

**Open Joint Stock  
Company  
MUGANBANK**

**Independent Auditors' Report  
and Financial Statements**

For the Year Ended 31 December 2005

# OPEN JOINT STOCK COMPANY MUGANBANK

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## **STATEMENT OF MANAGEMENT'S RESPONSIBILITIES FOR THE PREPARATION AND APPROVAL OF THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005**

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The following statement, which should be read in conjunction with the independent auditors' responsibilities stated in the independent auditor's audit report set out on page 2, is made with a view to distinguishing the respective responsibilities of management and those of the independent auditors in relation to the financial statements of Open Joint Stock Company Muganbank (the "Bank").

Management is responsible for the preparation of the financial statements that present fairly the financial position of the Bank at 31 December 2005, the results of its operations, cash flows and changes in equity for the year then ended, in accordance with International Financial Reporting Standards ("IFRS").

In preparing the financial statements, management is responsible for:

- selecting suitable accounting principles and applying them consistently;
- making judgements and estimates that are reasonable and prudent;
- stating whether IFRS have been followed, subject to any material departures disclosed and explained in the financial statements; and
- preparing the financial statements on a going concern basis, unless it is inappropriate to presume that the Bank will continue in business for the foreseeable future.

Management is also responsible for:

- designing, implementing and maintaining an effective and sound system of internal controls, throughout the Bank;
- maintaining proper accounting records that disclose, with reasonable accuracy at any time, the financial position of the Bank, and which enable them to ensure that the financial statements of the Bank comply with IFRS;
- maintaining statutory accounting records in compliance with legislation and accounting standards of the Republic of Azerbaijan;
- taking such steps as are reasonably available to them to safeguard the assets of the Bank; and
- detecting and preventing fraud and other irregularities.

The financial statements for the year ended 31 December 2005 were authorised for issue on 25 April 2006 by the Management Board.

**On behalf of the Board**

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**Chairman**

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**Chief Accountant**

## INDEPENDENT AUDITORS' REPORT

To the Shareholders and the Board of Directors of the Open Joint Stock Commercial Company Muganbank:

We have audited the accompanying balance sheet of Open Joint Stock Commercial Company Muganbank (the "Bank") as at 31 December 2005 and the related income statement and statements of cash flows and changes in equity (the "financial statements") for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion the financial statements present fairly, in all material respects, the financial position of the Bank as at 31 December 2005, and the results of its operations and its cash flows for the year then ended, in accordance with International Financial Reporting Standards.



11 April 2006

# OPEN JOINT STOCK COMPANY MUGANBANK

## INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2005 (in Azerbaijan Manats and in thousands)

|  | Notes | 2005                    | 2004                  |
|--|-------|-------------------------|-----------------------|
| Interest income  | 4, 22 | 9,673,640               | 8,609,810             |
| Interest expense   | 4, 22 | <u>(3,082,026)</u>      | <u>(2,061,246)</u>    |
| NET INTEREST INCOME BEFORE PROVISION FOR<br>IMPAIRMENT LOSSES ON INTEREST BEARING ASSETS |       | 6,591,614               | 6,548,564             |
| Provision for impairment losses on interest bearing assets                               | 5, 22 | <u>(1,634,186)</u>      | <u>(6,298,487)</u>    |
| NET INTEREST INCOME  |       | <u>4,957,428</u>        | <u>250,077</u>        |
| Net loss on foreign exchange operations  | 6     | (982,802)               | (134,440)             |
| Fee and commission income  | 7     | 4,506,187               | 5,569,202             |
| Fee and commission expense   | 7     | (506,392)               | (395,560)             |
| Net gain on investments available for sale   | 8     | 8,057                   | -                     |
| Other income   |       | <u>646</u>              | <u>14</u>             |
| NET NON-INTEREST INCOME  |       | <u>3,025,696</u>        | <u>5,039,216</u>      |
| OPERATING INCOME   |       | 7,983,124               | 5,289,293             |
| Recovery of provision/(provision) for impairment losses on other<br>transactions         | 5     | 295,680                 | (335,544)             |
| OPERATING EXPENSES   | 9, 22 | <u>(5,099,353)</u>      | <u>(3,658,204)</u>    |
| OPERATING PROFIT BEFORE INCOME TAX   |       | 3,179,451               | 1,295,545             |
| Income tax expense   | 10    | <u>(790,808)</u>        | <u>(341,237)</u>      |
| NET PROFIT   |       | <u><u>2,388,643</u></u> | <u><u>954,308</u></u> |

**On behalf of the Board**

\_\_\_\_\_  
**Chairman**

\_\_\_\_\_  
**Chief Accountant**

The notes on pages 8 to 39 form an integral part of these financial statements. The Independent Auditors' Report is on page 2.

# OPEN JOINT STOCK BANK MUGANBANK

## BALANCE SHEET

AS AT 31 DECEMBER 2005

(in Azerbaijan Manats and in thousands)

|  | Notes  | 2005               | 2004              |
|--|--------|--------------------|-------------------|
| <b>ASSETS</b>  |        |                    |                   |
| Cash and balances with the National Bank of Azerbaijan | 11     | 7,770,379          | 2,799,396         |
| Loans and advances to banks, net                       | 12     | 20,760,773         | 13,612,756        |
| Loans and advances to customers, net                   | 13, 22 | 69,297,111         | 58,178,478        |
| Embedded derivative financial instruments              |        | 77,558             | -                 |
| Securities available for sale                          |        | -                  | 41,433            |
| Investments in unconsolidated associate                | 14     | -                  | 1,715,000         |
| Fixed and intangible assets, net                       | 15     | 9,052,219          | 9,206,525         |
| Other assets   | 16     | 175,024            | 131,784           |
| <b>TOTAL ASSETS</b>                                    |        | <b>107,133,064</b> | <b>85,685,372</b> |
| <b>LIABILITIES AND EQUITY</b>                          |        |                    |                   |
| <b>LIABILITIES:</b>                                    |        |                    |                   |
| Loans and advances from banks and other institutions   | 17     | 25,209,192         | 42,278,703        |
| Customer accounts                                      | 18, 22 | 49,987,475         | 19,254,823        |
| Current income tax liabilities                         | 10     | 327,284            | 223,708           |
| Deferred income tax liabilities                        | 10     | 166,623            | 23,098            |
| Allowance for losses on other transactions             | 5      | 33,260             | 299,698           |
| Other liabilities                                      |        | 433,279            | 80,034            |
| <b>Total liabilities</b>                               |        | <b>76,157,113</b>  | <b>62,160,064</b> |
| <b>EQUITY:</b>   |        |                    |                   |
| Share capital  | 20     | 27,000,000         | 21,938,000        |
| Retained earnings                                      |        | 3,975,951          | 1,587,308         |
| <b>Total equity</b>                                    |        | <b>30,975,951</b>  | <b>23,525,308</b> |
| <b>TOTAL LIABILITIES AND EQUITY</b>                    |        | <b>107,133,064</b> | <b>85,685,372</b> |

**On behalf of the Board**

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**Chairman**

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**Chief Accountant**

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# OPEN JOINT STOCK COMPANY MUGANBANK

## STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2005 (in Azerbaijan Manats and in thousands)

|                         | Share capital     | Revenue reserves | Total equity      |
|-------------------------|-------------------|------------------|-------------------|
| <b>31 December 2003</b> | 14,392,797        | 633,000          | 15,025,797        |
| Increase in capital     | 7,545,203         | -                | 7,545,203         |
| Net profit              | -                 | 954,308          | 954,308           |
| <b>31 December 2004</b> | 21,938,000        | 1,587,308        | 23,525,308        |
| Increase in capital     | 5,062,000         | -                | 5,062,000         |
| Net profit              | -                 | 2,388,643        | 2,388,643         |
| <b>31 December 2005</b> | <u>27,000,000</u> | <u>3,975,951</u> | <u>30,975,951</u> |

On behalf of the Board

\_\_\_\_\_  
Chairman

\_\_\_\_\_  
Chief Accountant

The notes on pages 8 to 39 form an integral part of these financial statements. The Independent Auditors' Report is on page 2.

# OPEN JOINT STOCK COMPANY MUGANBANK

## STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2005 (in Azerbaijan Manats and in thousands)

|  | Notes | 2005             | 2004               |
|--|-------|------------------|--------------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |       |                  |                    |
| Profit before income taxes   |       | 3,179,451        | 1,295,545          |
| Adjustments for:   |       |                  |                    |
| Provision for impairment losses on interest bearing assets<br>(Recovery of provision)/provision for impairment losses on<br>other transactions |       | 1,634,186        | 6,298,487          |
| Depreciation and amortization  |       | (295,680)        | 335,544            |
| Net change in accruals   |       | 813,247          | 292,831            |
| Net unrealized loss arising from changes in foreign currency<br>exchange rates   |       | 21,912           | (108,443)          |
| Gain on disposal of investments  |       | 1,664,494        | 733,284            |
| Net change in recovery value of derivative financial<br>instruments  |       | (8,057)          | -                  |
|  |       | <u>(77,558)</u>  | <u>-</u>           |
| Cash flow from operating activities before changes in operating<br>assets and liabilities  |       | 6,931,995        | 8,847,248          |
| Changes in operating assets and liabilities<br>(Increase)/decrease in operating assets:  |       |                  |                    |
| Minimum reserve deposit with the National Bank of<br>Azerbaijan  |       | (455,966)        | (419,121)          |
| Loans and advances to banks  |       | 3,328,442        | (10,524,379)       |
| Loans and advances to customers  |       | (15,420,333)     | (26,521,107)       |
| Other assets   |       | (176,088)        | (121,917)          |
| Increase/(decrease) in operating liabilities:  |       |                  |                    |
| Loans and advances from banks and other institutions   |       | (16,595,533)     | 21,049,651         |
| Customer accounts  |       | 31,382,178       | 5,841,575          |
| Other liabilities  |       | <u>351,504</u>   | <u>121,566</u>     |
| Cash inflow/(outflow) from operating activities before income<br>taxes   |       | 9,346,199        | (1,726,484)        |
| Income tax paid  |       | <u>(543,707)</u> | <u>(133,111)</u>   |
| Net cash inflow/(outflow) from operating activities  |       | <u>8,802,492</u> | <u>(1,859,595)</u> |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |       |                  |                    |
| Purchase of fixed and intangible assets  |       | (658,941)        | (8,236,763)        |
| Dividends received   |       | 646              | -                  |
| Net proceeds from sale of investments available-for-sale   |       | <u>1,793,086</u> | <u>(1,750,000)</u> |
| Net cash inflow/(outflow) from investing activities  |       | <u>1,134,791</u> | <u>(9,986,763)</u> |

# OPEN JOINT STOCK COMPANY MUGANBANK

## STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

|  | Notes | 2005                     | 2004                    |
|--|-------|--------------------------|-------------------------|
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>             |       |                          |                         |
| Issue of ordinary share capital                          |       | <u>5,062,000</u>         | <u>6,846,036</u>        |
| Net cash inflows from financing activities               |       | <u>5,062,000</u>         | <u>6,846,036</u>        |
| Effect of foreign exchange rate changes on cash and cash |       | <u>(127,707)</u>         | <u>(36, 535)</u>        |
| NET INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS     |       | 14,871,576               | (5,036,857)             |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF THE YEAR       | 11    | <u>2,595,321</u>         | <u>7,632,178</u>        |
| CASH AND CASH EQUIVALENTS AT END OF THE YEAR             | 11    | <u><u>17,466,897</u></u> | <u><u>2,595,321</u></u> |

Interest paid and received by the Bank in cash during the year ended 31 December 2005 amounted to AZM 2,703,552 thousand and AZM 9,317,078 thousand, respectively. Interest paid and received by the Bank in cash during the year ended 31 December 2004 amounted to AZM 2,068,685 thousand and AZM 8,508,806 thousand, respectively.

### On behalf of the Board

\_\_\_\_\_  
Chairman

\_\_\_\_\_  
Chief Accountant

The notes on pages 8 to 39 form an integral part of these financial statements. The Independent Auditors' Report is on page 2.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

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### 1. ORGANISATION

Open Joint Stock Company Muganbank (“the Bank”) was incorporated in Azerbaijan in 1992 as a closed joint stock company and in 2005 it became an open joint stock company. The Bank is regulated by the National Bank of the Republic of Azerbaijan (the “NBA”) and conducts its business under the general license for banking activities and foreign currency operations number 29 issued on 25 November 1992 and renewed by the letter number 02-10/508 on 10 November 2000. The Bank had 14 branches in Azerbaijan as at 31 December 2005 and 2004. The Bank’s primary business consists of making payments and money transfers, commercial activities, trading with foreign currencies and originating loans and deposits.

The address of its registered office is 4, 28 May Street, Baku, Azerbaijan.

As at 31 December 2005 and 2004 the following individuals and legal entities owned the share capital of the Bank:

| Owner                       | 2005<br>Ownership<br>interest, % | 2004<br>Ownership<br>interest, % |
|-----------------------------|----------------------------------|----------------------------------|
| Mehdiyev Elmir              | 81.09                            | 73.30                            |
| Mehdiyev Maqbet             | 7.71                             | 9.49                             |
| Veliyeva Vefa               | 7.59                             | 9.35                             |
| Mehdiyeva Farida            | 3.61                             | 4.44                             |
| Mugan Sigorta Insurance Co. | -                                | 3.42                             |
| Total                       | <u>100.00</u>                    | <u>100.00</u>                    |

These financial statements were authorized for issue by the Management Board on 25 April 2006.

### 2. BASIS OF PRESENTATION

#### Accounting basis

These financial statements of the Bank have been prepared in accordance with International Financial Reporting Standards (“IFRS”). These financial statements are presented in thousands of Azerbaijan Manats (“AZM”) unless otherwise indicated. These financial statements have been prepared under the historical cost convention.

The Bank maintains its accounting records in accordance with Azerbaijan law, which in majority complies with IFRS. These financial statements have been prepared from the Azerbaijan statutory accounting records and have been adjusted to conform with IFRS. The preparation of financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates that are particularly susceptible to change relate to the allowances for impairment losses and the fair value of financial instruments.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

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### **Functional currency**

The functional currency of these financial statements is the Azerbaijan Manat (“AZM”).

### **3. SIGNIFICANT ACCOUNTING POLICIES**

#### **Investments in Associates**

An associate is an entity over which the Company is in a position to exercise significant influence, but not control or joint control, through participation in the financial and operating policy decisions of the investee.

The results and assets and liabilities of associates were stated in the financial statements for the year ended 31 December 2004 at cost less impairment in its value as the Bank does not execute control or significant influence over the associate.

#### **Recognition and measurement of financial instruments**

The Bank recognizes financial assets and liabilities on its balance sheet when it becomes a party to the contractual obligation of the instrument. Regular way purchases and sales of the financial assets and liabilities are recognized using settlement date accounting. Regular way purchases of financial instruments that will be subsequently measured at fair value between the trade date and the settlement date are accounted for in the same way as for acquired instruments.

Financial assets and liabilities are initially recognized at fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. The accounting policies for subsequent re-measurement of these items are disclosed in the respective accounting policies set out below.

#### **Cash and cash equivalents**

Cash and cash equivalents include cash on hand, unrestricted balances on correspondent and time deposit accounts with the National Bank of Azerbaijan with an original maturity within 90 days, advances to banks in countries included in the Organization for Economic Co-operation and Development (“OECD”), except for margin deposits for operations with plastic cards, which may be converted to cash within a short period of time and Government trading debt securities denominated in AZM. For the purposes of determining cash flows, the minimum reserve deposit required by the National Bank of Azerbaijan is not included as a cash equivalent due to restrictions on its availability (note 11).

#### **Loans and advances to bank**

In the normal course of business, the Bank maintains advances or deposits for various periods of time with other banks. Loans and advances to banks with a fixed maturity term are subsequently measured at amortized cost using the effective interest method. Those that do not have fixed maturities are accounted for under the effective interest method based on expected maturity. Amounts due from credit institutions are carried net of any allowance for impairment losses.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

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### **Repurchase and reverse repurchase agreements**

The Bank enters into sale and purchase back agreements (“repos”) and purchase and sale back agreements (“reverse repos”) in the normal course of its business. Repos and reverse repos are utilized by the Bank as an element of its treasury management and trading business.

A repo is an agreement to transfer a financial asset to another party in exchange for cash or other consideration and a concurrent obligation to reacquire the financial assets at a future date for an amount equal to the cash or other consideration exchanged plus interest. These agreements are accounted for as financing transactions. Financial assets sold under repo are retained in the financial statements and consideration received under these agreements is recorded as collateralized deposit received.

Assets purchased under reverse repos are recorded in the financial statements as cash placed on deposit which is collateralized by securities and other assets.

In the event that assets purchased under reverse repo are sold to third parties, the results are recorded with the gain or loss included in net gains/ (losses) on respective assets. Any related income or expense arising from the pricing difference between purchase and sale of the underlying assets is recognized as interest income or expense.

### **Originated loans**

Loans originated by the Bank are financial assets that are created by the Bank by providing money directly to a borrower or by participating in a loan facility.

All loans originated are initially recognized at fair value plus related transaction costs. Where the fair value of consideration given does not equal the fair value of the loan, for example where the loan is issued at lower than market rates, the difference between the fair value of consideration given and the fair value of the loan is recognized as a loss on initial recognition of the loan and included in the income statement as losses on origination of assets. Subsequently, the loan carrying value is measured using the effective interest method. Loans to customers that do not have fixed maturities are accounted for under the effective interest method based on expected maturity. Loans and advances to customers are carried net of any allowance for impairment losses.

### **Embedded derivative financial instruments**

Loans to customers originated by the Bank in AZM are linked to the foreign currency with one-way currency clause. Due to this clause, the Bank has an option to revalue the asset at foreign exchange rate favourable for the Bank, comparing to the foreign exchange rate valid as of the balance sheet date.

Derivative financial instruments are initially recorded and subsequently measured at fair value which approximates the fair value of the consideration given, with their subsequent re-measurement to fair value. Due to the special circumstances of the market in Azerbaijan, the fair value of this option can not be calculated since the forward rates for AZM are not available. Result of translation of these loans at the favourable rate are reported in assets (aggregate of positive market values). Positive valuation results are recognized in the profit and loss for the year in which they arise under net gain on foreign exchange operations

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) *(in Azerbaijan Manats and in thousands)*

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### **Write off of loans and advances**

Loans and advances are written off against the allowance for impairment losses in the case of the uncollectibility of loans and advances, including the repossession of collateral. Loans and advances are written off after management has exercised all possibilities available to collect the amounts due to the Bank and after the Bank has sold all available collateral. In accordance with the statutory legislation, loans may only be written off with the approval of the Shareholders' Council and, in certain cases, with the respective decision of the Court.

### **Non-accrual loans**

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is thereafter recognized using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

### **Allowance for impairment losses**

The Bank establishes an allowance for impairment losses of financial assets when there is objective evidence that a financial asset or group of financial assets is impaired. The allowance for impairment losses is measured as the difference between the carrying amount and the present value of expected future cash flows, including amounts recoverable from guarantees and collateral, discounted at the financial asset's original effective interest rate, for financial assets which are carried at amortized cost. If in a subsequent period the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized, the previously recognized impairment loss is reversed by adjusting an allowance account. For financial assets carried at cost the allowance for impairment losses is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. Such impairment losses are not reversed.

The determination of the allowance for impairment losses is based on an analysis of the risk assets and reflects the amount which, in the judgment of management, is adequate to provide for losses incurred. Allowances are made as a result of an individual appraisal of risk assets for financial assets that are individually significant, and an individual or collective assessment for financial assets that are not individually significant.

The change in the allowance for impairment losses is charged to the income statement and the total of the allowance for impairment losses is deducted in arriving at assets as shown in the balance sheet. Factors that the Bank considers in determining whether it has objective evidence that an impairment loss has been incurred include information about the debtors' or issuers' liquidity, solvency and business and financial risk exposures, levels of and trends in delinquencies for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees. These and other factors may, either individually or taken together, provide sufficient objective evidence that an impairment loss has been incurred in a financial asset or group of financial assets.

It should be understood that estimates of losses involve an exercise of judgment. While it is possible that in particular periods the Bank may sustain losses, which are substantial relative to the allowance for impairment losses, it is the judgment of management that the allowance for impairment losses is adequate to absorb losses incurred on the risk assets.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

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### Investments available for sale

Investments available-for-sale represent debt investments that are intended to be held for an indefinite period of time. The securities are measured at fair value. Gains or losses on available-for-sale securities are recognized directly in equity under “fair value reserve on investments available for sale”, through the statement of changes in equity, except for impairment losses and foreign exchange gains and losses, until the securities are derecognized, at which time the cumulative gains or losses previously recognized in equity are recognized in the income statement. However, interest calculated using the effective interest method is recognized in the income statement.

The Bank uses quoted market prices to determine the fair value for the Bank’s investments available-for-sale. If such quotes do not exist, management use appropriate valuation techniques.

When a decline in the fair value of available-for-sale investments has been recognized directly in equity and there is objective evidence that the investments are impaired, the cumulative loss that had been recognized directly in equity is removed from equity and recognized in the income statement even though the securities have not been derecognized. If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in the income statement, the impairment loss is reversed, with the amount of the reversal recognized in the income statement.

Dividends received are included in other income in the profit and loss account.

When there is objective evidence that such securities have been impaired, the cumulative loss previously recognized in equity is removed from equity and recognized in profit and loss for the period. Reversals of such impairment losses on debt instruments, which are objectively related to events occurring after the impairment, are recognized in profit and loss for the period. Reversals of such impairment losses on equity instruments are not recognized in profit and loss.

### Fixed and intangible assets

Fixed and intangible assets are carried at historical cost less accumulated depreciation and amortization and any recognized impairment loss. Depreciation on assets under construction and those not placed in service commences from the date the assets are ready for their intended use.

Depreciation of fixed assets and amortization of intangible assets is charged on their historical cost and is designed to write off assets over their useful lives. It is calculated on a straight line basis at the following annual rates:

|                        | <b>31 December<br/>2005</b> |
|------------------------|-----------------------------|
| Buildings              | 5%                          |
| Furniture and fixtures | 20%                         |
| Computer equipment     | 25%                         |
| Vehicles               | 20%                         |
| Other fixed assets     | 20%                         |
| Intangible assets      | 10%                         |

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) *(in Azerbaijan Manats and in thousands)*

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The carrying amounts of fixed and intangible assets are reviewed at each balance sheet date to assess whether they are recorded in excess of their recoverable amounts, and where the carrying values exceed the estimated recoverable amounts, the assets are written down to their recoverable amounts. An impairment is recognized in the respective period and is included in operating expenses. After the recognition of an impairment loss the depreciation charge for fixed assets is adjusted in future periods to allocate the assets' revised carrying value, less its residual value (if any), on a systematic basis over its remaining useful life.

### **Taxation**

Income tax expense represents the sum of the current and deferred tax expense.

The current tax expense is based on taxable profit for the year. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Bank's current tax expense is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognized for all taxable temporary differences and deferred tax assets are recognized to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilized. Such assets and liabilities are not recognized if the temporary difference arises from goodwill or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the tax profit nor the accounting profit.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax is calculated at the tax rates that are expected to apply in the period when the liability is settled or the asset is realised. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity.

Azerbaijan also has various other taxes, which are assessed on the Bank's activities. These taxes are included as a component of operating expenses in the income statement.

### **Deposits from banks and customers**

Customer and bank deposits are initially recognized at fair value, which amounts to the issue proceeds less transaction costs incurred. Subsequently amounts due are stated at amortized cost and any difference between net proceeds and the redemption value is recognized in the income statement over the period of the borrowings using the effective interest method.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) *(in Azerbaijan Manats and in thousands)*

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### **Provisions**

Provisions are recognized 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 obligation can be made.

### **Share capital**

Share capital is recognized at cost. Share capital contributions made in the form of assets other than cash are stated at their fair value at the date of contribution.

External costs directly attributable to the issue of new shares, other than on a business combination, are deducted from equity net of any related income taxes.

Dividends on ordinary shares are recognized in equity as a reduction in the period in which they are declared. Dividends that are declared after the balance sheet date are treated as a subsequent event under International Accounting Standard 10 "Events after the Balance Sheet Date" (IAS 10) and disclosed accordingly.

### **Retirement and other benefit obligations**

In accordance with the requirements of the Azeri legislation, the Bank withholds amounts of pension contributions from employee salaries and pays them to the state pension fund. In addition such pension system provides for the calculation of current payments by the employer as a percentage of current total disbursements to staff. Such expense is charged in the period the related salaries are earned. Upon retirement all retirement benefit payments are made by the state pension fund. The Bank does not have any pension arrangements separate from the state pension system of Azerbaijan, which requires current contributions by employer calculated as a percentage of current gross salary payments. In addition, the Bank has no post-retirement benefits or other significant compensated benefits requiring accrual.

### **Contingencies**

Contingent liabilities are not recognized in the financial statements, but disclosed unless the possibility of an outflow of resources embodying economic benefits is remote. Contingent assets are not recognized in the financial statements but disclosed when an inflow of economic benefits is probable.

### **Recognition of income and expense**

Interest income and expense are recognized on an accrual basis using the effective interest rate method. Interest income also includes income earned on investments. Other income is credited to the income statement when the related transactions are completed. Loan origination fees, if significant, are deferred (together with related direct costs) and recognized as an adjustment to the loan's effective yield. All other commissions are recognized when services are provided.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

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### Fee and commission income

Fee and commission income includes loan origination fees, loan commitment fees, loan servicing fees and other fees. Loan origination fees are deferred, together with the related direct costs, and recognized as an adjustment to the effective interest rate of the loan. Where it is probable that a loan commitment will lead to a specific lending arrangement, the loan commitment fees are deferred, together with the related direct costs, and recognized as an adjustment to the effective interest rate of the resulting loan. Where it is unlikely that a loan commitment will lead to a specific lending arrangement, the loan commitment fees are recognized in profit and loss over the remaining period of the loan commitment. Where a loan commitment expires without resulting in a loan, the loan commitment fee is recognized in profit and loss on expiry. Loan servicing fees are recognized as revenue as the services are provided. All other commissions are recognized when services are provided.

### Foreign currency translation

Monetary assets and liabilities denominated in foreign currencies are translated into Azerbaijan Manats at the appropriate spot rates of exchange ruling at the balance sheet date. Foreign currency transactions are accounted for at the exchange rates prevailing at the date of the transaction. Profits and losses arising from these translations are included in net gain/(loss) on foreign exchange operations.

### Rates of exchange

The exchange rates at the year end used by the Bank in the preparation of the financial statements are as follows:

|         | 31 December<br>2005 | 31 December<br>2004 |
|---------|---------------------|---------------------|
| AZM/USD | 4,593               | 4,903               |
| AZM/EUR | 5,459               | 6,682               |
| AZM/RUR | 160                 | 177                 |

### Offset of financial assets and liabilities

Financial assets and liabilities are offset and reported net on the balance sheet when the Bank has a legally enforceable right to set off the recognized amounts and the Bank intends either to settle on a net basis or to realize the asset and settle the liability simultaneously. In accounting for a transfer of a financial asset that does not qualify for derecognition, the Bank does not offset the transferred asset and the associated liability.

**Reclassifications** – Certain reclassifications have been made to the financial statements as at 31 December 2004 and for the year then ended to conform to the presentation as at 31 December 2005 and for the year then ended.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

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### Changes in IFRS

The International Accounting Standards Board has amended a number of IAS's and issued certain IFRS's effective for the reporting period beginning 1 January 2005. The effect of these changes was not significant for the financial statements of the Bank for the year ended 31 December 2005.

IAS 39 "Financial Instruments: Recognition and Measurement" was amended during 2005 effective for the reporting period beginning 1 January 2006, and IFRS 7 "Financial Instruments: Disclosures" was introduced in August 2005 and is effective for the reporting period beginning 1 January 2007. The Management of the Bank has not yet assessed the impact of such changes on the financial statements of the Bank

### 4. NET INTEREST INCOME

Net interest income comprises:

|   | 2005             | 2004             |
|---|------------------|------------------|
| <b>Interest income</b>  |                  |                  |
| Interest on loans and advances to customers   | 9,176,779        | 8,385,626        |
| Interest on guarantees  | 270,223          | 67,841           |
| Interest on debt securities   | 94,919           | -                |
| Interest on loans and advances to banks   | 84,435           | 156,343          |
| Interest on REPO transactions   | 47,284           | -                |
|   | <hr/>            | <hr/>            |
| Total interest income   | 9,673,640        | 8,609,810        |
|   | <hr/>            | <hr/>            |
| <b>Interest expense</b>   |                  |                  |
| Interest on customer accounts   | 1,844,259        | 1,031,531        |
| Interest on loans and advances from banks and other institutions                      | 1,237,767        | 1,029,715        |
|   | <hr/>            | <hr/>            |
| Total interest expense  | 3,082,026        | 2,061,246        |
|   | <hr/>            | <hr/>            |
| Net interest income before provision for impairment losses on interest bearing assets | <u>6,591,614</u> | <u>6,548,564</u> |

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

### 5. ALLOWANCE FOR IMPAIRMENT LOSSES

The movements in allowances for impairment losses on interest bearing assets were as follows:

|   | Loans and<br>advances to<br>customers | Loans and<br>advances to<br>banks | Total                   |
|---|---------------------------------------|-----------------------------------|-------------------------|
| <b>31 December 2003</b>                     | 4,922,075                             | 54,615                            | 4,976,690               |
| Provision                                   | 6,093,760                             | 204,727                           | 6,298,487               |
| Write-off of assets                         | (8,721,445)                           | -                                 | (8,721,445)             |
| Recoveries of assets previously written off | 710,470                               | -                                 | 710,470                 |
| <b>31 December 2004</b>                     | 3,004,860                             | 259,342                           | 3,264,202               |
| Provision/(Recovery)                        | 1,893,528                             | (259,342)                         | 1,634,186               |
| Write-off of assets                         | (2,896,690)                           | -                                 | (2,896,690)             |
| Recoveries of assets previously written off | 2,020                                 | -                                 | 2,020                   |
| <b>31 December 2005</b>                     | <b><u>2,003,718</u></b>               | <b><u>-</u></b>                   | <b><u>2,003,718</u></b> |

Allowances for impairment losses on investments available for sale were as follows:

|                         | Investments<br>available-<br>for-sale |
|-------------------------|---------------------------------------|
| <b>31 December 2003</b> | -                                     |
| Provision               | 35,846                                |
| <b>31 December 2004</b> | 35,846                                |
| Provision/(Recovery)    | (29,242)                              |
| Write-offs of assets    | (6,604)                               |
| <b>31 December 2005</b> | <b><u>-</u></b>                       |

The movements in allowances for losses on other transactions were as follows:

|                         | Guarantees<br>and other<br>commitments |
|-------------------------|--|
| <b>31 December 2003</b> | -                                      |
| Provision               | 299,698                                |
| <b>31 December 2004</b> | 299,698                                |
| Recovery                | (266,438)                              |
| <b>31 December 2005</b> | <b><u>33,260</u></b>                   |

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

### 6. NET LOSS ON FOREIGN EXCHANGE OPERATIONS

Net loss on foreign exchange operations comprise:

|   | 2005                    | 2004                    |
|---|-------------------------|-------------------------|
| Dealing, net                                  | 604,134                 | 598,844                 |
| Translation differences, net                  | <u>(1,586,936)</u>      | <u>(733,284)</u>        |
| Total net loss on foreign exchange operations | <u><b>(982,802)</b></u> | <u><b>(134,440)</b></u> |

### 7. FEE AND COMMISSION INCOME AND EXPENSE

Fee and commission income and expense comprise:

|  | 2005                    | 2004                    |
|--|-------------------------|-------------------------|
| <b>Fee and commission income:</b>          |                         |                         |
| Cash operations                            | 1,896,320               | 2,564,920               |
| Settlements                                | 1,231,094               | 2,028,290               |
| Foreign exchange and securities operations | 820,711                 | 741,025                 |
| Plastic cards operations                   | 46,054                  | 75,168                  |
| Documentary operations                     | 29,972                  | 39,183                  |
| Other operations                           | <u>482,036</u>          | <u>120,616</u>          |
| Total fee and commission income            | <u><b>4,506,187</b></u> | <u><b>5,569,202</b></u> |
| <b>Fee and commission expense:</b>         |                         |                         |
| Cash operations                            | 183,125                 | 130,657                 |
| Correspondent bank services                | 141,561                 | 219,337                 |
| Plastic cards operations                   | 136,878                 | 32,338                  |
| Documentary operations                     | 29,197                  | 2,846                   |
| Foreign exchange and securities operations | 14,394                  | 487                     |
| Other operations                           | <u>1,237</u>            | <u>9,895</u>            |
| Total fees and commission expense          | <u><b>506,392</b></u>   | <u><b>395,560</b></u>   |

### 8. NET GAIN ON INVESTMENTS AVAILABLE FOR SALE

Net gain on investments available for sale comprises:

|  | 2005                | 2004            |
|--|---------------------|-----------------|
| Gain on sale of investments                      | 9,800               | -               |
| Loss on sale of investments                      | <u>(1,743)</u>      | <u>-</u>        |
| Total net gain on investments available for sale | <u><b>8,057</b></u> | <u><b>-</b></u> |

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

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### 9. OPERATING EXPENSES

Operating expenses comprise:

|                               | 2005             | 2004             |
|-------------------------------|------------------|------------------|
| Staff costs                   | 1,755,640        | 1,701,930        |
| Depreciation and amortization | 813,247          | 292,831          |
| Communications                | 428,452          | 343,993          |
| Professional services         | 399,341          | 177,312          |
| Advertising costs             | 356,144          | 96,190           |
| Rent                          | 298,288          | 258,759          |
| Security                      | 211,889          | 172,454          |
| Stationery                    | 187,300          | 152,156          |
| Taxes, other than income tax  | 154,081          | 101,991          |
| Insurance                     | 119,294          | 69,103           |
| Occupancy costs               | 61,083           | 42,701           |
| Fixed assets maintenance      | 40,837           | 32,379           |
| Business trip expenses        | 29,238           | 21,251           |
| Membership fee                | 10,000           | 15,000           |
| Other                         | 234,519          | 180,154          |
|                               | <hr/>            | <hr/>            |
| Total operating expenses      | <b>5,099,353</b> | <b>3,658,204</b> |

### 10. INCOME TAXES

The Bank provides for taxes based on the statutory tax accounts maintained and prepared in accordance with the Azerbaijan statutory tax regulations which may differ from International Financial Reporting Standards. The Bank is subject to certain permanent tax differences due to non-tax deductibility of certain expenses

Deferred taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes. Temporary differences as at 31 December 2005 and 2004 relate mostly to different methods of income and expense recognition as well as to recorded values of certain assets.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

Temporary differences as at 31 December 2005 and 2004 comprise:

|   | 2005             | 2004            |
|---|------------------|-----------------|
| <b>Deferred assets:</b>   |                  |                 |
| Other assets  | 162,557          | -               |
| Total deferred assets   | <u>162,557</u>   | <u>-</u>        |
| <b>Deferred liabilities:</b>                                    |                  |                 |
| Loans and advances to banks                                     | (77,558)         | -               |
| Loans and advances to customers                                 | (194,399)        | -               |
| Allowance for off-balance sheet items                           | (197,005)        | -               |
| Fixed assets  | (450,970)        | (96,242)        |
| Total deferred liabilities                                      | <u>(919,932)</u> | <u>(96,242)</u> |
| Net deferred liabilities  | <u>(757,375)</u> | <u>(96,242)</u> |
| Deferred income tax liability at statutory rate 22% (2004: 24%) | <u>(166,623)</u> | <u>(23,098)</u> |

Relationships between tax expenses and accounting profit for the year ended 31 December 2005 and 2004 are explained as follows:

|   | 2005             | 2004             |
|---|------------------|------------------|
| Profit before income taxes                              | <u>3,179,451</u> | <u>1,295,545</u> |
| Statutory tax rate                                      | 24%              | 24%              |
| Theoretical tax at the statutory tax rate               | 763,068          | 310,931          |
| Tax effect of permanent differences                     | 42,888           | 30,306           |
| Effect of changes in income tax rate                    | (15,148)         | -                |
| Income tax expense                                      | <u>790,808</u>   | <u>341,237</u>   |
| Current income tax expense                              | 647,283          | 354,841          |
| Deferred income tax expense/(benefit)                   | 143,525          | (13,604)         |
| Income tax expense                                      | <u>790,808</u>   | <u>341,237</u>   |
| <b>Deferred income tax liabilities</b>                  | <b>2005</b>      | <b>2004</b>      |
| 1 January   | 23,098           | 36,702           |
| Increase /(decrease) in deferred income tax liabilities | 143,525          | (13,604)         |
| 31 December   | <u>166,623</u>   | <u>23,098</u>    |

Income tax liabilities consist of the following:

|                                 |                |                |
|---------------------------------|----------------|----------------|
| Current income tax liabilities  | 327,284        | 223,708        |
| Deferred income tax liabilities | 166,623        | 23,098         |
| Income tax liabilities          | <u>493,907</u> | <u>246,806</u> |

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

### 11. CASH AND BALANCES WITH THE NATIONAL BANK OF AZERBAIJAN

Cash and balances with the National Bank of Azerbaijan (“the NBA”) comprise:

|  | <b>2005</b>             | <b>2004</b>             |
|--|-------------------------|-------------------------|
| Cash on hand   | 3,753,145               | 1,366,285               |
| Balances with the National Bank of Azerbaijan                | <u>4,017,234</u>        | <u>1,433,111</u>        |
| Total cash and balances with the National Bank of Azerbaijan | <u><b>7,770,379</b></u> | <u><b>2,799,396</b></u> |

The balances with the NBA as at 31 December 2005 and 2004 include AZM 1,330,510 thousand and AZM 913,953 thousand, respectively, which represent the minimum reserve deposits required by the NBA. The Bank is required to maintain the reserve balance at the NBA at all times.

Cash and cash equivalents for the purposes of the statement of cash flows comprise:

|   | <b>2005</b>              | <b>2004</b>             |
|---|--------------------------|-------------------------|
| Cash and balances with the National Bank of Azerbaijan            | 7,770,379                | 2,799,396               |
| Loans and advances to banks in OECD countries                     | <u>11,027,028</u>        | <u>709,878</u>          |
|   | 18,797,407               | 3,509,274               |
| Less minimum reserve deposit with the National Bank of Azerbaijan | <u>(1,330,510)</u>       | <u>(913,953)</u>        |
| Total cash and cash equivalents                                   | <u><b>17,466,897</b></u> | <u><b>2,595,321</b></u> |

### 12. LOANS AND ADVANCES TO BANKS

Advances to banks comprise:

|  | <b>2005</b>              | <b>2004</b>              |
|--|--------------------------|--------------------------|
| Advances to banks                      | 20,746,994               | 13,857,329               |
| Loans to banks                         | <u>13,779</u>            | <u>14,769</u>            |
|  | 20,760,773               | 13,872,098               |
| Less allowance for impairment losses   | <u>-</u>                 | <u>(259,342)</u>         |
| Total loans and advances to banks, net | <u><b>20,760,773</b></u> | <u><b>13,612,756</b></u> |

Movements in allowances for impairment losses for the years ended 31 December 2005 and 2004 are disclosed in note 5.

As at 31 December 2005 and 2004 the Bank had advances to 2 banks totaling AZM 17,226,635 thousand and AZM 12,948,823 thousand, respectively, which individually exceeded 10% of the Bank’s equity which represents significant concentration of 83% and 95%, respectively.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

### 13. LOANS AND ADVANCES TO CUSTOMERS

Loans and advances to customers comprise:

|  | 2005                     | 2004                     |
|--|--------------------------|--------------------------|
| Originated loans   | 69,923,511               | 60,162,582               |
| Accrued interest income on loans and advances to customers | <u>1,377,318</u>         | <u>1,020,756</u>         |
|  | 71,300,829               | 61,183,338               |
| Less allowance for impairment losses                       | <u>(2,003,718)</u>       | <u>(3,004,860)</u>       |
|  | <b><u>69,297,111</u></b> | <b><u>58,178,478</u></b> |
| Loans collateralized by real estate                        | 45,616,095               | 19,607,809               |
| Loans collateralized by vehicles                           | 10,226,647               | 184,721                  |
| Loans collateralized by guarantees                         | 4,689,966                | 5,114,629                |
| Loans collateralized by deposits                           | 2,482,765                | 3,171,998                |
| Loans collateralized by inventories                        | 2,156,557                | 20,706,128               |
| Loans collateralized by securities                         | 1,572,332                | 780,035                  |
| Loans collateralized by others                             | 157,799                  | 73,545                   |
| Unsecured loans  | 3,021,350                | 10,523,717               |
| Accrued interest income on loans and advances to customers | <u>1,377,318</u>         | <u>1,020,756</u>         |
|  | 71,300,829               | 61,183,338               |
| Less allowance for impairment losses                       | <u>(2,003,718)</u>       | <u>(3,004,860)</u>       |
|  | <b><u>69,297,111</u></b> | <b><u>58,178,478</u></b> |

Movements in allowances for loan losses for the years ended 31 December 2005 and 2004 are disclosed in note 5.

As at 31 December 2005 and 2004 the Bank had loans to “Jalya Business” MMC of AZM 6,575,179 thousand and AZM 4,905,715 thousand in total, which individually exceeded 10% of the Bank’s equity.

|  | 2005                     | 2004                     |
|--|--------------------------|--------------------------|
| <b>Analysis by industry</b>                                |                          |                          |
| Individuals  | 38,415,111               | 30,145,933               |
| Trading  | 18,960,140               | 10,200,664               |
| Agriculture  | 5,680,070                | 3,256,392                |
| Manufacturing  | 4,710,870                | 9,317,746                |
| Construction   | 1,907,320                | 6,364,480                |
| Other  | 250,000                  | 877,367                  |
| Accrued interest income on loans and advances to customers | <u>1,377,318</u>         | <u>1,020,756</u>         |
|  | 71,300,829               | 61,183,338               |
| Less allowance for loan losses                             | <u>(2,003,718)</u>       | <u>(3,004,860)</u>       |
|  | <b><u>69,297,111</u></b> | <b><u>58,178,478</u></b> |

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

### 14. INVESTMENTS IN UNCONSOLIDATED ASSOCIATE

|                                 | Held<br>% | 2005     | Held<br>% | 2004             |
|---------------------------------|-----------|----------|-----------|------------------|
| Mugan Sigorta Insurance Co.     | 0.00%     | -        | 26.67%    | 1,750,000        |
| Allowance for impairment losses |           | -        | -         | (35,000)         |
|                                 |           | <u>-</u> |           | <u>1,715,000</u> |

The investment in Mugan Sigorta Insurance Co. was sold by the Bank on 29 December 2005 through Baku Stock Exchange.

### 15. FIXED AND INTANGIBLE ASSETS

|                                 | Buildings        | Furniture<br>and<br>fixtures | Computer<br>equipment | Vehicles      | Other<br>fixed<br>assets | Intangible<br>assets | Total            |
|---------------------------------|------------------|------------------------------|-----------------------|---------------|--------------------------|----------------------|------------------|
| <b>At cost</b>                  |                  |                              |                       |               |                          |                      |                  |
| 31 December 2004                | 8,040,000        | 963,079                      | 473,867               | 54,780        | 10,751                   | 310,379              | 9,852,856        |
| Additions                       | -                | 320,767                      | 127,217               | -             | 23,288                   | 187,669              | 658,941          |
| 31 December 2005                | <u>8,040,000</u> | <u>1,283,846</u>             | <u>601,084</u>        | <u>54,780</u> | <u>34,039</u>            | <u>498,048</u>       | <u>10,511,79</u> |
| <b>Accumulated depreciation</b> |                  |                              |                       |               |                          |                      |                  |
| 31 December 2004                | 352,628          | 128,708                      | 100,548               | 45,625        | 779                      | 18,043               | 646,331          |
| Charge for the year             | 402,000          | 231,477                      | 123,993               | 9,155         | 3,443                    | 43,179               | 813,247          |
| 31 December 2005                | <u>754,628</u>   | <u>360,185</u>               | <u>224,541</u>        | <u>54,780</u> | <u>4,222</u>             | <u>61,222</u>        | <u>1,459,578</u> |
| <b>Net book value</b>           |                  |                              |                       |               |                          |                      |                  |
| 31 December 2005                | <u>7,285,372</u> | <u>923,661</u>               | <u>376,543</u>        | <u>-</u>      | <u>29,817</u>            | <u>436,826</u>       | <u>9,052,219</u> |
| <b>Net book value</b>           |                  |                              |                       |               |                          |                      |                  |
| 31 December 2004                | <u>7,687,372</u> | <u>834,371</u>               | <u>373,319</u>        | <u>9,155</u>  | <u>9,972</u>             | <u>292,336</u>       | <u>9,206,525</u> |

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

### 16. OTHER ASSETS

Other assets comprise:

|                                | 2005           | 2004           |
|--------------------------------|----------------|----------------|
| Prepayments                    | 41,131         | 34,228         |
| Plastic cards settlements      | 701            | -              |
| Receivables from Western Union | 110,457        | 97,556         |
| Receivables from Migom         | 22,735         | -              |
| Total other assets             | <b>175,024</b> | <b>131,784</b> |

### 17. LOANS AND ADVANCES FROM BANKS AND OTHER INSTITUTIONS

Loans and advances from banks and other institutions comprise:

|  | 2005              | 2004              |
|--|-------------------|-------------------|
| Amount due to the National Fund for Support of Entrepreneurs | 10,957,200        | 9,058,033         |
| Demand deposits  | 9,250,336         | 13,511,670        |
| Time deposits and loans                                      | 5,000,000         | 19,709,000        |
| Accrued interest   | 1,656             | -                 |
| Total deposits from banks and other institutions             | <b>25,209,192</b> | <b>42,278,703</b> |

The Bank receives loans from the National Fund for Support of Entrepreneurs (“NFSE”) as a means of support of small and medium-sized entrepreneurs in Azerbaijan. Under the agreement with the Fund as at 31 December 2005 and 2004 the Bank obtained loans for AZM 10,957,200 thousand and AZM 9,058,033 thousand, respectively with maturity periods from 1 to 5 years and bearing annual interest rates ranging from 0.5% to 4%. Subsequently, these funds were used by the Bank to issue loans with the same maturity periods to the individual entrepreneurs in Azerbaijan at annual interest rates from 5% to 7%.

Beside loans from NFSE mentioned above, as at 31 December 2005 and 2004 the Bank had loans and advances from 2 and 3 banks of AZM 14,242,264 thousand and AZM 29,586,094 thousand in total, each of which individually exceeded 10% of the Bank’s equity.

### 18. CUSTOMER ACCOUNTS

Customer accounts comprise:

|   | 2005              | 2004              |
|---|-------------------|-------------------|
| Time deposits                                 | 42,717,601        | 12,922,731        |
| Repayable on demand                           | 6,734,430         | 6,173,466         |
| Accrued interest expense on customer accounts | 535,444           | 158,626           |
| Total customer accounts                       | <b>49,987,475</b> | <b>19,254,823</b> |

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

As at 31 December 2005 the Bank had deposit from the shareholder Mehdiyev Elmir of AZM 7,886,043 thousand in total, which individually exceeded 10% of the Bank's equity.

Analysis of customer accounts by industry:

|   | 2005              | 2004              |
|---|-------------------|-------------------|
| Individuals                                   | 42,417,683        | 12,317,690        |
| Trade   | 3,926,811         | 3,816,725         |
| Insurance                                     | 1,252,523         | 1,910,922         |
| Agriculture                                   | 911,198           | 537,055           |
| Manufacturing                                 | 575,201           | 132,619           |
| Construction                                  | 107,404           | 188,594           |
| Transport and communications                  | 68,025            | 3,011             |
| Energy and chemical                           | 852               | 4,363             |
| Other   | 192,334           | 185,218           |
| Accrued interest expense on customer accounts | 535,444           | 158,626           |
| Total customer accounts                       | <u>49,987,475</u> | <u>19,254,823</u> |

### 19. OTHER LIABILITIES

Other liabilities comprise:

|                                     | 2005           | 2004          |
|-------------------------------------|----------------|---------------|
| Settlements payable                 | 143,299        | -             |
| Accrued expenses                    | 183,660        | 23,834        |
| Taxes other than income tax payable | 37,761         | 45,570        |
| Other creditors                     | 68,559         | 10,630        |
| Total other liabilities             | <u>433,279</u> | <u>80,034</u> |

### 20. SHARE CAPITAL

As at 31 December 2005 the Bank's share capital comprised the following:

|                 | Authorized<br>share capital | Total issued<br>and paid up<br>share capital |
|-----------------|-----------------------------|--|
| Ordinary shares | <u>27,000,000</u>           | <u>27,000,000</u>                            |

On 24 May 2005 the Bank's shares were listed on the Baku Stock Exchange and the Bank became an open joint stock company. As at 31 December 2005 the authorized, registered and paid up share capital consisted of 27,000 ordinary shares with par value of AZM 1,000,000 each and amounted to AZM 27,000,000 thousand. All shares are ranked equally and carry one vote.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

As at 31 December 2004 the Bank's owners' capital comprised the following:

|                 | Authorized<br>owners' capital | Total paid up<br>owners' capital |
|-----------------|-------------------------------|----------------------------------|
| Ordinary shares | <u>21,938,000</u>             | <u>21,938,000</u>                |

As at 31 December 2004 owners' capital amounted to AZM 21,938,000 thousand.

### 21. FINANCIAL COMMITMENTS AND CONTINGENCIES

**Credit commitments** - In the normal course of business the Bank is a party to financial instruments with off-balance sheet risk in order to meet the needs of its customers. These instruments, involving varying degrees of credit risk, are not reflected in the balance sheet.

The risk-weighted amount is obtained by applying credit conversion factors and counterparty risk weightings according to the principles employed by the Basel Committee on Banking Supervision.

As at 31 December 2005 and 2004, the nominal or contract amounts and the risk weighted credit equivalents of instruments with off-balance sheet risks were:

|  | 2005                     |                            | 2004                     |                            |
|--|--------------------------|----------------------------|--------------------------|----------------------------|
|  | Nominal<br>Amount        | Risk<br>Weighted<br>Amount | Nominal<br>Amount        | Risk<br>Weighted<br>Amount |
| <b>Contingent liabilities and credit commitments</b> |                          |                            |                          |                            |
| Guarantees issued and similar commitments            | 9,850,234                | 9,850,234                  | 8,082,296                | 8,082,296                  |
| Commitments on credits and unused credit lines       | <u>2,841,710</u>         | <u>-</u>                   | <u>6,164,902</u>         | <u>-</u>                   |
| Total contingent liabilities and credit commitments  | <u><u>12,691,944</u></u> | <u><u>9,850,234</u></u>    | <u><u>14,247,198</u></u> | <u><u>8,082,296</u></u>    |

The Bank has made a provision of AZM 33,260 thousand and AZM 299,698 thousand against unused credit lines and guarantees issued as at 31 December 2005 and 2004.

**Capital commitments** - The Bank had no material commitments for capital expenditures outstanding as at 31 December 2005.

**Rental commitments** - No material rental commitments were outstanding as at 31 December 2005 and 2004.

**Insurance** - As at 31 December 2005 and 2004 the Bank's fixed assets were insured for AZM 102,969 thousand and AZM 68,286 thousand, respectively.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

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**Legal proceedings** - From time to time and in the normal course of business, claims against the Bank are received from customers and counterparties. Management is of the opinion that no material unaccrued losses will be incurred and accordingly no provision has been made in these financial statements.

**Taxes** - Azerbaijan commercial legislation and tax legislation in particular may give rise to varying interpretations and amendments. In addition, as management's interpretation of tax legislation may differ from that of the tax authorities, transactions may be challenged by the tax authorities, and as a result the Bank may be assessed additional taxes, penalties and interest. The Bank believes that it has already made all tax payments, and therefore no allowance has been made in the financial statements. Tax years remain open to review by the tax authorities for three years.

**Pensions and retirement plans** - Employees receive pension benefits from the Republic of Azerbaijan in accordance with the laws and regulations of the country. As at 31 December 2005 and 2004, the Bank was not liable for any supplementary pensions, post-retirement health care, insurance benefits, or retirement indemnities to its current or former employees.

**Operating Environment** - The Bank's principal business activities are within the Republic of Azerbaijan. Laws and regulations affecting the business environment in the Republic of Azerbaijan are subject to rapid changes and the Bank's assets and operations could be at risk due to negative changes in the political and business environment.

## 22. TRANSACTIONS WITH RELATED PARTIES

Related parties, as defined by IAS 24, are those counter parties that represent:

- (a) enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with the Bank (this includes holding companies, subsidiaries and fellow subsidiaries);
- (b) associates – enterprises in which the Bank has significant influence and which is neither a subsidiary nor a joint venture of the investor;
- (c) individuals owning directly or indirectly, an interest in the voting power of the Bank that gives them significant influence over the Bank;
- (d) key management personnel, that is, those persons having authority and responsibility for planning, directing and controlling the activities of the Bank, including directors and officers of the Bank (also non-executive directors and close members of the families of such individuals);
- (e) enterprises in which a substantial interest in the voting power is owned, directly or indirectly, by any person described in (c) or (d) or over which such a person is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the Bank and enterprises that have a member of key management in common with the Bank.
- (f) parties with joint control over the Bank;
- (g) joint ventures in which the Bank is a venture; and
- (h) post-employment benefit plans for the benefit of employees of the Bank, or of any entity that is a related party to the Bank.

## OPEN JOINT STOCK COMPANY MUGANBANK

### NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

In considering each possible related party relationship, attention is directed to the substance of the relationship, and not merely the legal form. The Bank had the following transactions outstanding with related parties:

|   | 2005                       |  | 2004                       |  |
|---|----------------------------|--|----------------------------|--|
|   | Related party transactions | Total category as per financial statements caption | Related party transactions | Total category as per financial statements caption |
| Loans to customers, gross   |                            | 71,300,829   |                            | 61,183,338   |
| - <i>shareholders and entities in which a substantial interest is owned by the shareholders of the Bank</i> | 161,653                    |  | -                          |  |
| - <i>key management personnel</i>   | 96,610                     |  | 17,677                     |  |
| Allowance for loans to customers  |                            | 2,003,718  |                            | 3,004,860  |
| - <i>shareholders and entities in which a substantial interest is owned by the shareholders of the Bank</i> | 3,233                      |  | -                          |  |
| - <i>key management personnel</i>   | 1,932                      |  | 354                        |  |
| Loans to customers, net   | <b>253,098</b>             | <b>69,297,111</b>                                  | <b>17,323</b>              | <b>58,178,478</b>                                  |
| Customer accounts   |                            | 49,987,475   |                            | 19,254,823   |
| - <i>shareholders and entities in which a substantial interest is owned by the shareholders of the Bank</i> | 7,987,506                  |  | 910,926                    |  |
| - <i>key management personnel</i>   | 538,159                    |  | 347,741                    |  |

During the year ended 31 December 2005 and 2004 the Bank originated loans and advances to related party customers amounting to AZM 275,935 thousand and AZM 58,704 thousand, and received loans and advances repaid of AZM 40,167 thousand and AZM 21,472 thousand respectively. The Bank had interest income accrued in respect of loans and advances granted to related parties totaling AZM 4,844 thousand and AZM 26 thousand as at 31 December 2005 and 2004.

During the year ended 31 December 2005 and 2004 the Bank received deposits from related party customers of AZM 13,720,253 thousand and AZM 777,410 thousand and repaid deposits totaling AZM 6,547,184 thousand and AZM 98,442 thousand respectively. The Bank had interest expense accrued in respect of deposits received from related parties totaling AZM 96,263 thousand and AZM 2,336 thousand as at 31 December 2005 and 2004.

## OPEN JOINT STOCK COMPANY MUGANBANK

### NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

Included in the profit and loss account for the year ended 31 December 2005 and 2004 are the following amounts which arose due to transactions with related parties:

|   | 2005                              |   | 2004                              |   |
|---|-----------------------------------|---|-----------------------------------|---|
|   | Related party transactions        | Total category as per financial statements caption        | Related party transactions        | Total category as per financial statements caption        |
| Interest income   |                                   | 9,673,640   |                                   | 8,609,810   |
| - <i>shareholders and entities in which a substantial interest is owned by the shareholders of the Bank</i> | 4,730                             |   | -                                 |   |
| - <i>key management personnel</i>   | 7,250                             |   | 1,266                             |   |
| Interest expense  |                                   | 3,082,026   |                                   | 2,061,246   |
| - <i>shareholders and entities in which a substantial interest is owned by the shareholders of the Bank</i> | 208,561                           |   | 76,767                            |   |
| - <i>key management personnel</i>   | 29,169                            |   | 30,073                            |   |
| Allowance / (recovery of allowance) for impairment losses   |                                   | 1,634,186   |                                   | 6,298,487   |
| - <i>shareholders and entities in which a substantial interest is owned by shareholders of the Bank</i>     | 3,149                             |   | -                                 |   |
| - <i>key management personnel</i>   | 1,567                             |   | (346)                             |   |
| Operating expenses  |                                   | 5,099,353   |                                   | 3,658,204   |
| - <i>shareholders and entities in which a substantial interest is owned by the shareholders of the Bank</i> | 148,228                           |   | 468,286                           |   |
|   |                                   | <b>31 December 2005</b>                                   |                                   | <b>31 December 2004</b>                                   |
|   | <b>Related party transactions</b> | <b>Total category as per financial statements caption</b> | <b>Related party transactions</b> | <b>Total category as per financial statements caption</b> |
| <b>Key management personnel compensation:</b>   |                                   |   |                                   |   |
| short-term employee benefits  | <u>355,514</u>                    | <u>1,755,640</u>  | <u>158,427</u>                    | <u>1,701,930</u>  |

Transactions with related parties entered into by the Bank during the years ended 31 December 2005 and 2004 and outstanding as at 31 December 2005 and 2004 were made in the normal course of business and mostly under arms length conditions.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

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### 23. FAIR VALUE OF FINANCIAL INSTRUMENTS

Estimated fair value disclosures of financial instruments is made in accordance with the requirements of IAS 32 “Financial Instruments: Disclosure and Presentation” and IAS 39 “Financial Instruments: Recognition and Measurement”. Fair value is defined as the amount at which the instrument could be exchanged in a current transaction between knowledgeable willing parties in an arm’s length transaction, other than in a forced or liquidation sale. As no readily available market exists for a large part of the Bank’s financial instruments, judgment is necessary in arriving at fair value, based on current economic conditions and specific risks attributable to the instrument. The estimates presented herein are not necessarily indicative of the amounts the Bank could realize in a market exchange from the sale of its full holdings of a particular instrument.

The fair value of financial assets and liabilities compared with the corresponding carrying amount in the balance sheet of the Bank is presented below:

|  | 31 December 2005 |            | 31 December 2004 |            |
|--|------------------|------------|------------------|------------|
|  | Carrying value   | Fair value | Carrying value   | Fair value |
| Cash and balances with the National Bank of the Republic of Azerbaijan | 7,770,379        | 7,770,379  | 2,799,396        | 2,799,396  |
| Loans and advances to banks, net                                       | 20,760,773       | 20,760,773 | 13,612,756       | 13,612,756 |
| Loans to customers, net  | 69,297,111       | 69,297,111 | 58,178,478       | 58,178,478 |
| Investments available-for-sale   | -                | -          | 41,433           | 41,433     |
| Investment in unconsolidated associate                                 | -                | -          | 1,715,000        | 1,715,000  |
| Other assets, net  | 175,024          | 175,024    | 131,784          | 131,784    |
| Loans and advances from banks  | 25,209,192       | 25,209,192 | 42,278,703       | 42,278,703 |
| Customer accounts  | 49,987,475       | 49,987,475 | 19,254,823       | 19,254,823 |
| Other liabilities  | 433,279          | 433,279    | 80,034           | 80,034     |

### 24. SUBSEQUENT EVENTS

The Azerbaijan Manat was denominated on 1 January 2006 and, starting from that date, AZM 5 thousand is equal to 1 New Azerbaijan Manat (“AZN”).

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

### 25. REGULATORY MATTERS

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (as set forth in the table below) of total (8%) and tier 1 capital (4%) to risk weighted assets.

The ratio was calculated according to the principles employed by the Basel Committee by applying the following risk estimates to the assets and off-balance sheet commitments net of allowances for impairment losses:

| Estimate | Description of position   |
|----------|---|
| 0%       | Cash and balances with the National Bank of Azerbaijan  |
| 0%       | State debt securities in Azerbaijan Manats  |
| 20%      | Loans and advances to banks for up to 1 year  |
| 100%     | Loans and advances to customers   |
| 100%     | Other assets  |
| 0%       | Standby letters of credit secured by customer funds   |
|          | Other standby letters of credit and other transaction related contingent obligations and commitments on unused loans with the initial maturity of over 1 year |
| 50%      |   |
| 100%     | Guarantees issued and similar commitments   |

The Bank's actual capital amounts and ratios are presented in the following table:

| Capital amounts and ratios    | Actual Amount | For Capital Adequacy purposes Amount | Ratio For Capital Adequacy purposes | Minimum Required Ratio |
|-------------------------------|---------------|--------------------------------------|-------------------------------------|------------------------|
| <b>As at 31 December 2005</b> |               |                                      |                                     |                        |
| Total capital                 | 30,975,951    | 30,975,952                           | 34%                                 | 8%                     |
| Tier 1 capital                | 30,975,951    | 30,975,952                           | 34%                                 | 4%                     |
| <b>As at 31 December 2004</b> |               |                                      |                                     |                        |
| Total capital                 | 23,525,308    | 22,775,308                           | 32%                                 | 8%                     |
| Tier 1 capital                | 23,525,308    | 23,525,308                           | 33%                                 | 4%                     |

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

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### 26. RISK MANAGEMENT POLICIES

Management of risk is fundamental to the banking business and is an essential element of the Bank's operations. The main risks inherent to the Bank's operations are those related to credit exposures, liquidity and market movements in interest rates and foreign exchange rates. A description of the Bank's risk management policies in relation to those risks follows.

The Bank manages the following risks:

#### **Liquidity risk**

Liquidity risk refers to the availability of sufficient funds to meet deposit withdrawals and other financial commitments associated with financial instruments as they actually fall due.

In order to manage liquidity risk, the Bank performs daily monitoring of expected future cash flows on clients' and banking operations, which is a part of the assets/liabilities management process. The Assets and Liabilities Management Committee (the "ALMC") sets limits on the minimum proportion of maturing funds available to meet deposit withdrawals and on the minimum level of interbank and other borrowing facilities that should be in place to cover withdrawals at unexpected levels of demand.

#### **Cash flow interest rate risk**

Cash flow interest rate risk is the risk that the future cash flow of a financial instrument will fluctuate because of changes in market interest rates.

The ALMC also manages interest rate and market risks by matching the Bank's interest rate position, which provides the Bank with a positive interest margin. The Department of Financial Control conducts monitoring of the Bank's current financial performance, estimates the Bank's sensitivity to changes in interest rates and its influence on the Bank's profitability.

The majority of the Bank's loan contracts and other financial assets and liabilities that bear interest are either variable or contain clauses enabling the interest rate to be changed at the option of the lender. The Bank monitors its interest rate margin and consequently does not consider itself exposed to significant interest rate risk or consequential cash flow risk.

The following table presents an analysis of interest rate risk and thus the potential of the Bank for gain or loss. Effective interest rates are presented by categories of financial assets and liabilities to determine interest rate exposure and effectiveness of the interest rate policy used by the Bank.

|   | 2005  |        |                     | 2004  |        |                     |
|---|-------|--------|---------------------|-------|--------|---------------------|
|   | AZM   | USD    | Other<br>currencies | AZM   | USD    | Other<br>currencies |
| <b>ASSETS</b>   |       |        |                     |       |        |                     |
| Loans and advances to banks, net                        | -     | 5.00%  | -                   | -     | -      | -                   |
| Loans and advances to customers, net                    | 9.04% | 19.81% | 25.41%              | 8.82% | 20.84% | 24.00%              |
| <b>LIABILITIES</b>                                      |       |        |                     |       |        |                     |
| Loans and advances from banks and<br>other institutions | 3.18% | 5.00%  | -                   | 2.11% | 1.79%  | -                   |
| Customer accounts                                       | 3.32% | 11.23% | 9.16%               | 2.14% | 8.94%  | 10.12%              |

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

The Bank receives loans from the National Fund for Support of Entrepreneurs as a means of support of small and medium-sized entrepreneurs in Azerbaijan. Under the agreement with the Fund as at 31 December 2005 and 2004 the Bank obtained loans for AZM 10,957,200 thousand and AZM 9,058,033 thousand, respectively with maturity periods from 1 to 5 years and bearing annual interest rates ranging from 0.5% to 4%. Subsequently, these funds were used by the Bank to issue loans with the same maturity periods to the individual entrepreneurs in Azerbaijan at annual interest rates from 5% to 7%. These rates are prescribed by the National Fund for Support of Entrepreneurs and the Bank cannot exceed them. These rates are significantly lower than market rates. This resulted in a decrease in the effective interest rates on loans and advances to customers granted in AZM and deposits from banks and other institutions.

The analysis of interest rate and liquidity risk on balance sheet transactions is presented in the following table:

|  | Up to 1<br>month         | 1 month to<br>3 months  | 3 months to<br>1 year    | 1 year to<br>5 years     | Over<br>5 years   | Overdue                 | Maturity<br>undefined    | 2005<br>Total             |
|--|--------------------------|-------------------------|--------------------------|--------------------------|-------------------|-------------------------|--------------------------|---------------------------|
| <b>ASSETS</b>  |                          |                         |                          |                          |                   |                         |                          |                           |
| Loans and advances to banks, net                                       | 20,746,994               | -                       | -                        | -                        | -                 | -                       | 13,779                   | 20,760,773                |
| Loans and advances to customers, net                                   | 4,714,336                | 4,862,118               | 30,715,238               | 27,813,939               | -                 | 1,191,480               | -                        | 69,297,111                |
| Total interest bearing assets  | <u>25,461,330</u>        | <u>4,862,118</u>        | <u>30,715,238</u>        | <u>27,813,939</u>        | <u>-</u>          | <u>1,191,480</u>        | <u>13,779</u>            | <u>90,057,884</u>         |
| Cash and balances with the National<br>Bank of Azerbaijan              | 6,439,869                | -                       | -                        | -                        | -                 | -                       | 1,330,510                | 7,770,379                 |
| Embedded derivative financial<br>instruments                           | 163                      | 8,268                   | 68,827                   | -                        | -                 | 300                     | -                        | 77,558                    |
| Fixed and intangible assets, net                                       | -                        | -                       | -                        | -                        | -                 | -                       | 9,052,219                | 9,052,219                 |
| Other assets   | 175,024                  | -                       | -                        | -                        | -                 | -                       | -                        | 175,024                   |
| <b>TOTAL ASSETS</b>  | <b><u>32,076,386</u></b> | <b><u>4,870,386</u></b> | <b><u>30,784,065</u></b> | <b><u>27,813,939</u></b> | <b><u>-</u></b>   | <b><u>1,191,780</u></b> | <b><u>10,396,508</u></b> | <b><u>107,133,064</u></b> |
| <b>LIABILITIES</b>   |                          |                         |                          |                          |                   |                         |                          |                           |
| Loans and advances from banks and<br>other institutions                | 9,270,325                | 5,032,667               | 450,000                  | 10,456,200               | -                 | -                       | -                        | 25,209,192                |
| Customer accounts  | 13,437,541               | 779,949                 | 9,181,128                | 26,588,857               | -                 | -                       | -                        | 49,987,475                |
| Total interest bearing liabilities                                     | <u>22,707,866</u>        | <u>5,812,616</u>        | <u>9,631,128</u>         | <u>37,045,057</u>        | <u>-</u>          | <u>-</u>                | <u>-</u>                 | <u>75,196,667</u>         |
| Current income tax liabilities   | 327,284                  | -                       | -                        | -                        | -                 | -                       | -                        | 327,284                   |
| Deferred income tax liabilities  | -                        | -                       | -                        | 166,623                  | -                 | -                       | -                        | 166,623                   |
| Provisions   | -                        | -                       | 33,217                   | 43                       | -                 | -                       | -                        | 33,260                    |
| Other liabilities  | 433,279                  | -                       | -                        | -                        | -                 | -                       | -                        | 433,279                   |
| <b>TOTAL LIABILITIES</b>   | <b><u>23,468,429</u></b> | <b><u>5,812,616</u></b> | <b><u>9,664,345</u></b>  | <b><u>37,211,723</u></b> | <b><u>-</u></b>   | <b><u>-</u></b>         | <b><u>-</u></b>          | <b><u>76,157,113</u></b>  |
| Liquidity gap  | <u>8,607,957</u>         | <u>(942,230)</u>        | <u>21,119,720</u>        | <u>(9,397,784)</u>       | <u>-</u>          | <u>-</u>                | <u>-</u>                 | <u>-</u>                  |
| Interest sensitivity gap   | <u>2,753,464</u>         | <u>(950,498)</u>        | <u>21,084,110</u>        | <u>(9,231,118)</u>       | <u>-</u>          | <u>-</u>                | <u>-</u>                 | <u>-</u>                  |
| Cumulative interest sensitivity gap                                    | <u>2,753,464</u>         | <u>1,802,966</u>        | <u>22,887,076</u>        | <u>13,655,958</u>        | <u>13,655,958</u> | <u>-</u>                | <u>-</u>                 | <u>-</u>                  |
| Cumulative interest sensitivity gap as<br>a percentage of total assets | <u>3%</u>                | <u>2%</u>               | <u>21%</u>               | <u>13%</u>               | <u>13%</u>        | <u>-</u>                | <u>-</u>                 | <u>-</u>                  |

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

|  | Up to 1<br>month  | 1 month to<br>3 months | 3 months to<br>1 year | 1 year to<br>5 years | Over<br>5 years | Overdue        | Maturity<br>undefined | 2004<br>Total     |
|--|-------------------|------------------------|-----------------------|----------------------|-----------------|----------------|-----------------------|-------------------|
| <b>ASSETS</b>  |                   |                        |                       |                      |                 |                |                       |                   |
| Loans and advances to banks, net                                       | 13,597,987        | -                      | -                     | -                    | -               | -              | 14,769                | 13,612,756        |
| Loans and advances to customers, net                                   | 2,715,932         | 7,563,183              | 25,622,403            | 21,168,841           | 464,984         | 643,135        | -                     | 58,178,478        |
| Total interest bearing assets  | 16,313,919        | 7,563,183              | 25,622,403            | 21,168,841           | 464,984         | 643,135        | 14,769                | 71,791,234        |
| Cash and balances with the National<br>Bank of Azerbaijan              | 1,885,443         | -                      | -                     | -                    | -               | -              | 913,953               | 2,799,396         |
| Securities available for sale  | -                 | -                      | -                     | -                    | -               | -              | 41,433                | 41,433            |
| Investment in unconsolidated   | -                 | -                      | -                     | -                    | -               | -              | 1,715,000             | 1,715,000         |
| Fixed and intangible assets, net                                       | -                 | -                      | -                     | -                    | -               | -              | 9,206,525             | 9,206,525         |
| Other assets   | 131,784           | -                      | -                     | -                    | -               | -              | -                     | 131,784           |
| <b>TOTAL ASSETS</b>  | <b>18,331,146</b> | <b>7,563,183</b>       | <b>25,622,403</b>     | <b>21,168,841</b>    | <b>464,984</b>  | <b>643,135</b> | <b>11,891,680</b>     | <b>85,685,372</b> |
| <b>LIABILITIES</b>   |                   |                        |                       |                      |                 |                |                       |                   |
| Loans and advances from banks and<br>other institutions                | 13,511,670        | 11,333                 | 19,806,100            | 8,949,600            | -               | -              | -                     | 42,278,703        |
| Customer accounts  | 8,443,029         | 1,102,930              | 4,196,178             | 5,512,686            | -               | -              | -                     | 19,254,823        |
| Total interest bearing liabilities                                     | 21,954,699        | 1,114,263              | 24,002,278            | 14,462,286           | -               | -              | -                     | 61,533,526        |
| Current income tax liabilities   | 223,708           | -                      | -                     | -                    | -               | -              | -                     | 223,708           |
| Deferred income tax liabilities  | -                 | -                      | -                     | 23,098               | -               | -              | -                     | 23,098            |
| Provisions   | 50,764            | 54,051                 | 101,855               | 88,125               | -               | 4,903          | -                     | 299,698           |
| Other liabilities  | 80,034            | -                      | -                     | -                    | -               | -              | -                     | 80,034            |
| <b>TOTAL LIABILITIES</b>   | <b>22,309,205</b> | <b>1,168,314</b>       | <b>24,104,133</b>     | <b>14,573,509</b>    | <b>-</b>        | <b>4,903</b>   | <b>-</b>              | <b>62,160,064</b> |
| Liquidity gap  | (3,978,059)       | 6,394,869              | 1,518,270             | 6,595,332            | 464,984         |                |                       |                   |
| Interest sensitivity gap   | (5,640,780)       | 6,448,920              | 1,620,125             | 6,706,555            | 464,984         |                |                       |                   |
| Cumulative interest sensitivity gap                                    | (5,640,780)       | 808,140                | 2,428,265             | 9,134,820            | 9,599,804       |                |                       |                   |
| Cumulative interest sensitivity gap as<br>a percentage of total assets | -7%               | 1%                     | 3%                    | 11%                  | 11%             |                |                       |                   |

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

Substantially all of the Bank's interest earning assets and interest bearing liabilities are at fixed rates of interest.

Asset and liability maturity periods and the ability to replace interest liabilities at an acceptable cost when they mature are crucial in determining the Bank's liquidity and its susceptibility to fluctuations in interest rates and exchange rates.

Currently, a considerable part of customer deposits are repayable on demand. However, the fact that these deposits are diversified by the number and type of customers and the Bank's previous experience indicates that these deposits are a stable and long-term source of finance for the Bank.

### Currency risk

Currency risk is defined as the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. The Bank is exposed to the effects of fluctuations in the prevailing foreign currency exchange rates on its financial position and cash flows. The Management Board sets limits on the level of exposure by currencies. These limits also comply with the minimum requirements of the NBA. The Bank's exposure to foreign currency exchange rate risk is presented in the table below:

|  | AZM               | USD<br>1 USD=<br>AZM 4,593 | EUR<br>1 EUR=<br>AZM 5,459 | Other<br>currencies | 2005<br>Total<br>AZM<br>thousand |
|--|-------------------|----------------------------|----------------------------|---------------------|----------------------------------|
| <b>ASSETS</b>  |                   |                            |                            |                     |                                  |
| Cash and balances with the National Bank of Azerbaijan | 4,262,273         | 3,423,850                  | 77,884                     | 6,372               | 7,770,379                        |
| Loans and advances to banks, net                       | -                 | 20,660,291                 | 7,516                      | 92,966              | 20,760,773                       |
| Loans and advances to customers, net                   | 26,205,850        | 42,640,285                 | 450,976                    | -                   | 69,297,111                       |
| Embedded derivative financial instruments              | -                 | 74,453                     | 3,105                      | -                   | 77,558                           |
| Fixed and intangible assets, net                       | 9,052,219         | -                          | -                          | -                   | 9,052,219                        |
| Other assets   | 41,131            | 133,893                    | -                          | -                   | 175,024                          |
| <b>TOTAL ASSETS</b>                                    | <b>39,561,473</b> | <b>66,932,772</b>          | <b>539,481</b>             | <b>99,338</b>       | <b>107,133,064</b>               |
| <b>LIABILITIES</b>                                     |                   |                            |                            |                     |                                  |
| Loans and advances from banks and other institutions   | 15,958,846        | 9,250,346                  | -                          | -                   | 25,209,192                       |
| Customer accounts                                      | 8,746,837         | 39,291,035                 | 1,878,480                  | 71,123              | 49,987,475                       |
| Current income tax liabilities                         | 327,284           | -                          | -                          | -                   | 327,284                          |
| Deferred income tax liabilities                        | 166,623           | -                          | -                          | -                   | 166,623                          |
| Provisions   | 40                | 33,220                     | -                          | -                   | 33,260                           |
| Other liabilities                                      | 433,279           | -                          | -                          | -                   | 433,279                          |
| <b>TOTAL LIABILITIES</b>                               | <b>25,632,909</b> | <b>48,574,601</b>          | <b>1,878,480</b>           | <b>71,123</b>       | <b>76,157,113</b>                |
| <b>OPEN POSITION</b>                                   | <b>13,928,564</b> | <b>18,358,171</b>          | <b>(1,338,999)</b>         | <b>28,215</b>       |                                  |

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

|  | AZM               | USD<br>1 USD=<br>AZM 4,903 | EUR<br>1 EUR=<br>AZM 6,682 | Other<br>currencies | 2004<br>Total<br>AZM<br>thousand |
|--|-------------------|----------------------------|----------------------------|---------------------|----------------------------------|
| <b>ASSETS</b>  |                   |                            |                            |                     |                                  |
| Cash and balances with the National Bank of Azerbaijan | 1,556,720         | 1,170,485                  | 72,057                     | 134                 | 2,799,396                        |
| Loans and advances to banks, net                       | -                 | 13,588,950                 | 23,675                     | 131                 | 13,612,756                       |
| Loans and advances to customers, net                   | 41,620,759        | 16,104,704                 | 453,015                    | -                   | 58,178,478                       |
| Securities available for sale                          | 41,433            | -                          | -                          | -                   | 41,433                           |
| Investment in unconsolidated                           | 1,715,000         | -                          | -                          | -                   | 1,715,000                        |
| Fixed and intangible assets, net                       | 9,206,525         | -                          | -                          | -                   | 9,206,525                        |
| Other assets   | 34,228            | 97,556                     | -                          | -                   | 131,784                          |
| <b>TOTAL ASSETS</b>                                    | <b>54,174,665</b> | <b>30,961,695</b>          | <b>548,747</b>             | <b>265</b>          | <b>85,685,372</b>                |
| <b>LIABILITIES</b>                                     |                   |                            |                            |                     |                                  |
| Loans and advances from banks and other institutions   | 14,058,033        | 28,220,670                 | -                          | -                   | 42,278,703                       |
| Customer accounts                                      | 5,526,365         | 13,521,055                 | 206,351                    | 1,052               | 19,254,823                       |
| Current income tax liabilities                         | 223,708           | -                          | -                          | -                   | 223,708                          |
| Deferred income tax liabilities                        | 23,098            | -                          | -                          | -                   | 23,098                           |
| Provisions   | 192,044           | 107,654                    | -                          | -                   | 299,698                          |
| Other liabilities                                      | 76,103            | 3,931                      | -                          | -                   | 80,034                           |
| <b>TOTAL LIABILITIES</b>                               | <b>20,099,351</b> | <b>41,853,310</b>          | <b>206,351</b>             | <b>1,052</b>        | <b>62,160,064</b>                |
| <b>OPEN POSITION</b>                                   | <b>34,075,314</b> | <b>(10,891,615)</b>        | <b>342,396</b>             | <b>(787)</b>        |                                  |

### Price Risk

Price risk is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices whether those changes are caused by factors specific to the individual security or its issuer or factors affecting all securities traded in the market. The Bank is exposed to price risks of its products which are subject to general and specific market fluctuations.

The Bank manages price risk through periodic estimations of potential losses that could arise from adverse changes in market conditions and establishing and maintaining appropriate stop-loss limits and margin and collateral requirements. With respect to undrawn loan commitments the Bank is potentially exposed to loss in an amount equal to the total amount of such commitments. However, the likely amount of loss is less than that, since most commitments are contingent upon certain conditions set out in the loan agreements.

### Fair value interest rate risk

Fair value interest rate risk is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates.

The Bank manages fair value interest rate risk through periodic estimation of potential losses that could arise from adverse changes in market conditions. The Management Board of the Bank conducts monitoring of the Bank's current financial performance, estimates the Bank's sensitivity to changes in fair value interest rates and its influence on the Bank's profitability.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) *(in Azerbaijan Manats and in thousands)*

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### **Credit risk**

The Bank is exposed to credit risk which is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.

The Bank structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, or groups of borrowers. Limits on the level of credit risk by borrower are reviewed and approved by the Supervisory Board twice a year. Actual exposure per borrower against limits is monitored on new loans granted. The Credit Committee may initiate a change in the limits; however this must be approved by the Supervisory Board.

Where appropriate, and in the case of most loans, the Bank obtains collateral and corporate guarantees. The credit risks are monitored on a continuous basis and are subject to annual or more frequent reviews, especially where no such security can be obtained.

Commitments to extend credit represent unused portions of credit in the form of loans, guarantees or letters of credit. The credit risk on off-balance sheet financial instruments is defined as a probability of losses due to the inability of the counterparty to comply with the contractual terms and conditions. With respect to credit risk on commitments to extend credit, the Bank is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments since most commitments to extend credit are contingent upon customers maintaining specific credit standards. The Bank applies the same credit policy to the contingent liabilities as it does to the balance sheet financial instruments, i.e. the one based on the procedures for approving the grant of loans, using limits to mitigate the risk, and current monitoring. The Bank monitors the term to maturity of credit commitments because longer term commitments generally have a greater degree of credit risk than shorter-term commitments.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

### Geographical concentration

The geographical concentration of assets and liabilities is set out below:

|  | Azerbaijan        | Other CIS countries | OECD countries    | Other non-OECD countries | 2005 Total         |
|--|-------------------|---------------------|-------------------|--------------------------|--------------------|
| <b>ASSETS</b>  |                   |                     |                   |                          |                    |
| Cash and balances with the National Bank of Azerbaijan | 7,770,379         | -                   | -                 | -                        | 7,770,379          |
| Loans and advances to banks, net                       | 9,305,499         | 169,054             | 11,027,028        | 259,192                  | 20,760,773         |
| Loans and advances to customers, net                   | 69,297,111        | -                   | -                 | -                        | 69,297,111         |
| Embedded derivative financial instruments              | 77,558            | -                   | -                 | -                        | 77,558             |
| Fixed and intangible assets, net                       | 9,052,219         | -                   | -                 | -                        | 9,052,219          |
| Other assets   | 175,024           | -                   | -                 | -                        | 175,024            |
| <b>TOTAL ASSETS</b>                                    | <b>95,677,790</b> | <b>169,054</b>      | <b>11,027,028</b> | <b>259,192</b>           | <b>107,133,064</b> |
| <b>LIABILITIES</b>                                     |                   |                     |                   |                          |                    |
| Loans and advances from banks and other institutions   | 25,209,192        | -                   | -                 | -                        | 25,209,192         |
| Customer accounts                                      | 49,639,012        | 104,128             | 6,700             | 237,635                  | 49,987,475         |
| Current income tax liabilities                         | 327,284           | -                   | -                 | -                        | 327,284            |
| Deferred income tax liabilities                        | 166,623           | -                   | -                 | -                        | 166,623            |
| Provisions   | 33,260            | -                   | -                 | -                        | 33,260             |
| Other liabilities                                      | 433,279           | -                   | -                 | -                        | 433,279            |
| <b>TOTAL LIABILITIES</b>                               | <b>75,808,650</b> | <b>104,128</b>      | <b>6,700</b>      | <b>237,635</b>           | <b>76,157,113</b>  |
| <b>NET POSITION</b>                                    | <b>19,869,140</b> | <b>64,926</b>       | <b>11,020,328</b> | <b>21,557</b>            |                    |

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005 (Continued) (in Azerbaijan Manats and in thousands)

|   | Azerbaijan        | Other CIS<br>countries | OECD<br>countries | Other<br>non-OECD<br>countries | 2004<br>Total     |
|---|-------------------|------------------------|-------------------|--------------------------------|-------------------|
| <b>ASSETS</b>   |                   |                        |                   |                                |                   |
| Cash and balances with the National<br>Bank of Azerbaijan | 2,799,396         | -                      | -                 | -                              | 2,799,396         |
| Loans and advances to banks, net                          | 12,716,504        | 66,283                 | 696,607           | 133,362                        | 13,612,756        |
| Loans and advances to customers, net                      | 58,178,478        | -                      | -                 | -                              | 58,178,478        |
| Securities available for sale                             | 41,433            | -                      | -                 | -                              | 41,433            |
| Investment in unconsolidated                              | 1,715,000         | -                      | -                 | -                              | 1,715,000         |
| Fixed and intangible assets, net                          | 9,206,525         | -                      | -                 | -                              | 9,206,525         |
| Other assets  | 131,784           | -                      | -                 | -                              | 131,784           |
| <b>TOTAL ASSETS</b>                                       | <b>84,789,120</b> | <b>66,283</b>          | <b>696,607</b>    | <b>133,362</b>                 | <b>85,685,372</b> |
| <b>LIABILITIES</b>  |                   |                        |                   |                                |                   |
| Loans and advances from banks and<br>other institutions   | 42,278,703        | -                      | -                 | -                              | 42,278,703        |
| Customer accounts   | 19,254,823        | -                      | -                 | -                              | 19,254,823        |
| Current income tax liabilities                            | 223,708           | -                      | -                 | -                              | 223,708           |
| Deferred income tax liabilities                           | 23,098            | -                      | -                 | -                              | 23,098            |
| Provisions  | 299,698           | -                      | -                 | -                              | 299,698           |
| Other liabilities   | 80,034            | -                      | -                 | -                              | 80,034            |
| <b>TOTAL LIABILITIES</b>                                  | <b>62,160,064</b> | <b>-</b>               | <b>-</b>          | <b>-</b>                       | <b>62,160,064</b> |
| <b>NET POSITION</b>                                       | <b>22,629,056</b> | <b>66,283</b>          | <b>696,607</b>    | <b>133,362</b>                 |                   |