statement of operations. Interest income continues to be accrued on the reduced carrying amount based on the original effective interest rate of the asset. Loans together with the associated allowance are written off when there is no realistic prospect of future recovery and all collateral has been realised or has been transferred to the Bank. If, in a subsequent year, the amount of the estimated impairment loss increases or decreases because of an event occurring after the impairment was recognised, the previously recognised impairment loss is increased or reduced by adjusting the allowance account. If a future write-off is later recovered, the recovery is credited to the statement of operations.

The present value of the estimated future cash flows is discounted at the financial asset's original effective interest rate. If a loan has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate. 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.

For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of the Bank's internal credit grading system that considers credit risk characteristics such as asset type, industry, geographical location, collateral type, past-due status and other relevant factors.

Future cash flows on a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience once established for assets with credit risk characteristics similar to those in the group. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the years on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect, and are directionally consistent with, changes in related observable data from year to year (such as changes in unemployment rates, property prices, commodity prices, payment status, or other factors that are indicative of incurred losses in the group or their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

For available-for-sale financial investments, the Bank assesses at each balance sheet date whether there is objective evidence that an investment or a group of investments is impaired.

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 3 Summary of significant accounting policies (continued)

### Impairment of financial assets (continued)

Amounts due from credit institutions and loans to customers (continued)

In the case of equity investments classified as available-for-sale, objective evidence would include a significant or prolonged decline in the fair value of the investment below its cost. Where there is evidence of impairment, the cumulative loss – measured as the difference between the acquisition coast and the current fair value, less any impairment loss on that investment previously recognised in the statement of operations – is removed from equity and recognised in the statement of operations. Impairment losses on equity investments are not reversed through the statement of operations; increases in their fair value after impairment are recognised directly in equity.

In the case of debt instruments classified as available-for-sale, impairment is assessed based on the same criteria as financial assets carried at amortised cost. Future interest income is based on the reduced carrying amount and is accrued using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss. The interest income is recorded in the statement of operations. If, in a subsequent year, the fair value of a debt instrument increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in the statement of operations, the impairment loss is reversed through the statement of operations.

### Derecognition of financial assets and liabilities

#### Financial assets

A financial asset (or, where applicable a part of a financial asset or part of a group of similar financial assets) is derecognised where:

- the rights to receive cash flows from the asset have expired;
- the Bank has transferred its rights to receive cash flows from the asset, or retained the right to receive cash flows from the asset, but has assumed an obligation to pay them in full without material delay to a third party under a 'pass-through' arrangement; and
- the Bank either (a) has transferred substantially all the risks and rewards of the asset, or (b) has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

Where the Bank has transferred its rights to receive cash flows from an asset and has neither transferred nor retained substantially all the risks and rewards of the asset nor transferred control of the asset, the asset is recognised to the extent of the Bank's continuing involvement in the asset. Continuing involvement that takes the form of a guarantee over the transferred asset is measured at the lower of the original carrying amount of the asset and the maximum amount of consideration that the Bank could be required to repay.

Where continuing involvement takes the form of a written and/or purchased option (including a cash-settled option or similar provision) on the transferred asset, the extent of the Bank's continuing involvement is the amount of the transferred asset that the Bank may repurchase, except that in the case of a written put option (including a cash-settled option or similar provision) on an asset measured at fair value, the extent of the Bank's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price.

#### Financial habilities

A financial liability is derecognised when the obligation under the liability is discharged or cancelled or expires.

Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability, and the difference in the respective carrying amounts is recognised in the statement of operations.

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 3 Summary of significant accounting policies (continued)

#### Derecognition of financial assets and liabilities (continued)

### Financial guarantees

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In the ordinary course of business, the Bank gives financial guarantees, consisting of letters of credit, guarantees and acceptances. Financial guarantees are initially recognised in the financial statements at fair value, in 'Other liabilities', being the premium received. Subsequent to initial recognition, the Bank's liability under each guarantee is measured at the higher of the amortised premium and the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee. Any increase in the liability relating to financial guarantees is taken to the statement of operations. The premium received is recognised in the statement of operations on a straight-line basis over the life of the guarantee.

#### Taxation

The current income tax expense is calculated in accordance with the regulations of the Republic of Azerbaijan .

Deferred tax assets and liabilities are calculated in respect of temporary differences using the liability method. Deferred income taxes are provided for all temporary differences arising between the tax bases of assets and liabilities and their carrying values for financial reporting purposes, except where the deferred income tax arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss.

A deferred tax asset is recorded only to the extent that it is probable that taxable profit will be available against which the deductible 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.

Azerbaijan also has various operating taxes that are assessed on the Bank's activities. These taxes are included as a component of administrative expenses.

### Property and equipment

Property and equipment are carried at cost, excluding the costs of day-to-day servicing, less accumulated depreciation and any accumulated impairment. Such cost includes the cost of replacing part of equipment when that cost is incurred if the recognition criteria are met.

The carrying values of property and equipment are reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable.

Depreciation of an asset begins when it is available for use. Depreciation is calculated on a straight-line basis over the following estimated useful lives:

|                                | Years |
|--------------------------------|-------|
| Furniture and fixtures         | 4     |
| Computers and office equipment | 4     |
| Motor vehicles                 | 4     |
| Other                          | 5     |

The asset's residual values, useful lives and methods are reviewed, and adjusted as appropriate, at each financial year-end.

Costs related to repairs and renewals are charged when incurred and included in other operating expenses, unless they qualify for capitalization.

(Figures in Tables are in Thousands of Azerbaijani Manats)

# 3. Summary of significant accounting policies (continued)

### Intangible assests

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Intangible assets consist of licences.

Intangible assets acquired separately are measured on initial recognition at cost. The cost of intangible assets acquired in a business combination is fair value as at the date of acquisition. Following initial recognition, intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses. The useful lives of intangible assets are assessed to be either finite or indefinite. Intangible assets with finite lives are amortised over the useful economic lives of 10 years and assessed for impairment whenever there is an indication that the intangible asset may be impaired. Amortisation periods and methods for intangible assets with indefinite useful lives are reviewed at least at each financial year-end.

#### **Provisions**

Provisions are recognised when the Bank has a present legal or constructive obligation as a result of past events, and 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 obligation can be made.

### Retirement and other employee benefit obligations

The Bank does not have any pension arrangements separate from the State pension system of the Republic of Azerbaijan, which requires current contributions by the employer calculated as a percentage of current gross salary payments; such expense is charged in the period the related salaries are earned. In addition, the Bank has no post-retirement benefits.

#### Share capital

Share capital

Ordinary shares are classified as equity. External costs directly attributable to the issue of new shares, other than on a business combination, are shown as a deduction from the proceeds in equity. Any excess of the fair value of consideration received over the par value of shares issued is recognised as additional paid-in capital.

#### Dividends

Dividends are recognised as a liability and deducted from equity at the balance sheet date only if they are declared before or on the balance sheet date. Dividends are disclosed when they are proposed before the balance sheet date or proposed or declared after the balance sheet date but before the financial statements are authorised for issue.

### Segment reporting

A segment is a distinguishable component of the Bank that is engaged either in providing products or services (business segment), or in providing products or services within a particular economic environment (geographical segment), which is subject to risks and rewards that are different from those of other segments. Segment income, segment expenses and segment performance include transfers between business segments and between geographical segments. As discussed in Note 2 the Bank's operations is treated as one business and geographical segment as its operations are in Azerbaijan and highly integrated and constitute a single industry segment, commercial banking; thus no segment reporting is separately presented herein.

## Contingencies

Contingent liabilities are not recognised in the balance sheet but are disclosed unless the possibility of any outflow in settlement is remote. A contingent asset is not recognised in the balance sheet but disclosed when an inflow of economic benefits is probable.

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## NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 3. Summary of significant accounting policies (continued)

#### Recognition of income and expenses

Revenue is recognised to the extent that it is probable that the economic benefits will flow to the Bank and the revenue can be reliably measured. Expenses are recognized when incurred. The following specific recognition criteria must also be met before revenue is recognised:

Interest and similar income and expense

For all financial instruments measured at amortised cost and interest bearing securities classified as trading or available-forsale, interest income or expense is recorded at the effective interest rate, which is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, where appropriate, to the net carrying amount of the financial asset or financial liability. The calculation takes into account all contractual terms of the financial instrument (for example, prepayment options) and includes any fees or incremental costs that are directly attributable to the instrument and are an integral part of the effective interest rate, but not future credit losses. The carrying amount of the financial asset or financial liability is adjusted if the Bank revises its estimates of payments or receipts. The adjusted carrying amount is calculated based on the original effective interest rate and the change in carrying amount is recorded as interest income or expense. Once the recorded value of a financial asset or a group of similar financial assets has been reduced due to an impairment loss, interest income continues to be recognised using the original effective interest rate applied to the new carrying amount.

### Fee and commission income and expense

The Bank earns fee and commission income from a diverse range of services it provides to its customers. Fee and commission income includes cash collection and withdrawal fees and customer services fees, which are recognized as revenue as the services are provided. Fee and commission expense consists of customer, external manager, brokerage and custodian fees.

## Foreign currency translation

The financial statements are presented in AZN, which is the Bank's functional and presentation currency. Transactions in foreign currencies are initially recorded in the functional currency, converted at the rate of exchange ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency rate of exchange ruling at the balance sheet date. Gains and losses resulting from the translation of foreign currency transactions are recognised in the statement of operations as gains less losses from foreign currencies - translation differences. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the date of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

Differences between the contractual exchange rate of a transaction in a foreign currency and the NBA exchange rate on the date of the transaction are included in gains less losses from dealing in foreign currencies.

The Bank used the following official exchange rates at 31 December 2008 and 2007 in the preparation of these financial statements:

2000

|                  | 2000       | 2007       |
|------------------|------------|------------|
| 1 US Dollar      | 0.801 AZN  | 0.8453 AZN |
| 1 Euro           | 1.1292 AZN | 1.2450 AZN |
| 1 Pound sterling | 1.1621 AZN | 1.6876 AZN |

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 3. Summary of significant accounting policies (continued)

### Future changes in accounting policies

Standards and interpretations issued but not yet effective

### Improvements to IFRS

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In May 2008, the IASB issued amendments to IFRS, which resulted from the IASB's annual improvements project. They comprise amendments that result in accounting changes for presentation, recognition or measurement purposes as well as terminology or editorial amendments related to a variety of individual IFRS standards. Most of the amendments are effective for annual periods beginning on or after January 1, 2009, with earlier application permitted. The Bank is currently evaluating the potential impact that the adoption of the amendments will have on its financial statements.

### LAS 23 "Borrowing Costs" (Revised)

A revised IAS 23 Borrowing costs was issued in March 2007, and becomes effective for financial years beginning on or after 1 January 2009. The standard has been revised to require capitalization of borrowing costs when such costs relate to a qualifying asset. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. In accordance with the transitional requirements in the Standard, the Bank will adopt this as a prospective change. Accordingly, borrowing costs will be capitalized on qualifying assets with a commencement date after 1 January 2009. No changes will be made for borrowing costs incurred to this date that have been expensed.

### IFRS 8 "Operating Segments"

IFRS 8 becomes effective for annual periods beginning on or after 1 January 2009. This Standard requires disclosure of information about the Bank's operating segments and replaces the requirement to determine primary (business) and secondary (geographical) reporting segments of the Bank. The Bank expects that the adoption of the pronouncements listed above will have no significant impact on the Bank's financial statements as the Bank represents a single reportable segment.

### 4. Significant accounting judgements and estimates

#### Judgements

In the process of applying the Bank's accounting policies, management has made the following judgements and made estimates which have effect on the amounts recognised in the financial statements:

## Allowance for loan impairment

The Bank regularly reviews its loans and receivables to assess impairment. The Bank uses its experienced judgement to estimate the amount of any impairment loss in cases where a borrower is in financial difficulties and there are few available sources of historical data relating to similar borrowers. Similarly, the Bank estimates changes in future cash flows based on the 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 group of loans and receivables. The Bank uses its experienced judgement to adjust observable data for a group of loans or receivables to reflect current circumstances.

### 5. Cash and cash equivalents

| ·   | 2008   | 2007   |
|---|--------|--------|
| Cash on hand  | 1,834  | 334    |
| Current accounts with the National Bank of the Republic of Azerbaijan | 4,043  | 2,815  |
| Current accounts with other financial institutions                    | 3,546  | 10,997 |
| Time deposits   | 29,288 | -      |
| Cash and cash equivalents   | 38,711 | 14,146 |

The current accounts with other financial institutions consist of correspondent accounts balances with resident and non-resident banks in the amount of AZN 816 (2007- AZN 10,997) and AZN 2,730 (2007-nil), respectively.

As of 31 December 2008 the Bank placed AZN 29,000 (2007 – nil) in time deposits with Azerbaijani banks maturing through 30 June 2009 and with effective annual interest rate of 15%-20%.

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## NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thousands of Azerbaijani Manats)

### 6. Amounts due from credit institutions

|   | 2008  | 2007   |   |
|---|-------|--------|---|
| Obligatory reserve with the National Bank of the Republic of Azerbaijan | 4,322 | 432    | - |
| Time deposits   | 8     | 10,328 |   |
| Blocked current accounts  | 1,145 | 13     |   |
| Amounts due from credit institutions                                    | 5,475 | 10,773 | • |

Credit institutions are required to maintain a non-interest earning cash deposit (obligatory reserve) with the NBA at 6% (2007 -10%) of the previous two-week average of funds attracted from customers by the bank. The Bank's ability to withdraw such deposit is restricted by statutory legislation.

The blocked current account is a security for settlement of letter of credit.

## 7. Securities purchased under agreements to resell

As of December 31, 2008 the Bank had entered into agreements to resell with a resident credit institution. The subject of these agreements are short-term notes issued by the National Bank of the Republic of Azerbaijan with a fair value of AZN 6,202 (2007 – nil). Interest income earned on these agreements for 2008 comprised AZN 177 (2007-nil).

### 8. Trading securities

Trading securities are corporate US dollar, Euro and Norwegian Crone denominated corporate shares traded internationally, and were held and managed by the Bank's external manager.

The Bank placed investments in US Dollars with the external asset manager and appointed it as its agents and delegated it to manage the investment and reinvestment of certain monies and assets. It also entered into a Custodian Agreement with an international financial institution to serve as the Custodian of the investment portfolios. The funds and assets are held at the third party Custodian, which monitors portfolios and is provided by the Bank the authority to release or deliver securities of the portfolio, register securities, and conduct transactions based on the asset manager's requests on buy/sell decisions. The Custodian provides the Bank a monthly report of all monies received in respect of the portfolio or paid out of the portfolio. The assets placed with external managers can be recalled by the Bank upon 20 days' written notice in advance.

The external asset manager, acting as an agent, have complete discretion but within the set of investment guidelines prescribed by the Bank, for the account of the Bank to buy, sell, retain, exchange or otherwise deal in investments and other assets, make deposits, subscribe to issues and offers for sale, and accept placements, underwritings and sub-underwritings, of any investments, advise on or execute transactions in unregulated collective investment schemes, effect transactions on all markets, negotiate and execute counterparty and account opening documentation, take all day to day decisions and otherwise act as the external manager judge appropriate in relation to the management of the funds.

## 9. Investment securities available-for-sale

|  | 2008           |               | 2007           |               |
|--|----------------|---------------|----------------|---------------|
|  | Carrying value | Nominal value | Carrying value | Nominal value |
| Bonds issued by the Ministry of Finance of<br>the Republic of Azerbaijan<br>Notes issued by the National Bank of the | 58,222         | 59,134        | -              |               |
| Republic of Azerbaijan   | 34,459         | 34,502        | 10,003         | 10,037        |
| Investment securities available-for-sale   | 92,681         | 93,636        | 10,003         | 10,037        |

Nominal interest rates and maturities of these securities are as follows:

|  | 2          | 008                   | 200        | 7            |
|--|------------|-----------------------|------------|--------------|
|  | %          | Maturity              | %          | Maturity     |
| Bonds issued by the Ministry of Finance of<br>the Republic of Azerbaijan | 5.9%-10.8% | January-April<br>2009 | -          | -            |
| Notes issued by the National Bank of the                                 |            |                       |            |              |
| Republic of Azerbaijan   | 4.0-4.7%   | January 2009          | 8.0%-12.0% | January 2008 |

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## NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 9. Investment securities available-for-sale (continued)

Subsequent to 31 December 2008, Bonds issued by the Ministry of Finance of the Republic of Azerbaijan which have matured amounting to AZN 42,161 and Notes issued by the National Bank of the Republic of Azerbaijan amounting to AZN 34,502 have been received by the Bank at their respective nominal values.

### 10. Loans to banks

As of 31 December 2008 the Bank had short-term unsecured loans denominated in Manats to two non-related resident commercial banks totalling AZN 7,800 (2007-nil) with contractual maturity of one to five months and annual interest rate ranging from 17% to 19%.

### 11. Loans to customers

Loans to customers comprise:

|                                 | 2008    | 2007   |
|---------------------------------|---------|--------|
| Legal entities                  | 41,916  | 9,380  |
| Individuals                     | 4,309   | 936    |
| Loans to customers (gross)      | 46,225  | 10,316 |
| Less - Allowance for impairment | (2,018) | -      |
| Loans to customers (net)        | 44,207  | 10,316 |

Loans are made within Azerbaijan in the following industry sectors:

|                          | 2008   | 2007   |
|--------------------------|--------|--------|
| Trade                    | 29,464 | 2,415  |
| Agriculture              | 8,031  | -      |
| Individuals              | 4,309  | 936    |
| Real estate construction | 3,359  | 6,793  |
| Telecommunication        | 610    | -      |
| Transport                | 156    | 172    |
| Food and beverage        | 95     | _      |
| Other                    | 201    | -      |
| Total loans (gross)      | 46,225 | 10,316 |
|                          |        |        |

As of 31 December 2008, the Bank had a concentration of loans represented by AZN 26,158 due from the six largest borrowers (57% of gross loan portfolio) (2007 – AZN 7,402 or 72% of gross loan portfolio). An allowance of AZN 274 (2007 – nil) was recognized against these loans.

Allowance for impairment of loans to customers

A reconciliation of the allowance for impairment of loans to customers by class is as follows:

|  | Corporate lending 2008 | Consumer lending<br>2008 | Total<br>2008 |
|--|------------------------|--------------------------|---------------|
| At 1 January   | -                      | -                        | -             |
| Charge for the year  | (1,264)                | (754)                    | (2,018)       |
| At 31 December   | (1,264)                | (754)                    | (2,018)       |
| Individual impairment  | (1,264)                | (754)                    | (2,018)       |
| Collective impairment  |                        |                          |               |
|  | (1,264)                | (754)                    | (2,018)       |
| Gross amount of loans, individually determined to be impaired before deducting any individually assessed |                        |                          |               |
| impairment allowance   | 7,091                  | 1,186                    | 8,277         |

The Bank has determined no objective evidence of either individual or collective impairment of loans outstanding as of 31 December 2007, and, accordingly, the Bank determined that no loan loss allowance is required against these loans.

Interest income accrued on loans, for which individual impairment allowances have been recognized, as at 31 December 2008, comprised AZN 134 (2007 – nil).

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## NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thousands of Azerbaijani Manats)

# 12. Property and equipment

The movements in property and equipment were as follows:

|  | Furniture<br>and fixtures | Computers<br>and office<br>equipment | Motor<br>vehicles | Other fixed assets    | Leased Hold<br>Improvement | Total |
|--|---------------------------|--------------------------------------|-------------------|-----------------------|----------------------------|-------|
| Cost                                     |                           |                                      |                   |                       |                            |       |
| 31 December 2007                         | 246                       | 284                                  | 195               | 31                    | -                          | 756   |
| Additions                                | 205                       | 93                                   | 153               | 7                     | 58                         | 516   |
| Disposals                                | -                         | -                                    | (30)              | -                     | -                          | (30)  |
| Transfers                                | 24                        | (5)                                  |                   | (19)                  | -                          | -     |
| 31 December 2008                         | 475                       | 372                                  | 318               | 19                    | 58                         | 1,242 |
| Accumulated depreciation                 |                           |                                      |                   |                       |                            |       |
| 31 December 2007                         | (10)                      | (6)                                  | (8)               | (1)                   | -                          | (25)  |
| Depreciation charge                      | (92)                      | (76)                                 | (51)              | (3)                   | -                          | (222) |
| Disposals                                | -                         | <u> </u>                             | 7                 | -<br>-                | -                          | 7     |
| 31 December 2008                         | (102)                     | (82)                                 | (52)              | (4)                   | -                          | (240) |
| Net book value:                          |                           |                                      |                   |                       |                            |       |
| 31 December 2007                         | 236                       | 278                                  | 188               | 30                    | -                          | 731   |
| 31 December 2008                         | 373                       | 290                                  | 266               | 15                    | 58                         | 1,002 |
|  | Furniture<br>and fixtures | Computers<br>and office<br>equipment | Motor<br>vehicles | Other Fixed<br>Assets | Leased Hold Improvement    | Total |
| Cost                                     |                           |                                      |                   |                       |                            |       |
| 18 June 2007                             | -                         | -                                    | _                 | -                     | -                          | ~     |
| Purchases                                | 246                       | 284                                  | 195               | 31                    | _                          | 756   |
| 31 December 2007                         | 246                       | 284                                  | 195               | 31                    |                            | 756   |
| Accumulated depreciation<br>18 June 2007 | -                         | _                                    | _                 | _                     | -                          | -     |
| Depreciation charge                      | (10)                      | (6)                                  | (8)               | (1)                   | -                          | (25)  |
| 31 December 2007                         | (10)                      | (6)                                  | (8)               | (1)                   | _                          | (25)  |
| Net book value:                          |                           |                                      | ·                 |                       |                            |       |
| 31 December 2007                         | 236                       | 278                                  | 188               | 30                    | -                          | 731   |
|  |                           |                                      | ·                 |                       |                            |       |

# 13. Intangible assets

The movements in intangible assets were as follows:

|                          |          |          | mputer<br>oftware Total |  |
|--------------------------|----------|----------|-------------------------|--|
| Cost                     | Licences | software | 1 otai                  |  |
| 31 December 2007         | 173      | _        | 173                     |  |
| Additions                | 20       | 75       | 95                      |  |
| Disposals                | (4)      | -        | (4)                     |  |
| 31 December 2008         | 189      | 75       | 264                     |  |
| Accumulated depreciation |          |          |                         |  |
| 31 December 2007         | (4)      | -        | (4)                     |  |
| Amortisation charge      | (21)     | (4)      | (25)                    |  |
| Disposals                | 4        | -        | ` 4                     |  |
| 31 December 2008         | (21)     | (4)      | (25)                    |  |
| Net book value:          |          |          |                         |  |
| 31 December 2007         | 169      |          | 169                     |  |
| 31 December 2008         | 168      | 71       | 239                     |  |

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## NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 13. Intangible assets (continued)

|                          | Licences | Computer software | Total |
|--------------------------|----------|-------------------|-------|
| Cost                     |          |                   |       |
| 18 June 2007             | •        | -                 | _     |
| Acquisitions             | 173      | -                 | 173   |
| 31 December 2007         | 173      |                   | 173   |
| Accumulated amortization |          |                   |       |
| 18 June 2007             | -        | -                 | -     |
| Amortisation charge      | (4)      | _                 | (4)   |
| 31 December 2007         | (4)      | -                 | (4)   |
| Net book value:          |          |                   |       |
| 31 December 2007         | 169      | •                 | 169   |

### 14. Taxation

The corporate income tax (expense) benefit comprises:

|                                | 2008    | 2007 |
|--------------------------------|---------|------|
| Current tax expense            | (2,508) | -    |
| Deferred tax (expense) benefit | (511)   | 61   |
| Income tax (expense) benefit   | (3,019) | 61   |

Azerbaijani legal entities must file individual tax declarations. The tax rate for banks for profits was 22% for 2008.

The effective income tax rate differs from the statutory income tax rates. A reconciliation of the income tax (expense) benefit based on statutory rates with actual is as follows:

|  | 2008    | 2007  |
|--|---------|-------|
| Profit (loss) before income tax (expense) benefit    | 13,784  | (315) |
| Statutory tax rate                                   | 22%     | 22%   |
| Theoretical income tax benefit at the statutory rate | (3,033) | 69    |
| Non-deductible expenses                              | 18      | (8)   |
| Tax-exempt income                                    | (32)    | -     |
| Income tax (expense) benefit                         | (3,019) | 61    |

Current income tax liability as of 31 December 2008 amounted to AZN 2,508 (2007 - nil).

Deferred tax assets and liabilities as of 31 December and their movements for the respective years comprise:

|  | 18 June 2007 | Origination and reversal of temporary differences | 2007                                  | Origination<br>and reversal<br>of temporary<br>differences | 2008  |
|--|--------------|---|---------------------------------------|--|-------|
| Tax effect of deductible                     |              |   | · · · · · · · · · · · · · · · · · · · |  |       |
| temporary differences:                       |              |   |                                       |  |       |
| Tax losses carried forward                   | =            | 126   | 126                                   | (126)  | -     |
| Accrued expenses                             | -            | 13  | 13                                    | 4  | 17    |
| Deferred tax assets                          |              | (139)   | (139)                                 | (122)  | 17    |
| Tax effect of taxable temporary differences: |              |   |                                       |  |       |
| Loans to customers                           | -            | (47)  | (47)                                  | (383)  | (430) |
| Property and equipment                       | _            | (28)  | (28)                                  | ` (5)  | (33)  |
| Intangible assets                            |              | (3)   | (3)                                   | (1)  | `(4)  |
| Deferred tax liabilities                     | -            | (78)  | (78)                                  | (389)  | (467) |
| Deferred tax assets/(liabilities)            | -            | 61  | 61                                    | (511)  | (450) |

(Figures in Tables are in Thousands of Azerbaijani Manats)

### 15. Other assets and liabilities

### Other assets comprise:

|   | 2008 | 2007 |
|---|------|------|
| Prepayments for acquisition of property and equipment | 459  | 76   |
| Other prepayments                                     | 61   | -    |
| Deferred expenses                                     | 46   | -    |
| Other   | 156  | 3    |
| Other assets  | 722  | 79   |

### Other liabilities comprise:

|  | 2008 | 2007 |
|--|------|------|
| Payables for professional services                   | 46   | 50   |
| Salary and other payables to employees               | 41   | -    |
| Settlements with suppliers                           | 13   | -    |
| Settlements on acquisition of property and equipment | _    | 66   |
| Other  | 37   |      |
| Other liabilities                                    | 137  | 116  |

# 16. Amounts due to financial institutions

|                                       | 2008   | 2007 |
|---------------------------------------|--------|------|
| Demand deposits                       | 27,433 | _    |
| Long-term loans                       | 1,485  | -    |
| Amounts due to financial institutions | 28,918 | -    |

Included in demand deposits amounts due to financial institutions of AZN 26,969 (93%) were due to the two financial institutions (2007 - nil).

As of 31 December 2008, the Bank had long-term loans from the Fund for Promotion to Entrepreneurs of AZN 1,485 with annual interest rate of 1% and contractual maturity ranging from 2013 to 2015 with interest payable quarterly.

### 17. Amounts due to customers

|  | 2008            | 2007          |
|--|-----------------|---------------|
| Current accounts   | 39,820          | 8,880         |
| Time deposits  | 15,293          | 2,536         |
| Amounts due to customers   | 55,113          | 11,416        |
| Held as security against letter of credits and guarantees        | 1,145           | 13            |
|  |                 |               |
|  | 2008            | 2007          |
| Current accounts – Legal entities                                | 2008<br>31,000  | 2007          |
| Current accounts – Legal entities Time deposits – Legal entities |                 | 2007<br>8,514 |
|  | 31,000          | -             |
| Time deposits – Legal entities                                   | 31,000<br>7,179 | 8,514         |

Amounts due to customers include accounts with the following types of customers:

|                          | 2008   | 2007   |
|--------------------------|--------|--------|
| Private enterprises      | 37,996 | 8,514  |
| Individuals              | 16,934 | 2,902  |
| State owned enterprises  | 183    |        |
| Amounts due to customers | 55,113 | 11,416 |

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### NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 17. Amounts due to customers (continued)

An analysis of customer accounts by economic sector follows:

|                            | 2008   | 2007   |
|----------------------------|--------|--------|
| Investment holding company | 34,137 | -      |
| Individuals                | 16,934 | 2,902  |
| Real estate constructions  | 1,629  | 8,474  |
| Trade                      | 1,074  | -      |
| Service                    | 904    | -      |
| Industry and manufacturing | 56     | -      |
| Transportation             | 43     | -      |
| Energy                     | 9      | -      |
| Communication              | -      | 2      |
| Other                      | 327    | 38     |
| Amounts due to customers   | 55,113 | 11,416 |

The average interest rate on term deposits of corporate and individual customers outstanding at the year-end amounted to 7% p.a. and 9% p.a. respectively (2007: 1% p.a. and 10% p.a.).

At 31 December 2008 amounts due to customers of AZN 34,137 (62%) were due to shareholder of the Bank (2007- AZN 8,454 (74%) was due to one third party customer).

## 18. Equity

The share capital of the Bank was contributed by the shareholders in AZN and they are entitled to dividends and any capital distribution in AZN. No dividends were declared and paid to the shareholders of the Bank in 2008.

On 21 May 2007 the shareholders of the Bank approved an initial issuance of 10,000 ordinary shares. The total consideration received for these shares was comprised of cash for AZN 10,000. This share issue was registered by the State Committee for Securities under the auspices of the President of Azerbaijan on 9 July 2007. As of 31 December 2007, the number of authorised ordinary shares comprised 10,000 with a nominal value of AZN 1,000 each. All authorised shares have been issued and fully paid.

In December 2007 the Bank's shareholders have decided to increase the share capital from AZN 10 million to AZN 35 million and have made cash contribution of AZN 25 million for the increase in share capital. The Bank has applied for state registration of the share capital increase. As of 31 December 2007, the state registration of the increase has not been completed, and accordingly, the cash contributions made by the Bank's shareholders were recognized as advances by shareholders for increase in share capital in the Bank's balance sheet. As of 25 February 2008 the Bank has registered its share capital of AZN 35,000 consisting of 10,000 shares with par value of AZN 3,500 each with the appropriate authorities, and accordingly the advances for increase in share capital of AZN 25,000 have been reclassified to share capital.

On 18 January 2008 the Bank's shareholders have decided to increase the share capital from AZN 35 million to AZN 58 million and have made cash contribution of AZN 23 million for the increase in share capital.

On 21 May 2008 the shareholders further increased its share capital from existing AZN 58 million to AZN 100 million and made cash contribution of AZN 42 million on 22 May 2008. The Bank has completed the registration of the increases in share capital on 20 June 2008, thus, bringing share par value up to AZN 10,000 each and total paid-in share capital to AZN 100 million as of 31 December 2008.

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 19. Commitments and contingencies

#### Operating environment

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As an emerging market, Azerbaijan does not possess a well-developed business and regulatory infrastructure that would generally exist in a more mature market economy. However, there have been a number of developments that positively affect the overall investment climate of the country.

While operations in Azerbaijan may involve risks that are not typically associated with those in developed markets (including the risk that the Azerbaijan Manat is not freely convertible outside of the country and undeveloped debt and equity markets), over the last few years the Azerbaijani government has made progress in implementing the reforms necessary to create banking, judicial, taxation and regulatory systems. This includes the adoption of a new body of legislation including new Tax Code, new Civil and Customs Codes, procedural laws and securities regulations. In management's view, these steps contribute to mitigate the risks of doing business in Azerbaijan.

The existing tendency aimed at the overall improvement of the business environment is expected to persist. The future stability of the Azerbaijani economy is largely dependent upon these reforms and developments and the effectiveness of economic, financial and monetary measures undertaken by the government. However, the Azerbaijan economy is vulnerable to market downturns and economic slowdowns elsewhere in the world. The ongoing global financial crisis has resulted in capital markets instability, deterioration of liquidity in the banking sector, and tighter credit conditions within Azerbaijan. The Azerbaijan Government has introduced a range of stabilization measures aimed at ensuring solvency and providing liquidity and supporting refinancing of foreign debt for Azerbaijan banks and companies.

While management believes it is taking appropriate measures to support the sustainability of the Bank's business in the current circumstances, unexpected further deterioration in the areas described above could negatively affect the Bank's results and financial position in a manner not currently determinable.

### Legal

In the ordinary course of business, the Bank is subject to legal actions and complaints. Management believes that the ultimate liability, if any, arising from such actions or complaints will not have a material adverse effect on the financial condition or the results of future operations of the Bank.

#### Taxation

Azerbaijani tax, currency and customs legislation 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 authorities. Recent events within the Azerbaijan suggest that the tax authorities are taking a more assertive position in its interpretation of the legislation and assessments and, as a result, it is possible that transactions and activities that have not been challenged in the past may be challenged. As such, significant additional taxes, penalties and interest may be assessed. Fiscal periods remain open to review by the authorities in respect of taxes for three calendar years proceeding the year of review.

Management believes that its interpretation of the relevant legislation as of 31 December 2008 is appropriate and that the Bank's tax, currency and customs positions will be sustained.

#### Insurance

The Bank has not currently obtained insurance coverage related to liabilities arising from errors or omissions. Liability insurance is generally not available in Azerbaijan at present.

### Financial commitments and contingencies

The primary purpose of these instruments is to ensure that funds are available to a customer as required. Guarantees and standby letters of credit represent irrevocable assurances that the Bank will make payments in the event that a customer cannot meet its obligations to third parties. Documentary and commercial letters of credit, which are written undertakings by the Bank on behalf of a customer authorizing a third party to draw drafts on the Bank up to a stipulated amount under specific terms and conditions, are collateralized by the underlying shipments of goods, to which they relate, or cash deposits and, therefore, carry less risk than a direct borrowing.

# NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thousands of Azerbaijani Manats)

# 19. Commitments and contingencies (continued)

## Financial commitments and contingencies (continued)

As of 31 December 2008 and 2007 the Bank's financial commitments and contingencies comprised:

| 6,733   | _  |
|---------|--|
| 7,881   | _  |
| 2,119   | 294  |
| 16,733  | 294  |
| (1,145) | (13)                                       |
| 15,588  | 281  |
|         | 7,881<br>2,119<br><b>16,733</b><br>(1,145) |

## 20. Net fee and commission income

|                                | 2008  | 2007 |
|--------------------------------|-------|------|
| Cash operations                | 811   | 5    |
| Currency conversion operations | 446   | 8    |
| Settlements operations         | 262   | 2    |
| Other                          | 8     | -    |
| Fee and commission income      | 1,527 | 15   |
| Securities operations          | (276) | (7)  |
| Settlements operations         | (99)  | (3)  |
| Guarantees and commitments     | (65)  | -    |
| Currency conversion operations | (2)   | -    |
| Other                          | (11)  | (3)  |
| Fee and commission expense     | (453) | (13) |
| Net fee and commission income  | 1,074 | 2    |

# 21. Salaries and other employee benefits, and other administrative expenses

| -  | 2008    | 2007  |
|--|---------|-------|
| Salaries   | (965)   | (220) |
| Social security costs                            | (211)   | (49)  |
| Salaries and other employee benefits             | (1,176) | (269) |
| Depreciation charge (note 12)                    | (222)   | (25)  |
| Amortization charge (note 13)                    | (25)    | (4)   |
| Depreciation and amortization                    | (247)   | (29)  |
| Professional fees                                | (426)   | (77)  |
| Personnel training                               | (93)    | (17)  |
| Business travel and related expenses             | (90)    | (15)  |
| Insurance  | . (80)  | -     |
| Occupancy and rent                               | (70)    | (12)  |
| Communications                                   | (33)    | -     |
| Repair and maintenance of property and equipment | (31)    | (19)  |
| Office supplies                                  | (27)    | -     |
| Security   | (26)    | -     |
| Entertainment                                    | (25)    | -     |
| Utilities  | (15)    | -     |
| Operating taxes                                  | (12)    | (59)  |
| Premium for deposit insurance                    | (12)    | -     |
| Membership fees                                  | (11)    | (10)  |
| Other  | (33)    | (54)  |
| General and administrative expenses              | (984)   | (263) |

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 22. Risk management

#### Introduction

Risk is inherent in the Bank's activities but it is managed through a process of ongoing identification, measurement and monitoring, subject to risk limits and other controls. This process of risk management is critical to the Bank's continuing profitability and each individual within the Bank is accountable for the risk exposures relating to his or her responsibilities. The Bank is exposed to credit risk, liquidity risk and market risk, the latter being subdivided into trading and non-trading risks. It is also subject to operating risks.

The independent risk control process does not include business risks such as changes in the environment, technology and industry. They are monitored through the Bank's strategic planning process.

Risk management structure

The Board of Directors is ultimately responsible for identifying and controlling risks; however, there are separate independent bodies responsible for managing and monitoring risks.

Board of Directors

The Board of Directors is responsible for the overall risk management approach and for approving the risk strategies and principles.

Audit Committee

The Audit Committee has the overall responsibility for the establishment and development of the audit mission and strategy. It is responsible for the fundamental audit issues and monitoring Internal Audit's activities.

Management Board

The Management Board has the responsibility to monitor the overall risk process within the Bank.

Risk Committee

The Risk Committee has the overall responsibility for the development of the risk strategy and implementing principles, frameworks, policies and limits. It is responsible for the fundamental risk issues and manages and monitors relevant risk decisions.

Risk Management

The Risk Management Department is responsible for implementing and maintaining risk related procedures to ensure an independent control process.

Bank Treasury

Bank Treasury is responsible for managing the Bank's assets and liabilities and the overall financial structure. It is also primarily responsible for the funding and liquidity risks of the Bank.

Internal Audit

Risk management processes throughout the Bank are audited annually by the internal audit function, that examines both the adequacy of the procedures and the Bank's compliance with the procedures. Internal Audit discusses the results of all assessments with management, and reports its findings and recommendations to the Audit Committee.

Risk measurement and reporting systems

The Bank's risks are measured using a method which reflects both the expected loss likely to arise in normal circumstances and unexpected losses, which are an estimate of the ultimate actual loss based on statistical models. The models make use of probabilities derived from historical experience, adjusted to reflect the economic environment. The Bank also runs worse case scenarios that would arise in the event that extreme events which are unlikely to occur do, in fact, occur.

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 22. Risk management (continued)

### Introduction (continued)

Monitoring and controlling risks is primarily performed based on limits established by the Bank. These limits reflect the business strategy and market environment of the Bank as well as the level of risk that the Bank is willing to accept, with additional emphasis on selected industries. In addition the Bank monitors and measures the overall risk bearing capacity in relation to the aggregate risk exposure across all risks types and activities.

Information compiled from all the businesses is examined and processed in order to analyse, control and identify early risks. This information is presented and explained to the Management Board, the Risk Committee, and the head of each business division. The report includes aggregate credit exposure, hold limit exceptions and liquidity ratios. On a monthly basis detailed reporting of industry, customer and geographic risks takes place. Senior management assesses the appropriateness of the allowance for credit losses on a quarterly basis. The Board of Directors receives a comprehensive risk report once a quarter which is designed to provide all the necessary information to assess and conclude on the risks of the Bank.

For all levels throughout the Bank, specifically tailored risk reports are prepared and distributed in order to ensure that all business divisions have access to extensive, necessary and up-to-date information.

A daily briefing is given to the Management Board and all other relevant employees of the Bank on the utilisation of market limits and liquidity, plus any other risk developments.

Risk mitigation

Bank actively uses collateral to reduce its credit risks.

Excessive risk concentration

Concentrations arise when a number of counterparties are engaged in similar business activities, or activities in the same geographic region, or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Concentrations indicate the relative sensitivity of the Bank's performance to developments affecting a particular industry or geographical location.

In order to avoid excessive concentrations of risks, the Bank's policies and procedures include specific guidelines to focus on maintaining a diversified portfolio. Identified concentrations of credit risks are controlled and managed accordingly.

#### Credit risk

Credit risk is the risk that the Bank will incur a loss because its customers, clients or counterparties failed to discharge their contractual obligations. The Bank manages and controls credit risk by setting limits on the amount of risk it is willing to accept for individual counterparties and for geographical and industry concentrations, and by monitoring exposures in relation to such limits.

The Bank has established a credit quality review process to provide early identification of possible changes in the creditworthiness of counterparties, including regular collateral revisions. Counterparty limits are established by the use of a credit risk classification system. The credit quality review process allows the Bank to assess the potential loss as a result of the risks to which it is exposed and take corrective action.

### Credit-related commitments risks

The Bank makes available to its customers guarantees which may require that the Bank make payments on their behalf. Such payments are collected from customers based on the terms of the letter of credit. They expose the Bank to similar risks to loans and these are mitigated by the same control processes and policies.

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 22. Risk management (continued)

### Credit risk (continued)

The table below shows the maximum exposure to credit risk for the components of the balance sheet. The maximum exposure is shown gross, before the effect of mitigation through the use of master netting and collateral agreements.

|  |       | Gross maximum           | Gross maximum    |
|--|-------|-------------------------|------------------|
|  | Notes | <i>exposure</i><br>2008 | exposute<br>2007 |
| Cash and cash equivalents (excluding cash on hand) | 5     | 36,877                  | 13,812           |
| Amounts due from credit institutions               | 6     | 5,475                   | 10,773           |
| Securities purchased under agreements to resell    | 7     | 6,202                   | -                |
| Trading securities                                 | 8     | 598                     | _                |
| Investment securities available-for-sale           | 9     | 92,681                  | 10,003           |
| Loans to banks                                     | 10    | 7,800                   | -                |
| Loans to customers                                 | 11    | 46,225                  | 10,316           |
| Other assets                                       | 15    | 93                      | 0                |
|  |       | 195,951                 | 44,904           |
| Financial commitments and contingencies            | 19    | 16,733                  | 294              |
| Total credit risk exposure                         |       | 212,684                 | 45,198           |

Where financial instruments are recorded at fair value, the amounts shown above represent the current credit risk exposure but not the maximum risk exposure that could arise in the future as a result of changes in values.

For more detail on the maximum exposure to credit risk for each class of financial instrument, references shall be made to the specific notes. The effect of collateral and other risk mitigation techniques is shown below.

### Credit quality per class of financial assets

The credit quality of financial assets is managed by the Bank internal credit ratings. The table below shows the credit quality by class of asset for loan-related balance sheet lines, based on the Bank's credit rating system.

|  | 1     | Veither past          | due nor impa              | uired                             |  |               |
|--|-------|-----------------------|---------------------------|-----------------------------------|--|---------------|
|  | Notes | High<br>grade<br>2008 | Standard<br>grade<br>2008 | Sub-<br>standard<br>grade<br>2008 | Past due or individually impaired 2008 | Total<br>2008 |
| Investment securities available-for-sale |       | 92,681                | _                         | -                                 | -                                      | 92,681        |
| Loans to banks                           |       | -                     | 7,800                     | -                                 | -                                      | 7,800         |
| Loans to customers                       |       |                       |                           |                                   |  | ŕ             |
| Corporate lending                        |       | 34,826                | -                         | -                                 | 5,827                                  | 40,653        |
| Consumer lending                         |       | 3,123                 | -                         | _                                 | 431                                    | 3,554         |
|  |       | 37,949                | -                         |                                   | 6,258                                  | 44,207        |
| Total                                    |       | 130,630               | 7,800                     |                                   | 6,258                                  | 144,688       |
|  |       | Neither past o        | lue nor impa              | ired                              |  |               |
|  | Notes | High<br>grade<br>2007 | Standard<br>grade<br>2007 | Sub-<br>standard<br>grade<br>2007 | Past due or individually impaired 2007 | Total<br>2007 |
| Investment securities available-for-sale |       | 10,003                | _                         | -                                 | -                                      | 10,003        |
| Loans to banks<br>Loans to customers     |       | -                     | -                         | -                                 | -                                      | , <u>-</u>    |
| Corporate lending                        |       | 9,380                 | -                         | -                                 | -                                      | 9,380         |
| Consumer lending                         |       | 936                   | _                         | _                                 | -                                      | 936           |
|  |       | 10,316                |                           |                                   |  | 10,316        |
| Total                                    |       | 20,319                |                           | -                                 |  | 20,319        |

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 22. Risk management (continued)

#### Credit risk (continued)

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Credit quality per class of financial assets (continued)

It is the Bank's policy to maintain accurate and consistent risk ratings across the credit portfolio. This facilitates focused management of the applicable risks and the comparison of credit exposures across all lines of business, geographic regions and products. The rating system is supported by a variety of financial analytics, combined with processed market information to provide the main inputs for the measurement of counterparty risk. All internal risk ratings are tailored to the various categories and are derived in accordance with the Bank's rating policy. The attributable risk ratings are assessed and updated regularly.

### Impairment assessment

The main considerations for the loan impairment assessment include whether any payments of principal or interest are overdue by more than 90 days or there are any known difficulties in the cash flows of counterparties, credit rating downgrades, or infringement of the original terms of the contract. The Bank addresses impairment assessment in two areas: individually assessed allowances and collectively assessed allowances.

#### Individually assessed allowances

The Bank determines the allowances appropriate for each individually significant loan on an individual basis. Items considered when determining allowance amounts include the sustainability of the counterparty's business plan, its ability to improve performance once a financial difficulty has arisen, projected receipts and the expected dividend payout should bankruptcy ensue, the availability of other financial support and the realisable value of collateral, and the timing of the expected cash flows. The impairment losses are evaluated at each reporting date, unless unforeseen circumstances require more careful attention.

### Collectively assessed allowances

Allowances are assessed collectively for losses on loans to customers that are not individually significant (including credit cards, residential mortgages and unsecured consumer lending) and for individually significant loans where there is not yet objective evidence of individual impairment. Allowances are evaluated on each reporting date with each portfolio receiving a separate review.

The collective assessment takes account of impairment that is likely to be present in the portfolio even though there is no yet objective evidence of the impairment in an individual assessment. Impairment losses are estimated by taking into consideration of the following information: historical losses on the portfolio, current economic conditions, the appropriate delay between the time a loss is likely to have been uncured and the time it will be identified as requiring an individually assessed impairment allowance, and expected receipts and recoveries once impaired. Local management is responsible for deciding the length of this period which can extend for as long as one year. The impairment allowance is then reviewed by credit management to ensure alignment with the Bank's overall policy.

Financial guarantees and letters of credit are assessed and provision made in a similar manner as for loans.

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## NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 22. Risk management (continued)

### Credit risk (continued)

The Bank's monetary assets and liabilities are geographical concentrated as follows:

|  |            |       |                               | 2007          |            |      |                                  |            |
|--|------------|-------|-------------------------------|---------------|------------|------|----------------------------------|------------|
|  | Azerbaijan | OECD  | CIS and<br>other non-<br>OECD | Total         | Azerbaijan | OECD | CIS and<br>other<br>non-<br>OECD | Total      |
| Assets:  |            |       |                               |               |            |      |                                  |            |
| Cash and cash equivalents  Amounts due from credit | 35,980     | 2,677 | 54                            | 38,711        | 14,146     | -    | -                                | 14,146     |
| institutions                                       | 4,330      | 1,145 |                               | E 175         | 10 772     |      |                                  | 10 770     |
| Securities purchased under                         | 4,550      | 1,145 | -                             | <b>5,4</b> 75 | 10,773     | -    | -                                | 10,773     |
| repurchase   |            |       |                               |               |            |      |                                  |            |
| agreements   | 6,202      | -     | -                             | 6,202         | _          | -    | _                                | _          |
| Trading securities                                 | 598        | -     | -                             | 598           | -          | _    | _                                | -          |
| Investment securities available-for-               |            |       |                               |               |            |      |                                  |            |
| sale   | 92,681     | -     | _                             | 92,681        | 10,003     | -    | _                                | 10,003     |
| Loans to banks                                     | 7,800      | -     | _                             | 7,800         | ´ -        | _    | _                                |            |
| Loans to customers                                 | 44,207     | -     | _                             | 44,207        | 10,316     | _    | -                                | 10,316     |
| Other assets                                       | 89         | 4     |                               | 93            |            |      | -                                | -          |
|  | 191,887    | 3,826 | 54                            | 195,767       | 45,237     | -    |                                  | 45,237     |
| Liabilities:                                       |            |       |                               |               |            |      |                                  |            |
| Amounts due to financial                           |            |       |                               |               |            |      |                                  |            |
| institutions                                       | 28,918     | _     | -                             | 28,918        | =          | _    | _                                | _          |
| Amounts due to customers                           | 55,083     | _     | 30                            | 55,113        | 11,416     | _    | -                                | 11,416     |
| Current tax liability                              | 2,508      | _     | _                             | 2,508         | · -        | -    | -                                | , <u>-</u> |
| Other liabilities                                  | 87         | -     | -                             | 87            | 50         | -    | _                                | 50         |
| Advances from shareholders for                     |            |       |                               |               |            |      |                                  |            |
| increase in share capital                          |            |       |                               | -             | 25,000     | -    | -                                | 25,000     |
|  | 86,596     |       | 30                            | 86,626        | 36,466     | -    | -                                | 36,466     |
| Net balance sheet position                         | 105,291    | 3,826 | 24                            | 109,141       | 8,771      |      | -                                | 8,771      |

## Liquidity risk and funding management

Liquidity risk is the risk that the Bank will be unable to meet its payment obligations when they fall due under normal and stress circumstances. To limit this risk, management has arranged diversified funding sources in addition to its core deposit base, manages assets with liquidity in mind, and monitors future cash flows and liquidity on a daily basis. This incorporates an assessment of expected cash flows and the availability of high grade collateral which could be used to secure additional funding if required.

The Bank maintains a portfolio of highly marketable and diverse assets that can be easily liquidated in the event of an unforeseen interruption of cash flow. In addition, the Bank maintains obligatory reserves with the NBA, the amount of which depends on the level of customer funds attracted.

The liquidity position is assessed and managed by the Bank based on certain liquidity ratios established by the NBA. As at 31 December 2008 and 2007 these ratios were as follows:

|   | 2008, % | 2007, % |
|---|---------|---------|
| Instant Liquidity Ratio (assets receivable or realisable within one day / liabilities repayable |         |         |
| on demand)  | 235     | 500     |

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 22. Risk management (continued)

#### Credit risk (continued)

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Analysis of financial liabilities by remaining contractual maturities

The table below summarises the maturity profile of the Bank's financial liabilities at 31 December 2008 and 2007 based on contractual undiscounted repayment obligations. Repayments which are subject to notice are treated as if notice were to be given immediately. However, the Bank expects that many customers will not request repayment on the earliest date the Bank could be required to pay and the table does not reflect the expected cash flows indicated by the Bank's deposit retention history.

| Financial liabilities As at 31 December 2008 | Less than 3<br>months | 3 to 12<br>months | 1 to 5<br>years | Over<br>5 yeats | Total  |
|--|-----------------------|-------------------|-----------------|-----------------|--------|
| Amounts due to financial institutions        | 27,441                | 11                | 1,205           | 341             | 28,998 |
| Amounts due to customers                     | 15,293                | 39,860            | 235             | -               | 55,388 |
| Current tax liability                        | 2,508                 | -                 | -               | -               | 2,508  |
| Other liabilities                            | 3                     | 84                | -               | ~               | 87     |
| Total undiscounted financial liabilities     | 45,245                | 39,955            | 1,440           | 341             | 86,891 |
| Financial liabilities                        | Less than 3           | 3 to 12           | 1 to 5          | Over            |        |
| As at 31 December 2007                       | months                | months            | years           | 5 yeats         | Total  |
| Amounts due to customers                     | 8,880                 | 2,536             | _               | _               | 11,416 |
| Other liabilities                            | 25                    | 25                | -               | -               | 50     |
| Advances from shareholders for increase in   |                       |                   |                 |                 |        |
| share capital                                | 25,000                |                   | -               | _               | 25,000 |
| Total undiscounted financial liabilities     | 33,905                | 2,561             |                 | _               | 36,466 |

The table below shows the contractual expiry by maturity of the Bank's financial commitments and contingencies.

|      | Less than 3 months | 3 to 12<br>months | 1 to 5<br>years | Maturity<br>undefined | Total  |
|------|--------------------|-------------------|-----------------|-----------------------|--------|
| 2008 | 885                | 8,715             | 401             | 6,732                 | 16,733 |
| 2007 | 294                | · -               | _               | ´ <u>-</u>            | 294    |

The Bank expects that not all of the contingent liabilities or commitments will be drawn before expiry of the commitments.

The Bank's capability to repay its liabilities relies on its ability to realise an equivalent amount of assets within the same period of time. There is a significant concentration of deposits from organizations of related parties in the period of one year. Any significant withdrawal of these funds would have an adverse impact on the operations of the Bank. Management believes that this level of funding will remain with the Bank for the foreseeable future and that in the event of withdrawal of funds, the Bank would be given sufficient notice so as to realise its liquid assets to enable repayment.

The maturity analysis does not reflect the historical stability of current accounts. Their liquidation has historically taken place over a longer period than indicated in the tables above. These balances are included in amounts due in less than three months in the tables above.

### Operational risk

Operational risk is the risk of loss arising from systems failure, human error, fraud or external events. When controls fail to perform, operational risks can cause damage to reputation, have legal or regulatory implications, or lead to financial loss. The Bank cannot expect to eliminate all operational risks, but through a control framework and by monitoring and responding to potential risks, the Bank is able to manage the risks. Controls include effective segregation of duties, access, authorisation and reconciliation procedures, staff education and assessment processes, including the use of internal audit.

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 22. Risk management (continued)

#### Market risk

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Market risk is the risk that the fair value or future cash flows of financial instruments will fluctuate due to changes in market variables such as interest rates, foreign exchanges, and equity prices. The Bank manages exposures to market risk based of sensitivity analysis. The Bank has no significant concentration of market risk.

#### Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair values of financial instruments. The following table demonstrates the sensitivity to a reasonable possible change in interest rates, with all other variables held constant, of the Bank's statement of operations.

The sensitivity of the statement of operations is the effect of the assumed changes in interest rates on the net interest income for one year, based on the floating rate non-trading financial assets and financial liabilities held at December 31, 2007. The sensitivity of equity is calculated by revaluing fixed rate available-for-sale financial assets at December 31, 2007 for the effects of the assumed changes in interest rates based on the assumption that there are parallel shifts in the yield curve.. The use of sensitivity analyses has limitations because the year-end exposure does not reflect the exposure during the year.

|  | Increase in %<br>rate<br>2008 | Sensitivity<br>of equity<br>2008 | Decrease in<br>% rate<br>2008 | Sensitivity of<br>equity<br>2008 |
|--|-------------------------------|----------------------------------|-------------------------------|----------------------------------|
| Bonds issued by the Ministry of Finance of the<br>Republic of Azerbaijan   | 1.5%                          | 873                              | (1.5%)                        | (873)                            |
| Notes issued by the National Bank of the<br>Republic of Azerbaijan   | 5.0%                          | 1,706                            | (5.0%)                        | (1,706)                          |
|  | Increase in %<br>rate         | Sensitivity<br>of equity         | Decrease in<br>% rate         | Sensitivity of equity            |
|  | 2007                          | 2007                             | 2007                          | 2007                             |
| Bonds issued by the Ministry of Finance of the<br>Republic of Azerbaijan<br>Notes issued by the National Bank of the |                               |                                  | 2007                          | * *                              |

## Currency risk

Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. The Supervisory Board has set limits on positions by currency based on the NBA regulations. Positions are monitored on a daily basis.

The tables below indicate the currencies to which the Bank had significant exposure at December 31, 2008 and 2007 on its non-trading monetary assets and liabilities and its forecast cash flows. The analysis calculates the effect of a reasonably possible movement of the currency rate against the AZN, with all other variables held constant on the statement of operations (due to the fair value of currency sensitive non-trading monetary assets and liabilities). The effect on equity does not differ from the effect on the statement of operations. A negative amount in the table reflects a potential net reduction in statement of operations or equity, while a positive amount reflects a net potential increase.

| Currency | Increase in currency | Effect on ptofit | Increase in currency | Effect on profit |
|----------|----------------------|------------------|----------------------|------------------|
|          | rate in %            | before tax       | rate in %            | before tax       |
|          | 2008                 | 2008             | 2007                 | 2007             |
| USD      | 4.4%                 | (12)             | 3.1%                 | (340)            |
| EUR      | 18.1%                | 206              | 10.1%                |                  |
| Currency | Decrease in currency | Effect on profit | Decrease in currency | Effect on profit |
|          | rate in %            | before tax       | rate in %            | before tax       |
|          | 2008                 | 2008             | 2007                 | 2007             |
| USD      | (4.4%)               | 12               | (2.9%)               | 318              |
| EUR      | (18.1%)              | (206)            | (8.4%)               |                  |

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## NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thousands of Azerbaijani Manats)

### 23. Fair values of financial instruments

Set out below is a comparison by class of the carrying amounts and fair values of the Bank's financial instruments that are carried in the financial statements. The table does not include the fair values of non-financial assets and non-financial liabilities.

|                               | Carrying<br>value<br>2008 | Fair value<br>2008 | Unrecognised<br>gain/(loss)<br>2008 | Carrying<br>value<br>2007 | Fair value<br>2007 | Unrecognised<br>gain/(loss)<br>2007 |
|-------------------------------|---------------------------|--------------------|-------------------------------------|---------------------------|--------------------|-------------------------------------|
| Financial assets              |                           | ****               |                                     |                           |                    |                                     |
| Cash and cash equivalents     | 38,711                    | 38,711             | -                                   | 14,146                    | 14,146             | _                                   |
| Amounts due from credit       |                           | •                  |                                     | ,                         | •                  |                                     |
| institutions                  | 5,475                     | 5,475              | _                                   | 10,773                    | 10,773             | =                                   |
| Securities purchased under    | •                         | •                  |                                     | ,                         | ,                  |                                     |
| agreements to resell          | 6,202                     | 6,202              | -                                   |                           |                    | -                                   |
| Trading securities            | 598                       | 598                | =                                   | -                         | _                  | -                                   |
| Investment securities         | 92,681                    | 92,681             | _                                   | 10,003                    | 10,003             | -                                   |
| available-for-sale            |                           | •                  |                                     | ,                         | -,                 |                                     |
| Loans to banks                | 7,800                     | 7,800              | -                                   | -                         | -                  | _                                   |
| Loans to customers            | 44,207                    | 43,811             | 396                                 | 10,316                    | 10,302             | (14)                                |
| Other assets                  | 93                        | 93                 | -                                   | , <u>-</u>                | -                  | -                                   |
| Financial liabilities         |                           |                    |                                     |                           |                    |                                     |
| Amounts due to financial      |                           |                    |                                     |                           |                    |                                     |
| institutions                  | 28,918                    | 28,479             | (439)                               | _                         | _                  | _                                   |
| Amounts due to customers      | 55,113                    | 55,113             | -                                   | 11,416                    | 11,416             | _                                   |
| Current tax liability         | 2,508                     | 2,508              | -                                   | , ,                       |                    | ~                                   |
| Other liabilities             | 87                        | 87                 | -                                   | 50                        | 50                 | -                                   |
| Advances from shareholders    |                           |                    |                                     |                           |                    |                                     |
| for increase in share capital | -                         | -                  | -                                   | 25,000                    | 25,000             | -                                   |
| Total unrecognised change     |                           |                    |                                     |                           |                    |                                     |
| in unrealised fair value      |                           |                    | (43)                                |                           |                    | (14)                                |

The following describes the methodologies and assumptions used to determine fair values for those financial instruments which are not already recorded at fair value in the financial statements.

## Assets for which fair value approximates carrying value

For financial assets and financial liabilities that are liquid or having a short term maturity (less than thee months) it is assumed that the carrying amounts approximate to their fair value. This assumption is also applied to demand deposits, savings accounts without a specific maturity and variable rate financial instruments.

## Fixed rate financial instruments

The fair value of fixed rate financial assets and liabilities carried at amortised cost are estimated by comparing market interest rates when they were first recognised with current market rates offered for similar financial instruments. The estimated fair value of fixed interest bearing deposits is based on discounted cash flows using prevailing money-market interest rates for debts with similar credit risk and maturity. For quoted debt issued the fair values are calculated based on quoted market prices. For those notes issued where quoted market prices are not available, a discounted cash flow model is used based on a current interest rate yield curve appropriate for the remaining term to maturity.

### Financial instruments recorded at fair value

The following table shows an analysis of financial instruments recorded at fair value, between those whose fair value is based on quoted market prices, those involving valuation techniques where all the model inputs are observable in the market, and those where the valuation techniques involves the use of non-market observable inputs.

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## NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 23. Fair values of financial instruments (continued)

Financial instruments recorded at fair value (continued)

|  | Quoted market price<br>2008 | Valuation techniques –<br>market observable<br>inputs<br>2008  | Total<br>2008 |
|--|-----------------------------|--|---------------|
| Financial assets                         |                             |  |               |
| Securities purchased under agreements to |                             |  |               |
| resell                                   | ~                           | 6,202  | 6,202         |
| Trading securities                       | 598                         | , <u>-</u>   | 598           |
| Investment securities available-for-sale | -                           | 92,681   | 92,681        |
|  | 598                         | 98,883   | 99,481        |
|  |                             | Valuation techniques –<br>matket observable  |               |
|  | Quoted market price         | inputs   | Total         |
|  | 2007                        | 2007   | 2007          |
| Financial assets                         |                             | A CONTRACTOR OF THE CONTRACTOR |               |
| Investment securities available-for-sale | -                           | 10,003   | 10,003        |
|  | -                           | 10,003   | 10,003        |

## 24. Maturity analysis of financial assets and liabilities

The table below shows an analysis of financial assets and liabilities according to when they are expected to be recovered or settled. See Note 19 "Risk management" for the Bank's contractual undiscounted repayment obligations.

|   | 2008       |           |         | 2007     |           |        |  |
|---|------------|-----------|---------|----------|-----------|--------|--|
| -   | Within one | More than |         | Within   | Mote than |        |  |
|   | year       | one year  | Total   | one year | one year  | Total  |  |
| Financial assets                                |            |           |         |          |           |        |  |
| Cash and cash equivalents                       | 38,711     | -         | 38,711  | 14,146   | ~         | 14,146 |  |
| Amounts due from credit institutions            | 5,475      | -         | 5,475   | 10,773   | _         | 10,773 |  |
| Securities purchased under agreements to resell | 6,202      | -         | 6,202   | -        | _         | _      |  |
| Trading securities                              | 598        | -         | 598     | -        | _         | _      |  |
| Investment securities available-for-sale        | 92,681     | -         | 92,681  | 10,003   | _         | 10,003 |  |
| Loans to banks                                  | 7,800      | -         | 7,800   | -        | -         | _      |  |
| Loans to customers                              | 27,631     | 16,576    | 44,207  | 7,536    | 2,780     | 10,316 |  |
| Other assets                                    | 93         | -         | 93      | -        | -         | •      |  |
| Total   | 179,191    | 16,576    | 195,767 | 42,457   | 2,780     | 45,237 |  |
| Financial liabilities                           |            |           |         |          |           |        |  |
| Amounts due to financial institutions           | 27,433     | 1,485     | 28,918  | _        | =         | -      |  |
| Amounts due to customers                        | 54,913     | 200       | 55,113  | 11,416   | _         | 11,416 |  |
| Current tax liability                           | 2,508      | -         | 2,508   | -        |           | _      |  |
| Other liabilities                               | 87         | _         | 87      | 50       | _         | 50     |  |
| Advances from shareholders for increase in      |            |           |         |          |           |        |  |
| share capital                                   |            | -         | -       | 25,000   | -         | 25,000 |  |
| Total   | 84,941     | 1,685     | 86,626  | 36,466   | -         | 36,466 |  |
| Net   | 94,250     | 14,891    | 109,141 | 5,991    | 2,780     | 8,771  |  |

Long-term loans are generally not available in Azerbaijan except for programs set up by international financial institutions. However, in the Azerbaijan marketplace, many short-term credits are granted with the expectation of renewing the loans at maturity. As such, the ultimate maturity of assets may be different from the analysis presented above. In addition, the maturity analysis does not reflect the historical stability of current accounts. Their liquidation has historically taken place over a longer period than indicated in the tables above. These balances are included in amounts due on demand in the tables above. While trading securities are shown at demand, realizing such assets upon demand is dependent upon financial market conditions. Significant security positions may not be liquidated in a short period of time without adverse price effects.

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## NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 25. Related party disclosures

In accordance with IAS 24 "Related Party Disclosures", 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. In considering each possible related party relationship, attention is directed to the substance of the relationship, not merely the legal form.

Related party transactions were made on terms equivalent to those that prevail in arm's length transactions.

Related parties may enter into transactions which unrelated parties might not, and transactions between related parties may not be effected on the same terms, conditions and amounts as transactions between unrelated parties.

The volumes of related party transactions, outstanding balances at the year end, and related expense and income for the year are as follows:

|  | 2008             |   |  | 2007                                   |       |                  |   |  |  |       |
|--|------------------|---|--|--|-------|------------------|---|--|--|-------|
|  | Sharehold<br>ers | Entities with significant influence over the Bank | Entities<br>under<br>common<br>control | Key<br>manag<br>ement<br>person<br>nel | Other | Sharehol<br>ders | Entities with significant influence over the Bank | Entities<br>under<br>common<br>control | Key<br>manag<br>ement<br>person<br>nel | Other |
| Amounts due to financial institutions at January 1   | -                | -   | 37                                     | -                                      | -     | -                | -   | -                                      | -                                      | -     |
| Amounts received during the year                     | -                | ~   | 53,561                                 | -                                      | -     | -                | -   | 37                                     | -                                      | -     |
| Amounts repaid during the year                       |                  |   | (26,512)                               |  |       |                  |   |  |  |       |
| Amounts due to financial institutions at December 31 |                  |   | (27,086)                               | . <u> </u>                             |       | <u>-</u>         | <del></del>                                       | 37_                                    |  | -     |
| Deposits at 1 January Deposits received during       | 2,536            | -   | -                                      | -                                      | -     | -                | -   | -                                      | -                                      | -     |
| the year <sup>1</sup>                                | 71,000           | -   | 5,908                                  | 100                                    | -     | 2,536            | -   | -                                      | -                                      | -     |
| Deposits repaid during the year                      | (40,233)         |   | (5,808)                                |  |       |                  | -   | -                                      |  |       |
| Deposits at 31 December                              | 33,303           |   | 100                                    | 100                                    |       | 2,536            |   | •                                      |  |       |
| Current accounts at 31<br>December                   | 3,901            | -   | 1,973                                  | 17                                     | 6,791 | 100              | -   | -                                      | -                                      | -     |
| Interest expense on deposits                         | 1,312            | -   | 5                                      | 6                                      | -     | 1                | -   | -                                      | -                                      | -     |

Compensation of key management personnel was comprised of the following:

|  | 2008 | 2007      |
|--|------|-----------|
| Salaries and other short-term benefits | 335  | 95        |
| Social security costs                  | 74   | <u>21</u> |
| Total key management compensation      | 409  | 116       |

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## NOTES TO FINANCIAL STATEMENTS (CONTINUED)

(Figures in Tables are in Thousands of Azerbaijani Manats)

## 26. Capital adequacy

The Bank maintains an actively managed capital base to cover risks inherent in the business. The adequacy of the Bank's capital is monitored using, among other measures, the ratios established the NBA and the Basel Capital Accord 1988 in supervising the Bank.

The primary objectives of the Bank's capital management are to ensure that the Bank complies with externally imposed capital requirements and that the Bank maintains strong credit ratings and healthy capital ratios in order to support its business and to maximise shareholders' value.

The Bank manages its capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of its activities. In order to maintain or adjust the capital structure, the Bank may adjust the amount of dividend payment to shareholders, return capital to shareholders or issue capital securities. No changes were made in the objectives, policies and processes from the previous years.

NBA capital adequacy ratio

The NBA requires banks to maintain a minimum capital adequacy ratio of 12% of risk-weighted assets. As of 31 December 2008 and 2007 the Bank's capital adequacy ratio on this basis was as follows:

|                              | 2008    | 2007   |
|------------------------------|---------|--------|
| Tier 1 capital               | 99,480  | 9,480  |
| Tier 2 capital               | 10,465  | 212    |
| Less deductions from capital | (239)   | (169)  |
| Total capital                | 109,706 | 9,523  |
| Risk-weighted assets         | 97,040  | 32,716 |
| Capital adequacy ratio       | 113%    | 29%    |

Capital adequacy ratio under Basel Capital Accord 1988

The Bank's capital adequacy ratio, computed in accordance with the Basel Capital Accord 1988, with subsequent amendments including the amendment to incorporate market risks, as of 31 December 2008 and 2007, comprised:

|                      | 2008    | 2007  |
|----------------------|---------|---|
| Tier 1 capital       | 100,000 | 9,764   |
| Tier 2 capital       | -       | -   |
| Total capital        | 100,000 | 9,764   |
| •                    |         | Zila kozatowa zi zila zila zila zila zila zila zila |
| Risk-weighted assets | 57,186  | 27,645  |
| Tier 1 capital ratio | 175%    | 35%   |
| Total capital ratio  | 175%    | 35%   |

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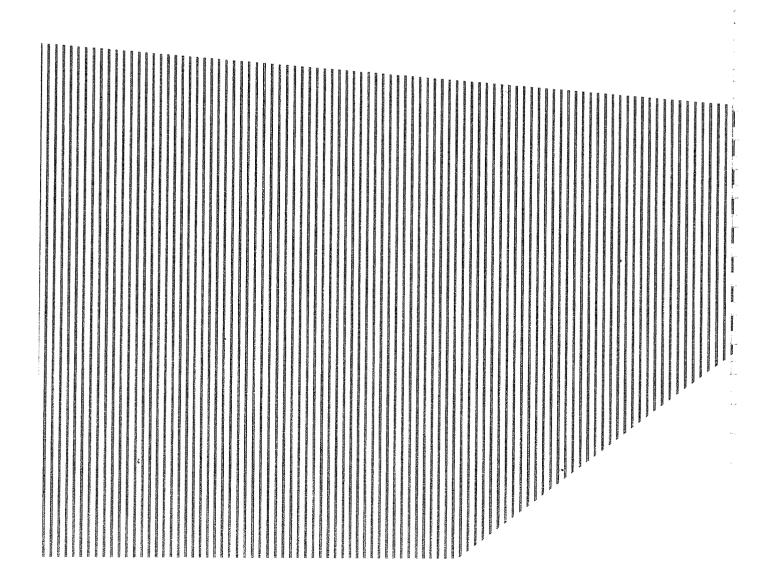
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