

# **OPEN JOINT STOCK COMPANY MUGANBANK**

**Financial Statements**

For the Year Ended 31 December 2007

# 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 2007**

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The following statement, which should be read in conjunction with the independent auditors' responsibilities stated in the independent auditors' report set out on pages 2 to 3, 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 as at 31 December 2007, 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 2007 were authorized for issue on 2 June 2008 by the Management Board.

On behalf of the Board

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Chairman

*2 June 2008*

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Head of Finance Department

*2 June 2008*

## **INDEPENDENT AUDITORS' REPORT**

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

### **Report on the Financial Statements**

We have audited the accompanying financial statements of Open Joint Stock Company Muganbank, which comprise the balance sheet as at 31 December 2007, and the income statement, statements of changes in equity and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

### **Management's Responsibility for the Financial Statements**

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

### **Auditor's Responsibility**

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

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

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

## **Opinion**

In our opinion, the financial statements present fairly, in all material respects the financial position of Open Joint Stock Company Muganbank as at 31 December 2007, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

2 June 2008

*Deloitte & Touche*

# OPEN JOINT STOCK COMPANY MUGANBANK

## INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2007

(in New Azerbaijan Manats and in thousands, except for earnings per share which is in Manats)

	Notes	Year ended 31 December 2007	Year ended 31 December 2006
Interest income	4, 23	6,782	3,622
Interest expense	4, 23	<u>(3,247)</u>	<u>(1,521)</u>
NET INTEREST INCOME BEFORE PROVISION FOR IMPAIRMENT LOSSES ON INTEREST BEARING ASSETS		3,535	2,101
Provision for impairment losses on loans to customers	5, 23	<u>(865)</u>	<u>(620)</u>
NET INTEREST INCOME		<u>2,670</u>	<u>1,481</u>
Net gain/(loss) on foreign exchange operations	6	3	(58)
Fee and commission income	7	2,088	1,508
Fee and commission expense	7	(288)	(144)
Net loss on investments available-for-sale		(2)	(3)
Other income		<u>-</u>	<u>61</u>
NET NON-INTEREST INCOME		<u>1,801</u>	<u>1,364</u>
OPERATING INCOME		4,471	2,845
OPERATING EXPENSES	8, 23	(2,963)	(1,766)
Provision for impairment losses on other transactions	5	<u>(47)</u>	<u>(2)</u>
PROFIT BEFORE INCOME TAX		1,461	1,077
Income tax expense	9	<u>(312)</u>	<u>(248)</u>
NET PROFIT		<u>1,149</u>	<u>829</u>
EARNINGS PER SHARE			
Basic (AZN)	10	24.58	26.16

### On behalf of the Board

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

2 June 2008  
Baku

\_\_\_\_\_  
**Head of Finance Department**

2 June 2008  
Baku

The notes on pages 9 to 48 form an integral part of these financial statements. The Independent Auditors' Report is on pages 2 and 3.

# OPEN JOINT STOCK BANK MUGANBANK

## BALANCE SHEET

AS AT 31 DECEMBER 2007

(in New Azerbaijan Manats and in thousands)

	Notes	31 December 2007	31 December 2006
<b>ASSETS</b>			
Cash and balances with the National Bank of Azerbaijan	11	8,686	4,539
Due from banks	12, 23	11,821	5,337
Investments available-for-sale	14	3,402	646
Loans to customers	13, 23	48,218	24,128
Property and equipment	15	7,560	5,014
Other assets	16	570	332
<b>TOTAL ASSETS</b>		<b>80,257</b>	<b>39,996</b>
<b>LIABILITIES AND EQUITY</b>			
<b>LIABILITIES</b>			
Loans from banks and other financial institutions	17	36,927	12,696
Customer accounts	18, 23	24,682	16,576
Debt securities issued	19	4,162	-
Current income tax payable		134	97
Deferred income tax liability	9	258	266
Other liabilities	20, 23	453	265
<b>Total liabilities</b>		<b>66,616</b>	<b>29,900</b>
<b>EQUITY</b>			
Share capital	21	11,000	7,800
Revaluation reserve		702	702
Retained earnings		1,939	1,594
<b>Total equity</b>		<b>13,641</b>	<b>10,096</b>
<b>TOTAL LIABILITIES AND EQUITY</b>		<b>80,257</b>	<b>39,996</b>

**On behalf of the Board**

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

*2 June 2008*

*Baku*

\_\_\_\_\_  
**Head of Finance Department**

*2 June 2008*

*Baku*

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# OPEN JOINT STOCK COMPANY MUGANBANK

## STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2007 (in New Azerbaijan Manats and in thousands)

	Share capital	Revaluation reserve	Retained earnings	Total equity
<b>31 December 2005</b>	5,400	-	795	6,195
Issue of ordinary shares	2,400	-	-	2,400
Fixed assets revaluation, net of tax	-	702	-	702
Dividends paid	-	-	(30)	(30)
Net profit	-	-	829	829
<b>31 December 2006</b>	<u>7,800</u>	<u>702</u>	<u>1,594</u>	<u>10,096</u>
Issue of ordinary shares	3,200	-	-	3,200
Dividends paid	-	-	(804)	(804)
Net profit	-	-	1,149	1,149
<b>31 December 2007</b>	<u>11,000</u>	<u>702</u>	<u>1,939</u>	<u>13,641</u>

On behalf of the Board

\_\_\_\_\_  
Chairman

2 June 2008  
Baku

\_\_\_\_\_  
Head of Finance Department

2 June 2008  
Baku

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# OPEN JOINT STOCK COMPANY MUGANBANK

## STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2007

(in New Azerbaijan Manats and in thousands)

	Notes	Year ended 31 December 2007	Year ended 31 December 2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Profit before income tax		1,461	1,077
Adjustments for:			
Provision for impairment losses		865	622
Translation loss on foreign exchange rates		19	79
Depreciation and amortization		470	236
Loss on disposal of property and equipment		7	-
Loss on disposal of investments available-for-sale		2	3
Change in interest accruals, net		(70)	(318)
		<u>2,754</u>	<u>1,699</u>
Cash flows from operating activities before changes in operating assets and liabilities			
Changes in operating assets and liabilities			
Increase in operating assets:			
Minimum reserve deposit with National Bank of Azerbaijan		(553)	(984)
Due from banks		(4,302)	(2,948)
Loans to customers		(24,667)	(10,861)
Other assets		(249)	(216)
Increase in operating liabilities:			
Loans from banks and other financial institutions		24,178	7,771
Customer accounts		7,909	6,864
Other liabilities		188	173
		<u>5,258</u>	<u>1,498</u>
Cash inflow from operating activities before taxation			
Income tax paid		(283)	(181)
		<u>4,975</u>	<u>1,317</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchase of property and equipment		(3,012)	(2,627)
Proceeds on sale of investments available-for-sale		42,046	16,269
Purchase of investments available-for-sale		(44,804)	(16,917)
		<u>(5,770)</u>	<u>(3,275)</u>

# OPEN JOINT STOCK COMPANY MUGANBANK

## STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED)

(in New Azerbaijan Manats and in thousands)

	Notes	Year ended 31 December 2007	Year ended 31 December 2006
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Issue of ordinary share capital		3,200	2,400
Proceeds from debt securities issued		4,162	-
Dividends paid		(804)	(30)
		<u>6,558</u>	<u>2,370</u>
Net cash inflow from financing activities			
		<u>6,558</u>	<u>2,370</u>
<i>Effect of changes in foreign exchange rate on cash and cash equivalents</i>		(9)	(30)
NET INCREASE IN CASH AND CASH EQUIVALENTS		<u>5,754</u>	<u>382</u>
CASH AND CASH EQUIVALENTS, beginning of year	11	<u>3,875</u>	<u>3,493</u>
CASH AND CASH EQUIVALENTS, end of year	11	<u><u>9,629</u></u>	<u><u>3,875</u></u>

Interest paid and received by the Bank in cash during the year ended 31 December 2007 amounted to AZN 2,996 thousand and AZN 6,879 thousand, respectively. Interest paid and received by the Bank in cash during the year ended 31 December 2006 amounted to AZN 1,417 thousand and AZN 3,200 thousand, respectively.

### On behalf of the Board

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

2 June 2008  
Baku

\_\_\_\_\_  
**Head of Finance Department**

2 June 2008  
Baku

The notes on pages 9 to 48 form an integral part of these financial statements. The Independent Auditors' Report is on pages 2 and 3.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (in New 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 17 and 15 branches in Azerbaijan as at 31 December 2007 and 2006, respectively. 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 2007 and 2006 the following individuals and legal entities owned the share capital of the Bank:

Owner	31 December 2007 %	31 December 2006 %
Mehdiyev Elmir	67.08	79.21
Mehdiyev Maqbet	11.97	7.90
Veliyeva Vefa	11.00	7.82
Mehdiyeva Farida	9.95	5.07
Total	<u>100.00</u>	<u>100.00</u>

These financial statements were authorized for issue by the Management Board on 2 June 2008.

### 2. BASIS OF PRESENTATION

#### Accounting basis

These financial statements of the Bank have been prepared in accordance with International Financial Reporting Standards (“IFRS”) issued by the International Accounting Standards Board (“IASB”) and Interpretations issued by the International Financial Reporting Interpretations Committee (“IFRIC”). These financial statements are presented in thousands of New Azerbaijan Manats (“AZN”), unless otherwise indicated. These financial statements have been prepared under the historical cost convention, except measurement at fair value of certain financial instruments and measurement of buildings at revalued amounts according to International Accounting Standards. (“IAS” No: 16 “Property, Plant and Equipment”).

The Bank maintains its accounting records in accordance with Azerbaijan law. These financial statements have been prepared from the Azerbaijan statutory accounting records and have been adjusted to conform to IFRS. These adjustments include certain reclassifications to reflect the economic substance of underlying transactions including reclassifications of certain assets and liabilities, income and expenses to appropriate financial statement captions.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED)

(in New Azerbaijan Manats and in thousands)

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### Key assumptions

The preparation of financial statements in accordance with IFRS requires management to make estimates and assumptions that affect the reported amounts. Such estimates and assumptions are based on the information available to the Banks's management as at the date of the financial statements. Therefore, actual results could differ from those estimates and assumptions. Estimates that are particularly susceptible to change relate to the provisions for impairment losses.

Key assumptions concerning the future and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial period include:

	31 December 2007	31 December 2006
Loans to customers	48,218	24,128
Property and equipment	7,560	5,014

Loans to customers are measured at amortised cost less allowance for impairment losses. The estimation of allowances for impairments involves the exercise of significant judgment. The Bank estimates allowances for impairment with the objective of maintaining balance sheet provisions at a level believed by management to be sufficient to absorb losses incurred in the Bank's loan portfolio. The calculation of provisions on impaired loans is based on the likelihood of the asset being written off and the estimated loss on such a write-off. These assessments are made using statistical techniques based on historic experience. These determinations are supplemented by the application of management judgment.

The Bank considers accounting estimates related to provisions for loans key sources of estimation uncertainty because: (i) they are highly susceptible to change from period to period as the assumptions about future default rates and valuation of losses relating to impaired loans and advances are based on recent performance experience, and (ii) any significant difference between the Bank's estimated losses (as reflected in the provisions) and actual losses will require the Bank to take provisions which, if significantly different, could have a material impact on its future income statement and its balance sheet. The Bank's assumptions about estimated losses are based on past performance, past customer behavior, the credit quality of recent underwritten business and general economic conditions, which are not necessarily an indication of future losses.

Buildings are measured at revalued amounts. The date of the latest appraisal was as at 31 December 2006. The next revaluation is scheduled as at 31 December 2008.

Taxation is discussed in Note 9.

### Functional currency

The functional currency of these financial statements is the New Azerbaijan Manat ("AZN").

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) *(in New Azerbaijan Manats and in thousands)*

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### 3. SIGNIFICANT ACCOUNTING POLICIES

#### **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 purchase and sale 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 trade date and 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 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 original maturity within 90 days, advances to banks in countries included in the Organization for Economic Co-operation and Development ("OECD"). For purposes of determining cash flows, the minimum reserve deposit required by the NBA is not included as a cash equivalent due to restrictions on its availability.

#### **Due from banks**

In the normal course of business, the Bank maintains advances or deposits for various periods of time with other banks. Due from banks are subsequently measured at amortized cost using the effective interest method. Amounts due from credit institutions are carried net of any allowance for impairment losses.

#### **Loans to customers**

Loans to customers are non-derivative assets with fixed or determinable payments that are not quoted in an active market, other than those classified in other categories of financial assets.

Loans granted by the Bank 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 according to nature of these losses. Subsequently, loans are carried at amortized cost using the effective interest method. Loans to customers 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 2007 (CONTINUED)

*(in New Azerbaijan Manats and in thousands)*

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

Loans and advances are written off against allowance for impairment losses in case of uncollectibility of loans and advances, including through repossession of collateral. Loans and advances are written off after management has exercised all possibilities available to collect 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 Supervisory Board and, in certain cases, with the respective decision of the Court.

### **Allowance for impairment losses**

The Bank accounts for allowance for impairment losses of financial assets when there is objective evidence that a financial asset or group of financial assets is impaired. Impairment losses are measured as the difference between carrying amounts 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. For financial assets carried at cost, the impairment losses are 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 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. Provisions 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 impairment losses is charged to profit, and the total of the 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.

The Bank accounts for impairment losses on financial assets at amortised cost using allowance account, for financial assets measured at cost through direct write off.

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 that 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 2007 (CONTINUED)

(in New 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. Such securities are initially recorded at fair value. Subsequently the securities are measured at fair value, with such re-measurement recognized directly in equity until sold when gain/loss previously recorded in equity recycles through the income statement, except for impairment losses, foreign exchange gains or losses and interest income accrued using the effective interest method, which are recognized directly in the income statement. The Bank uses quoted market prices to determine the fair value for the Bank's investments available for sale. If the market for investments is not active, the Bank establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and other applicable methods. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the Bank uses that technique. Dividends received are included other income in the income statement.

### Property, equipment and intangible assets

Property, equipment and intangible assets are carried at historical cost (except for buildings which are stated at revalued amounts) less accumulated depreciation and amortization and any recognized impairment losses. Depreciation and amortization of property, equipment and intangible assets is charged on the carrying value of those assets and is designed to write off assets over their useful economic lives. It is calculated on a straight line basis at the following annual prescribed rates:

Buildings	5%
Furniture and office equipment	20%
Computers	25%
Vehicles	20%
Other fixed assets	20%
Intangible assets	10%

The carrying amounts of property, equipment and intangible assets are reviewed at each balance sheet date to assess whether they are recorded in excess of their recoverable amounts, and where carrying values exceed this estimated recoverable amount, assets are written down to their recoverable amount.

Impairment is recognized in the respective period and is included in operating expenses. After the recognition of an impairment loss the depreciation charge for property, equipment and intangible 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.

Buildings held for use in supply of services, or for administrative purposes, are stated in the balance sheet at their revalued amounts, being the fair value at the date of revaluation, determined from market-based evidence by appraisal undertaken by professional independent appraisers, less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations are performed with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair values at the balance sheet date.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED)

*(in New Azerbaijan Manats and in thousands)*

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Any revaluation increase arising on the revaluation of such buildings is credited to the fixed assets revaluation reserve, except to the extent that it reverses a revaluation decrease for the same asset previously recognized as an expense, in which case the increase is credited to the income statement to the extent of the decrease previously charged. A decrease in carrying amount arising on the revaluation of such buildings is charged as an expense to the extent that it exceeds the balance, if any, held in the properties revaluation reserve relating to a previous revaluation of that asset.

Depreciation on revalued buildings is charged to income statement. On the subsequent sale or retirement of a revalued property, the attributable revaluation surplus remaining in the properties revaluation reserve is transferred directly to retained earnings.

### **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 during the reporting period.

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 realized. 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.

Deferred income tax assets and deferred income tax liabilities are offset and reported net on the balance sheet if:

- The Bank has a legally enforceable right to set off current income tax assets against current income tax liabilities; and
- Deferred income tax assets and the deferred income tax liabilities relate to income taxes levied by the same taxation authority on the same taxable entity.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED)

*(in New Azerbaijan Manats and in thousands)*

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### **Loans from banks and other financial institutions, customers accounts**

Loans from banks and other financial institutions and customer accounts are initially recognized at fair value. 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.

### **Finance leases**

Financial leases are leases that transfer substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract. The lease classified as finance lease if:

- The lease transfers ownership of the asset to the lessee by the end of the lease term;
- The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;
- The lease term is for the major part of the economic life of the asset even if title is not transferred;
- At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- The leased assets are of a specialized nature such that only the lessee can use them without major modifications being made.

At the commencement of the lease term, the Bank as a lessee recognizes finance leases as assets and liabilities in its balance sheet at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. Subsequently, the minimum lease payments are apportioned between the finance charge and the reduction of the outstanding liability. The finance charge is allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability. Depreciation of the lease property is charged in accordance with depreciation policy that is applied to property owned by the Bank.

### **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.

### **Financial guarantee contracts issued and letters of credit**

Financial guarantee contracts and letters of credit issued by the Bank are credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. Such financial guarantee contracts and letters of credit issued are initially recognized at fair value. Subsequently they are measured at the higher of (a) the amount recognized as a provision and (b) the amount initially recognized less, where appropriate, cumulative amortization of initial premium revenue received over the financial guarantee contracts or letter of credit issued.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED)

*(in New Azerbaijan Manats and in thousands)*

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### **Share capital**

Contributions to share capital are recognized at cost.

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 Azerbaijan Republic's legislation state pension system provides for the calculation of current payments by the employer as a percentage of current total payments to staff. This expense is charged in the period the related salaries are earned. Upon retirement all retirement benefit payments are made by pension funds selected by employees. The Bank does not have any pension arrangements separate from the State pension system of the Azerbaijan Republic. In addition, the Bank has no post-retirement benefits or other significant compensated benefits requiring accrual.

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

Interest income and expense are recognized on an accrual basis using the effective interest method. The effective interest method is a method of calculating the amortized cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly

discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

Once a financial asset or a group of similar financial assets has been written down (partly 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.

Interests earned on assets at fair value are classified within interest income.

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 the income statement 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 the income statement on expiry. Loan servicing fees are recognized as revenue as the services are provided. 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 2007 (CONTINUED)

*(in New Azerbaijan Manats and in thousands)*

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### Foreign currency translation

Monetary assets and liabilities denominated in foreign currencies are translated into AZN 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 on foreign exchange operations.

### Rates of exchange

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

	31 December 2007	31 December 2006
AZN/1 US Dollar	0.8453	0.8714
AZN/1 Euro	1.2450	1.1471

### 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.

### Segment reporting

A segment is a distinguishable component of the Bank that is engaged either in providing products or services (business segment) or in providing products or services within a particular economic environment (geographical segment), which is subject to risks and rewards that are different from those of other segments. Segments with a majority of revenue earned from sales to external customers and whose revenue, result or assets are ten per cent or more of all the segments are reported separately. Geographical segments of the Bank have been reported separately within these financial statements based on the ultimate domicile of the counterparty, e.g. based on economic risk rather than legal risk of the counterparty.

### Adoption of new standards

In the current year, the Bank has adopted all of the new and revised Standards and Interpretations issued by the International Accounting Standards Board (the IASB) and the International Financial Reporting Interpretations Committee (the IFRIC) of the IASB that are relevant to its operations and effective for reporting periods beginning on 1 January 2007. The adoption of these new and revised Standards and Interpretations has not resulted in significant changes to the Bank's accounting policies that have affected the amounts reported for the current or prior years except for the effect of application of IFRS 7 "Financial Instruments: Disclosure" ("IFRS 7").

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED)

(in New Azerbaijan Manats and in thousands)

IFRS 7 is effective for annual periods beginning on or after 1 January 2007. IFRS 7 establishes new requirements and recommendations on financial instrument disclosure. Adoption of IFRS 7 did not affect the classification and measurement of Bank's financial instruments in the financial statements. Additional information was disclosed in the financials statements for the current and comparative reporting periods as required by IFRS 7.

At the date of these financial statements the following Standard applicable to the Bank was issued but not yet effective for these financial statements: Effective 1 January 2009, the new IFRS 8 "Operating Segments" will replace IAS 14 "Operating Segments". The management is currently assessing the impact of the adoption of this new Standard for future periods. The Bank anticipates that other new Standards and Interpretations will have no material financial impact on the financial statements of the Bank.

### 4. NET INTEREST INCOME

	Year ended 31 December 2007	Year ended 31 December 2006
<b>Interest income comprises:</b>		
Interest income on assets recorded at amortized cost:		
- interest income on assets that has been written down as a result of an impairment loss	4,768	3,356
- interest income on unimpaired assets	1,679	62
Interest income on investments available-for-sale	248	129
Interest income on guarantees	87	75
Total interest income	<u>6,782</u>	<u>3,622</u>
Interest income on assets recorded at amortized cost comprises:		
Interest on loans to customers	6,125	3,280
Interest on loans and advances to banks	322	138
Total interest income on financial assets recorded at amortized cost	<u>6,447</u>	<u>3,418</u>
Interest income on investments available-for-sale	248	129
Interest income on guarantees	87	75
Total interest income	<u>6,782</u>	<u>3,622</u>
Interest expense on liabilities recorded at amortized cost comprise:		
Interest on customer accounts	(2,343)	(1,184)
Interest on deposits from banks	(610)	(337)
Interest on debt securities issued	(294)	-
Total interest expense on financial assets recorded at amortized cost	<u>(3,247)</u>	<u>(1,521)</u>
Net interest income before provision for impairment losses on interest bearing assets	<u><u>3,535</u></u>	<u><u>2,101</u></u>

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) *(in New Azerbaijan Manats and in thousands)*

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### 5. ALLOWANCE FOR IMPAIRMENT LOSSES

The movements in allowance for impairment losses on interest earning assets were as follows:

	<b>Loans to customers</b>
<b>31 December 2005</b>	401
Provision	620
Write-off of assets	<u>(465)</u>
<b>31 December 2006</b>	556
Provision	<u>865</u>
<b>31 December 2007</b>	<u><u>1,421</u></u>

The movements in allowances for impairment losses on guarantees and other commitments were as follows:

	<b>Guarantees and other commitments</b>
<b>31 December 2005</b>	7
Provision	<u>2</u>
<b>31 December 2006</b>	9
Provision	<u>47</u>
<b>31 December 2007</b>	<u><u>56</u></u>

### 6. NET GAIN/(LOSS) ON FOREIGN EXCHANGE OPERATIONS

Net gain/(loss) on foreign exchange operations comprises:

	<b>Year ended 31 December 2007</b>	<b>Year ended 31 December 2006</b>
Dealing, net	22	21
Translation differences, net	<u>(19)</u>	<u>(79)</u>
Total net gain/(loss) on foreign exchange operations	<u><u>3</u></u>	<u><u>(58)</u></u>

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) *(in New Azerbaijan Manats and in thousands)*

### 7. FEE AND COMMISSION INCOME AND EXPENSE

Fee and commission income and expense comprise:

	Year ended 31 December 2007	Year ended 31 December 2006
<b>Fee and commission income:</b>		
Cash operations	1,057	638
Settlements and account servicing	603	520
Foreign exchange operations	194	154
Documentary operations	170	164
Plastic cards operations	53	29
Other	11	3
	<u>2,088</u>	<u>1,508</u>
<b>Fee and commission expense:</b>		
Plastic cards operations	(96)	(60)
Documentary operations	(76)	(4)
Cash operations	(51)	(23)
Settlements and account servicing	(35)	(27)
Securities operations	(26)	(11)
Foreign exchange operations	(3)	-
Other	(1)	(19)
	<u>(288)</u>	<u>(144)</u>
Total fee and commission income		
Total fee and commission expense		

### 8. OPERATING EXPENSES

Operating expenses comprise:

	Year ended 31 December 2007	Year ended 31 December 2006
Staff costs	1,500	853
Depreciation and amortization	470	236
Operating lease expenses	163	87
Communication	157	104
Professional fees	122	86
Security	99	66
Advertising	96	148
Printing and office supplies	69	47
Repair and maintenance	62	31
Taxes other than income tax	53	30
Business trip expenses	27	12
Utilities	23	17
Insurance	23	8
Membership fees	11	3
Software maintenance	9	9
Other operating expenses	79	29
	<u>2,963</u>	<u>1,766</u>
Total operating expenses		

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

### 9. INCOME TAXES

The Bank provides for taxes based on the statutory tax accounts maintained and prepared in accordance with the Azerbaijan statutory tax regulations that 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 2007 and 2006 relate mostly to different methods of income and expense recognition as well as to recorded values of certain assets.

Temporary differences as at 31 December 2007 and 2006 comprise:

	31 December 2007	31 December 2006
<b>Deferred assets:</b>		
Other liabilities	51	32
Other assets	-	5
	<u>51</u>	<u>37</u>
Total deferred assets		
	<u>51</u>	<u>37</u>
<b>Deferred liabilities:</b>		
Property and equipment	(1,225)	(1,088)
Provisions on other transactions	-	(103)
Loans to customers	-	(54)
	<u>(1,225)</u>	<u>(1,245)</u>
Total deferred liabilities		
	<u>(1,225)</u>	<u>(1,245)</u>
Net deferred liabilities		
	<u><b>(1,174)</b></u>	<u><b>(1,208)</b></u>
Deferred income tax liability at statutory rate 22%		
	<u><b>(258)</b></u>	<u><b>(266)</b></u>

Relationships between tax expenses and accounting profit for the year ended 31 December 2007 and 2006 are explained as follows:

	Year ended 31 December 2007	Year ended 31 December 2006
Profit before income tax	<u>1,461</u>	<u>1,077</u>
Statutory tax rate	22%	22%
Theoretical tax at the statutory tax rate	321	237
Tax effect of permanent differences	<u>(9)</u>	<u>11</u>
<b>Income tax expense</b>	<u><b>312</b></u>	<u><b>248</b></u>

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

	Year ended 31 December 2007	Year ended 31 December 2006
Current income tax expense	320	214
Deferred income tax (benefit)/expense	(8)	34
<b>Income tax expense</b>	<b>312</b>	<b>248</b>
	<b>31 December 2007</b>	<b>31 December 2006</b>
<b>Deferred income tax liabilities</b>		
At beginning of the period	266	33
(Decrease)/ increase in the deferred income tax recognized in income statement	(8)	34
Increase in the deferred income tax recognized in equity	-	199
<b>At end of the period</b>	<b>258</b>	<b>266</b>

### 10. EARNINGS PER SHARE

	Year ended 31 December 2007	Year ended 31 December 2006
<b>Profit:</b>		
Net profit for the year	1,149	829
<b>Weighted average number of ordinary shares</b> for basic earnings per share	46,737	31,685
<b>Earnings per share – basic (AZN)</b>	<b>24.58</b>	<b>26.16</b>

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

Cash and balances with the National Bank of Azerbaijan comprise:

	31 December 2007	31 December 2006
Cash on hand	2,500	1,039
Balances with the National Bank of Azerbaijan	6,186	3,500
<b>Total cash and balances with the National Bank of Azerbaijan</b>	<b>8,686</b>	<b>4,539</b>

## OPEN JOINT STOCK COMPANY MUGANBANK

### NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

The balances with the NBA as at 31 December 2007 and 2006 include AZN 1,770 thousand and AZN 1,217 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 provided that average daily balance for 15 days period will be eventually higher than required mandatory reserve.

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

	<b>31 December 2007</b>	<b>31 December 2006</b>
Cash and balances with the National Bank of Azerbaijan	8,686	4,539
Loans and advances to banks in OECD countries	<u>2,713</u>	<u>553</u>
	11,399	5,092
Less minimum reserve deposit with the National Bank of Azerbaijan	<u>(1,770)</u>	<u>(1,217)</u>
Total cash and cash equivalents	<u><b>9,629</b></u>	<u><b>3,875</b></u>

#### 12. DUE FROM BANKS

Due from banks comprise:

	<b>31 December 2007</b>	<b>31 December 2006</b>
Correspondent accounts with other banks	11,818	5,334
Loans to banks	<u>3</u>	<u>3</u>
Total loans and advances to banks	<u><b>11,821</b></u>	<u><b>5,337</b></u>

Included in due from banks is accrued interest in the amount of AZN 22 thousand and nil as at 31 December 2007 and 2006, respectively.

As at 31 December 2007 and 2006 the Bank had due from 1 bank, which individually exceeded 10 % of the Bank's equity.

As at 31 December 2007 and 2006 maximum credit risk exposure of due from banks amounted to AZN 11,821 thousand and AZN 5,337 thousand, respectively.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

### 13. LOANS TO CUSTOMERS

Loans to customers comprise:

	<b>31 December 2007</b>	<b>31 December 2006</b>
Originated loans	49,639	24,684
Less allowance for impairment losses	<u>(1,421)</u>	<u>(556)</u>
Total loans to customers, net	<u><b>48,218</b></u>	<u><b>24,128</b></u>

Included in loans to customers is accrued interest in the amount of AZN 994 thousand and AZN 696 thousand as at 31 December 2007 and 2006, respectively.

Movements in allowances for impairment losses for the years ended 31 December 2007 and 2006 are disclosed in Note 5.

The table below summarizes the amount of loans secured by collateral, rather than the fair value of the collateral itself:

	<b>31 December 2007</b>	<b>31 December 2006</b>
Loans collateralized by real estate	33,059	15,086
Loans collateralized by vehicles	7,605	5,079
Loans collateralized by guarantees	3,827	1,045
Loans collateralized by deposits	1,067	1,203
Loans collateralized by others	594	86
Loans collateralized by securities	469	417
Loans collateralized by inventories	425	722
Unsecured loans	<u>1,172</u>	<u>490</u>
Total loans to customers, net	<u><b>48,218</b></u>	<u><b>24,128</b></u>

	<b>31 December 2007</b>	<b>31 December 2006</b>
<b>Analysis by industry</b>		
Individuals	14,902	6,743
Construction	14,205	5,650
Trading	11,949	6,816
Manufacturing	3,287	2,526
Agriculture	2,682	2,053
Other	<u>1,193</u>	<u>340</u>
Total loans to customers, net	<u><b>48,218</b></u>	<u><b>24,128</b></u>

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

Loans to individuals comprise the following products:

	31 December 2007	31 December 2006
Car loans	6,967	4,833
Mortgage loans	3,435	-
Consumer loans	568	68
Plastic cards	446	214
Other	3,486	1,628
<b>Total loans to individuals, net</b>	<b>14,902</b>	<b>6,743</b>

As at 31 December 2007 and 2006 the Bank had loans to 3 and 2 customers totaling AZN 6,976 thousand and AZN 3,466 thousand, respectively, which individually exceeded 10% of the Bank's equity.

As at 31 December 2007 and 2006 maximum credit risk exposure of loans to customers amounted to AZN 48,218 thousand and AZN 24,128 thousand, respectively.

As at 31 December 2007 and 2006 loans to customers included loans in amount of AZN 1,256 thousand and AZN 2,083 thousand, respectively, whose terms have been renegotiated. Otherwise these loans would be past due or impaired.

As at 31 December 2007 and 2006 loans to customers included loans in amount of AZN 6,598 thousand and AZN 7,866 thousand, respectively that were individually determined to be impaired.

## 14. INVESTMENTS AVAILABLE-FOR-SALE

Investments available-for-sale comprise:

	Interest to nominal %	31 December 2007	Interest to nominal %	31 December 2006
<b>Debt securities</b>				
<i>National Bank of the Republic of Azerbaijan</i>	9.99%	1,000	-	-
<i>National Bank of the Republic of Azerbaijan</i>	6.80%	1,000	-	-
<i>National Bank of the Republic of Azerbaijan</i>	11.28%	478	-	-
<i>National Bank of the Republic of Azerbaijan</i>	11.15%	924	-	-
<i>National Bank of the Republic of Azerbaijan</i>	-	-	12.99%	646
<b>Total debt securities available-for-sale</b>		<b>3,402</b>		<b>646</b>

Included in investments available-for-sale is accrued discount receivable in the amount of AZN 7 thousand and AZN 1 thousand as at 31 December 2007 and 2006, respectively.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

### 15. PROPERTY AND EQUIPMENT

	Buildings	Furniture and office equipment	Computer equipment	Vehicles	Other fixed assets	Construction in progress	Total
<b>At revalued cost</b>							
31 December 2005	1,608	257	120	11	7	-	2,003
Additions	2,031	226	70	266	8	15	2,616
Revaluation	671	-	-	-	-	-	671
31 December 2006	4,310	483	190	277	15	15	5,290
Additions	2,488	295	110	39	9	71	3,012
Disposals	-	(7)	(2)	(10)	-	-	(19)
Transfers	87	-	-	-	(1)	(86)	-
31 December 2007	6,885	771	298	306	23	-	8,283
<b>Accumulated depreciation</b>							
31 December 2005	(151)	(72)	(46)	(11)	(1)	-	(281)
Charge for the year	(88)	(72)	(35)	(28)	(2)	-	(225)
Eliminated on revaluation	230	-	-	-	-	-	230
31 December 2006	(9)	(144)	(81)	(39)	(3)	-	(276)
Charge for the year	(227)	(117)	(53)	(58)	(4)	-	(459)
Disposals	-	7	2	3	-	-	12
31 December 2007	(236)	(254)	(132)	(94)	(7)	-	(723)
<b>Net book value</b>							
31 December 2007	<b>6,649</b>	<b>517</b>	<b>166</b>	<b>212</b>	<b>16</b>	<b>-</b>	<b>7,560</b>
31 December 2006	<b>4,301</b>	<b>339</b>	<b>109</b>	<b>238</b>	<b>12</b>	<b>15</b>	<b>5,014</b>

As at 31 December 2007 and 2006 included in property and equipment were fully depreciated assets of AZN 46 thousand and AZN 36 thousand, respectively.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) *(in New Azerbaijan Manats and in thousands)*

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### 16. OTHER ASSETS

Other assets comprise:

	31 December 2007	31 December 2006
Settlements on money transfer systems	388	194
Intangible assets	84	88
Prepayments for supplies and services	79	29
Plastic cards settlements	19	21
	<u>570</u>	<u>332</u>
Total other assets	<u><u>570</u></u>	<u><u>332</u></u>

Intangible assets include software and licenses.

	<b>Intangible assets</b>
<b>At cost</b>	
31 December 2005	100
Additions	<u>11</u>
31 December 2006	111
Additions	<u>7</u>
31 December 2007	<u>118</u>
<b>Accumulated amortization</b>	
31 December 2005	12
Charge for the year	<u>11</u>
31 December 2006	23
Charge for the year	<u>11</u>
31 December 2007	<u>34</u>
<b>Net book value</b>	
31 December 2007	<u><u>84</u></u>
31 December 2006	<u><u>88</u></u>

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

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

Loans from banks and other financial institutions comprise:

	<b>31 December 2007</b>	<b>31 December 2006</b>
Demand deposits	11,538	1,776
Loans from National Fund for Support of Entrepreneurs	9,657	7,987
Loans from other banks and financial institutions	9,054	2,833
Loans from NBA	4,800	100
Loan from National Mortgage Fund	1,878	-
	<u>36,927</u>	<u>12,696</u>
Total loans from banks and other institutions	<u><b>36,927</b></u>	<u><b>12,696</b></u>

Included in loans from banks and other financial institutions is accrued interest in the amount of AZN 55 thousand and AZN 2 thousand as at 31 December 2007 and 2006, respectively.

### 18. CUSTOMER ACCOUNTS

Customer accounts comprise:

	<b>31 December 2007</b>	<b>31 December 2006</b>
Time deposits	18,063	10,287
Demand deposits	3,320	3,390
Security deposits	3,299	2,899
	<u>24,682</u>	<u>16,576</u>
Total customer accounts	<u><b>24,682</b></u>	<u><b>16,576</b></u>

Included in customer accounts is accrued interest in the amount of AZN 458 thousand and AZN 261 thousand as at 31 December 2007 and 2006, respectively.

As at 31 December 2007 and 2006 customer accounts of AZN 2,896 thousand (12%) and AZN 1,148 thousand (7%), respectively, were due to 2 customers, which represents significant concentration.

	<b>31 December 2007</b>	<b>31 December 2006</b>
<b>Analysis by sector:</b>		
Individuals	19,974	12,033
Insurance	2,667	1,438
Trade	1,246	2,171
Construction	543	586
Manufacturing	100	192
Transport and communications	48	94
Agriculture	2	37
Other	102	25
	<u>24,682</u>	<u>16,576</u>
Total customer accounts	<u><b>24,682</b></u>	<u><b>16,576</b></u>

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) *(in New Azerbaijan Manats and in thousands)*

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### 19. DEBT SECURITIES ISSUED

Debt securities issued represent unsecured notes issued by the Bank on the Latvian Stock Exchange and amounted to 5,000,000 USD with a face value of 1,000 USD and a maturity date of 26 June 2010 with annual fixed coupon rate equal to 13.5%. Note holders have the right to demand repayment of principal prior to maturity (put option) on 26 June 2009. There are no restrictions regarding sale and purchase of the notes in the secondary market.

### 20. OTHER LIABILITIES

Other liabilities comprise:

	<b>31 December 2007</b>	<b>31 December 2006</b>
Payables under finance lease	197	158
Accrued expenses	121	35
Provisions on other transactions	56	9
Taxes other than income tax payable	36	14
Settlements payable	36	9
Other creditors	7	40
	<hr/>	<hr/>
Total other liabilities	<b>453</b>	<b>265</b>

The future minimum lease payments under finance leases of fixed assets are as follows:

	<b>31 December 2007</b>	<b>31 December 2006</b>
Less than one year	132	87
Later than one year not later than five years	102	106
More than 5 years	-	-
	<hr/>	<hr/>
Total minimum lease payments	234	193
Less: deferred finance expenses	(37)	(35)
	<hr/>	<hr/>
Net payables under finance lease	<b>197</b>	<b>158</b>
	<hr/>	<hr/>
Current portion	113	64
Long-term portion	84	94
	<hr/>	<hr/>
Net payables under finance lease	<b>197</b>	<b>158</b>

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) *(in New Azerbaijan Manats and in thousands)*

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### 21. SHARE CAPITAL

As at 31 December 2007 and 2006 authorized, issued and paid-in share capital consisted of 55,000 and 39,000 ordinary shares with par value of AZN 200 each. All shares are ranked equally and carry one vote.

The below table provides a reconciliation of the number of shares outstanding as at 31 December 2007 and 2006:

	<b>Ordinary shares</b>
31 December 2005	27,000
Issue of shares	<u>12,000</u>
31 December 2006	39,000
Issue of shares	<u>16,000</u>
<b>31 December 2007</b>	<b><u><u>55,000</u></u></b>

In 2007 and 2006 the Bank declared dividends of AZN 804 thousand and AZN 30 thousand on ordinary shares for 2006 and 2005 financial years, respectively.

### 22. FINANCIAL COMMITMENTS AND CONTINGENCIES

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 Bank's maximum exposure to credit loss under contingent liabilities and commitments to extend credit, in the event of non-performance by the other party where all counterclaims, collateral or security prove valueless, is represented by the contractual amounts of those instruments.

The Bank uses the same credit control and management policies in undertaking off-balance sheet commitments as it does for on-balance operations.

Provision for losses on contingent liabilities amounted to AZN 56 thousand and AZN 9 thousand as at 31 December 2007 and 2006, respectively.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

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As at 31 December 2007 and 2006 the nominal or contract amounts were:

	31 December 2007	31 December 2006
<b>Contingent liabilities and credit commitments</b>		
Guarantees issued and similar commitments	2,082	5,150
Letters of credit	495	-
Commitments on loans and unused credit lines	<u>223</u>	<u>469</u>
 Total contingent liabilities and credit commitments	 <u><b>2,800</b></u>	 <u><b>5,619</b></u>

As at 31 December 2007 and 2006 included in commitments on loans and unused credit lines are AZN 223 thousand and AZN 469 thousand, respectively, representing the Bank's commitments to extend loans within unused credit line limits that are conditioned on the following: a borrower has to apply to the Bank each time it wants to extend its borrowings within preliminary unused; and the Bank may approve the extension of finance based on a borrower's financial performance, debt service and other credit risk characteristics.

**Capital commitments** - The Bank had no material commitments for capital expenditures outstanding as at 31 December 2007.

**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.

The Bank is receiving claims from individual customers with respect to certain commissions withheld by the Bank for loan agreements service. The NBA issued an instruction requiring banks to disclose effective interest rates on loans granted to individuals. Management is of the opinion that such claims would not have adverse consequences for the Bank, and is in the process of establishing procedures on disclosing additional information in loan agreements in compliance with the NBA instruction.

**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.

**Operating environment** - The Bank's principal business activities are within Azerbaijan. Laws and regulations affecting the business environment in 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.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

### 23. TRANSACTIONS WITH RELATED PARTIES

Related parties or transactions with related parties, as defined by IAS 24 “Related party disclosures”, represent:

- (a) Parties that directly, or indirectly through one or more intermediaries: control, or are controlled by, or are under common control with, the Bank (this includes parents, subsidiaries and fellow subsidiaries); have an interest in the Bank that gives them significant influence over the Bank; and that have joint control over the Bank;
- (b) Associates – enterprises on which the Bank has significant influence and which is neither a subsidiary nor a joint venture of the investor;
- (c) Members of key management personnel of the Bank or its parent;
- (d) Close members of the family of any individuals referred to in (a) or (c);
- (e) Parties that are entities controlled, jointly controlled or significantly influenced by, or for which
- (f) significant voting power in such entity resides with, directly or indirectly, any individual referred to in (c) or (d); or
- (g) Post-employment benefit plans for the benefit of employees of the Bank, or of any entity that is a related party of the Bank.

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:

	31 December 2007		31 December 2006	
	Related party transactions	Total category as per financial statements caption	Related party transactions	Total category as per financial statements caption
Loans to customers, gross		49,639		24,684
- <i>shareholders and entities in which a substantial interest is owned by the shareholders of the Bank</i>	140		71	
- <i>key management personnel</i>	473		83	
Allowance for loans to customers		1,421		556
- <i>shareholders and entities in which a substantial interest is owned by the shareholders of the Bank</i>	3		1	
- <i>key management personnel</i>	9		2	
Customer accounts		24,682		16,576
- <i>shareholders and entities in which a substantial interest is owned by the shareholders of the Bank</i>	9		55	
- <i>key management personnel</i>	257		186	
Other liabilities		453		265
- <i>shareholders and entities in which a substantial interest is owned by the shareholders of the Bank</i>	-		-	
- <i>key management personnel</i>	-		17	



# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

### 24. SEGMENT REPORTING

#### Business segments

The Bank is organized on the basis of two main business segments:

- Retail banking – representing private banking services, private customer current accounts, savings, deposits, investment savings products, custody, credit and debit cards, consumer loans and mortgages.
- Corporate banking – representing direct debit facilities, current accounts, deposits, overdrafts, loan and other credit facilities, foreign currency and derivative products.

There are no other material items of income or expense between the business segments. Internal charges and transfer pricing adjustments have been reflected in the performance of each business. Revenue sharing agreements are used to allocate external customer revenues to a business segment on a reasonable basis.

Segment information about these businesses is presented below.

	Retail banking	Corporate banking	Unallocated	31 December 2007/ Year ended 31 December 2007 Total
Interest income	3,937	2,597	248	6,782
Interest expense	(2,197)	(1,050)	-	(3,247)
Provision for impairment losses on interest bearing assets	(672)	(193)	-	(865)
Net gain on foreign exchange operations	-	-	3	3
Fee and commission income	883	1,205	-	2,088
Fee and commission expense	-	(288)	-	(288)
Net loss on sale of investments available-for- sale	-	-	(2)	(2)
Operating income	1,951	2,271	249	4,471
Operating expenses	(1,293)	(1,505)	(165)	(2,963)
Provision for impairment losses on other transactions	-	(47)	-	(47)
Profit before income tax	658	719	84	1,461
Income tax expense	-	-	(312)	(312)
Net profit	<b>658</b>	<b>719</b>	<b>(228)</b>	<b>1,149</b>
Segment assets	<b>15,309</b>	<b>36,718</b>	<b>28,230</b>	<b>80,257</b>
Segment liabilities	<b>20,010</b>	<b>9,287</b>	<b>37,061</b>	<b>66,358</b>

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

	Retail banking	Corporate banking	Unallocated	31 December 2006/ Year ended 31 December 2006 Total
Interest income	1,789	1,704	129	3,622
Interest expense	(1,118)	(403)	-	(1,521)
Provision for impairment losses on interest bearing assets	(435)	(185)	-	(620)
Net loss on foreign exchange operations	-	-	(58)	(58)
Fee and commission income	643	865	-	1,508
Fee and commission expense	-	(144)	-	(144)
Net loss on sale of investments available-for- sale	-	-	(3)	(3)
Other income	-	61	-	61
Operating income	879	1,898	68	2,845
Operating expenses	(546)	(1,178)	(42)	(1,766)
Provision for impairment losses on other transactions	-	(2)	-	(2)
Profit before income tax	333	718	26	1,077
Income tax expense	-	-	(248)	(248)
Net profit	<b>333</b>	<b>718</b>	<b>(222)</b>	<b>829</b>
Segment assets	<b>6,958</b>	<b>18,031</b>	<b>15,007</b>	<b>39,996</b>
Segment liabilities	<b>12,042</b>	<b>4,543</b>	<b>13,049</b>	<b>29,634</b>

The Bank conducts its activities only within the Republic of Azerbaijan and major parts of its revenue and net profit arrives from operations in the Republic of Azerbaijan.

## 25. FAIR VALUE OF FINANCIAL INSTRUMENTS

Estimated fair value disclosures of financial instruments are 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 forced or liquidation sale. 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:

## OPEN JOINT STOCK COMPANY MUGANBANK

### NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

	31 December 2007		31 December 2006	
	Carrying value	Fair value	Carrying value	Fair value
Cash and balances with the National Bank of the Republic of Azerbaijan	8,686	8,686	4,539	4,539
Due from banks	11,821	11,821	5,337	5,337
Investments available-for-sale	3,402	3,402	646	646
Loans from banks and other financial institutions	36,927	36,927	12,696	12,696
Customer accounts	24,682	24,682	16,576	16,576
Debt securities issued	4,162	4,162	-	-
Payable under finance lease	197	197	158	158

## 26. REGULATORY MATTERS

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios of total (5%) and tier 1 capital (10%) to risk weighted assets.

The ratio was calculated according to the principles employed by the Basle 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 Azerbaijani Manats
20%	Loans and advances to banks for up to 1 year
100%	Loans and advances to customers (excluding mortgage loans for residential purposes which are at 50%)
100%	Other assets
100%	Obligations and commitments on unused loans with the initial maturity of over 1 year
50%	year
100%	Guarantees

As at 31 December 2007 the Banks's total capital amount for Capital Adequacy purposes was AZN 13,641 thousand and tier 1 capital amount was AZN 12,939 thousand with ratios of 23% and 22%, respectively.

As at 31 December 2006 the Banks's total capital amount for Capital Adequacy purposes was AZN 10,096 thousand and tier 1 capital amount was AZN 9,934 thousand with ratios of 29% and 27%, respectively.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) *(in New Azerbaijan Manats and in thousands)*

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### 27. CAPITAL MANAGEMENT

The Bank manages its capital to ensure that Bank will be able to continue as a going concern while maximising the return to stakeholders through the optimisation of the debt and equity balance.

The capital structure of the Bank consists of equity attributable to equity holders of the parent, comprising issued capital, reserves and retained earnings as disclosed in consolidated statement of changes in equity.

The Management Board reviews the capital structure on a semi-annual basis. As a part of this review, the Board considers the cost of capital and the risks associated with each class of capital. Based on recommendations of the Board, the Bank balances its overall capital structure through the payment of dividends, new share issues as well as the issue of new debt or the redemption of existing debt.

The Bank's overall capital risk management policy remains unchanged from 2006.

### 28. RISK MANAGEMENT POLICIES

Management of risk is fundamental to the Bank's 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 risk
- Liquidity risk
- Market risk.

The Bank recognizes that it is essential to have efficient and effective risk management processes in place. To enable this, the Bank has established a risk management framework, whose main purpose is to protect the Bank from risk and allow it to achieve its performance objectives. Through the risk management framework, the Bank manages the risks the following risks:

#### **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.

Risk management and monitoring is performed within set limits of authority, by the Credit Committees and the Bank's Management Board. Before any application is made by the Credit Committee, all recommendations on credit processes (borrower's limits approved, or amendments made to loan agreements, etc.) are reviewed and approved by the branch risk-manager or the Risk Management Department. Daily risk management is performed by the Head of Credit Departments and Branch

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

### Credit divisions

The Bank structures the level of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, or groups of borrowers, and to industry (and geographical) segments. Limits on the level of credit risk by a borrower and a product (by industry sector, by region) are approved quarterly by the Management Board. The exposure to any one borrower including banks and brokers is further restricted by sub-limits covering on and off-balance sheet exposures which are set by the Credit Committee. Actual exposures against limits are monitored daily.

Where appropriate, and in the case of most loans, the Bank obtains collateral and corporate and personal guarantees but a significant portion is personal lending, where no such facilities can be obtained. Such risks are monitored on a continuous basis and subject to annual or more frequent reviews.

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 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 a loss in an amount equal to the total unused commitments. However, the likely amount of the 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 off balance sheet contingencies because longer term commitments generally have a greater degree of credit risk than short-term commitments.

### Maximum Exposure

The Banks maximum exposure to credit risk varies significantly and is dependant on both individual risks and general market economy risks.

The following table presents the maximum exposure to credit risk of financial assets and contingent liabilities. For financial assets the maximum exposure equals to a carrying value of those assets prior to any offset or collateral. For financial guarantees and other contingent liabilities the maximum exposure to credit risk is the maximum amount the Bank would have to pay if the guarantee was called on or in the case of commitments, if the loan amount was called on.

	<b>Maximum exposure</b>	<b>Offset</b>	<b>Net exposure after offset</b>	<b>Collateral Pledged</b>	<b>31 December 2007 Net exposure after offset and collateral</b>
Due from banks	11,821	-	11,821	-	11,821
Loans to customers	48,218	1,388	46,830	45,687	1,143
Investments available-for-sale	3,402	-	3,402	-	3,402

  

	<b>Maximum exposure</b>	<b>Offset</b>	<b>Net exposure after offset</b>	<b>Collateral Pledged</b>	<b>31 December 2006 Net exposure after offset and collateral</b>
Due from banks	5,337	-	5,337	-	5,337
Loans to customers	24,128	1,183	22,945	22,385	560
Investments available-for-sale	646	-	646	-	646

## OPEN JOINT STOCK COMPANY MUGANBANK

### NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED)

(in New Azerbaijan Manats and in thousands)

Financial assets are graded according to the current credit rating they have been issued by an internationally regarded agency. The highest possible rating is AAA. Investment grade financial assets have ratings from AAA to BBB. Financial assets which have ratings lower than BBB are classed as speculative grade.

The following table details the credit ratings of financial assets held by the Bank:

							<b>31 December 2007</b>
	<b>AAA</b>	<b>AA</b>	<b>A</b>	<b>BBB</b>	<b>&gt;BBB</b>	<b>Not rated</b>	<b>Total</b>
Due from banks	-	-	2,647	-	1,757	7,417	11,821
Loans to customers	-	-	-	-	-	48,218	48,218
Investments available-for-sale	-	-	-	-	3,402	-	3,402

							<b>31 December 2006</b>
	<b>AAA</b>	<b>AA</b>	<b>A</b>	<b>BBB</b>	<b>&gt;BBB</b>	<b>Not rated</b>	<b>Total</b>
Due from banks	-	-	553	-	4,148	636	5,337
Loans to customers	-	-	-	-	-	24,128	24,128
Investments available-for-sale	-	-	-	-	646	-	646

The Bank has developed internal rating model, which allow it to determine the rating of counterparties. The rating of corporate borrower is based on an analysis of the financial ratios of the borrower, and an analysis of the market and industry sector, in which the borrower operates. The model also takes into consideration various qualitative factors, such as management efficiency and borrower's market share.

The application of the internal rating model results in a standardized approach in the analysis of corporate borrowers and provides a quantitative assessment of the creditworthiness of a borrower that does not have a rating from an international rating agency. The model takes into account specific local market conditions.

The quality of the internal rating model is examined on a regular basis through an assessment of both its effectiveness and validity. The Bank revises the model when deficiencies are identified.

The Bank applies internal rating methodologies to specific corporate loans and groups of retail and small business loans, which incorporate various underlying master scales that are different from that used by international rating agencies. As a result, it is not possible to make a cross-product score comparison which would agree to the outstanding balance of loans to customers per the balance sheet. As such, more detailed information is not being presented.

The banking industry is generally exposed to credit risk through its financial assets and contingent liabilities. Credit risk exposure of the Bank is concentrated within Azerbaijan. The exposure is monitored on a regular basis to ensure that the credit limits and credit worthiness guidelines established by the Bank's risk management policy are not breached.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

The following table details the carrying value of assets that are impaired and the ageing of those that are past due but not impaired:

	Financial assets past due but not impaired					31 December 2007	
	Neither past due nor impaired	0-3 months	3-6 months	6 months to 1 year	Greater than one year	Financial assets that have been written down as a result of an impairment loss	Total
Due from banks	11,821	-	-	-	-	-	11,821
Loans to customers	15,234	-	-	-	-	32,984	48,218
Investments available-for-sale	3,402	-	-	-	-	-	3,402

	Financial assets past due but not impaired					31 December 2006	
	Neither past due nor impaired	0-3 months	3-6 months	6 months to 1 year	Greater than one year	Financial assets that have been written down as a result of an impairment loss	Total
Due from banks	5,337	-	-	-	-	-	5,337
Loans to customers	7,623	-	-	-	-	16,505	24,128
Investments available-for-sale	646	-	-	-	-	-	646

### Geographical concentration

The ALMC exercises control over the risk in the legislation and regulatory arena and assesses its influence on the Bank's activity. This approach allows the Bank to minimize potential losses from the investment climate fluctuations in Azerbaijan.

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

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

	Azerbaijan	Other non-OECD countries	OECD countries	31 December 2007 Total
<b>ASSETS</b>				
Cash and balances with the National Bank of Azerbaijan	8,686	-	-	8,686
Due from banks	8,967	141	2,713	11,821
Investments available-for-sale	3,402	-	-	3,402
Loans to customers	48,218	-	-	48,218
Property and equipment	7,560	-	-	7,560
Other assets	184	386	-	570
<b>TOTAL ASSETS</b>	<b>77,017</b>	<b>527</b>	<b>2,713</b>	<b>80,257</b>
<b>LIABILITIES</b>				
Loan from banks and other financial institutions	33,215	429	3,283	36,927
Customer accounts	24,682	-	-	24,682
Debt securities issued	-	3,456	706	4,162
Current income tax payable	134	-	-	134
Deferred income tax liability	258	-	-	258
Other liabilities	417	36	-	453
<b>TOTAL LIABILITIES</b>	<b>58,706</b>	<b>3,921</b>	<b>3,989</b>	<b>66,616</b>
<b>NET POSITION</b>	<b>18,311</b>	<b>(3,394)</b>	<b>(1,276)</b>	

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

	Azerbaijan	Other non-OECD countries	OECD countries	31 December 2006 Total
<b>ASSETS</b>				
Cash and balances with the National Bank of Azerbaijan	4,539	-	-	4,539
Due from banks	4,453	331	553	5,337
Investments available-for-sale	646	-	-	646
Loans to customers	24,128	-	-	24,128
Property and equipment	5,014	-	-	5,014
Other assets	332	-	-	332
<b>TOTAL ASSETS</b>	<b>39,112</b>	<b>331</b>	<b>553</b>	<b>39,996</b>
<b>LIABILITIES</b>				
Loan from banks and other financial institutions	12,696	-	-	12,696
Customer accounts	16,509	67	-	16,576
Current income tax payable	97	-	-	97
Deferred income tax liability	266	-	-	266
Other liabilities	265	-	-	265
<b>TOTAL LIABILITIES</b>	<b>29,833</b>	<b>67</b>	<b>-</b>	<b>29,900</b>
<b>NET POSITION</b>	<b>9,279</b>	<b>264</b>	<b>553</b>	

### 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.

The Assets and Liabilities Management Committee (“ALMC”) controls these types of risks by means of maturity analysis, determining the Bank’s strategy for the next financial period. Current liquidity is managed by the Treasury Department, which deals in the money markets for current liquidity support and cash flow optimisation.

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

An analysis of the liquidity and interest rate risks is presented in the following table. The tables have been drawn up to detail:

(i) The remaining contractual maturity of non-derivative financial liabilities based on the undiscounted cash flows of financial liabilities (both interest and principal cash flows) based on the earliest date on which the Bank can be required to pay, and

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

(ii) The expected maturity for non-derivative financial assets based on the undiscounted contractual maturities of the financial assets including interest that will be earned on those assets except where the Bank anticipates that the cash flow will occur in a different period.

	Weighted average effective interest rate	Up to 1 month	1 month to 3 months	3 month to 1 year	1 year to 5 years	Over 5 years	31 December 2007 Total
<b>ASSETS</b>							
Due from banks	12.80%	72	144	7,423	-	-	7,639
Loans to customers	18.37%	3,971	5,832	22,510	24,241	2,591	59,145
Investments available-for-sale	8.41%	3,419	-	-	-	-	3,419
Total interest bearing assets at fixed rates		7,462	5,976	29,933	24,241	2,591	70,203
Due from banks	4.78%	2,671	-	-	-	-	2,671
Total interest bearing assets at variable rates		2,671	-	-	-	-	2,671
Total interest bearing assets		10,133	5,976	29,933	24,241	2,591	72,874
Cash and balances with NBA		8,686	-	-	-	-	8,686
Due from banks		2,385	-	-	-	-	2,385
Other assets		407	-	-	-	-	407
<b>TOTAL ASSETS</b>		<b>21,611</b>	<b>5,976</b>	<b>29,933</b>	<b>24,241</b>	<b>2,591</b>	<b>84,352</b>
<b>LIABILITIES</b>							
Loans from banks other financial institutions	6.39%	9,932	564	12,704	14,597	1,801	39,598
Customer accounts	14.72%	6,121	2,054	10,094	5,930	-	24,199
Debt securities issued	14.84%	-	-	577	5,082	-	5,659
Total interest bearing liabilities at fixed rates		16,053	2,618	23,375	25,609	1,801	69,456
Total interest bearing liabilities		16,053	2,618	23,375	25,609	1,801	69,456
Loans from banks and other financial institutions		3	-	-	-	-	3
Customer accounts		3,320	-	-	-	-	3,320
Income tax payable		-	134	-	-	-	134
Other liabilities		36	157	132	102	-	427
Guarantees issued		604	209	1,148	121	-	2,082
Commitments on loans and unused credit lines		-	-	223	-	-	223
<b>TOTAL LIABILITIES</b>		<b>20,016</b>	<b>3,118</b>	<b>24,878</b>	<b>25,832</b>	<b>1,801</b>	<b>75,645</b>
Liquidity gap		1,595	2,858	5,055	(1,591)	790	
Interest sensitivity gap for fixed rate instruments		(8,591)	3,358	6,558	(1,368)	790	
Interest sensitivity gap for variable rate instruments		2,671	-	-	-	-	
Interest sensitivity gap		(5,920)	3,358	6,558	(1,368)	790	
Cumulative interest sensitivity gap		<b>(5,920)</b>	<b>(2,562)</b>	<b>3,996</b>	<b>2,628</b>	<b>3,418</b>	

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

	Weighted average effective interest rate	Up to 1 month	1 month to 3 months	3 month to 1 year	1 year to 5 years	Over 5 years	31 December 2006 Total
<b>ASSETS</b>							
Due from banks	8.00%	2,824	-	-	-	-	2,824
Loans to customers	18.46%	1,837	1,373	6,321	20,624	-	30,155
Investments available-for-sale	12.99%	649					649
Total interest bearing assets at fixed rates		5,310	1,373	6,321	20,624	-	33,628
Total interest bearing assets		5,310	1,373	6,321	20,624	-	33,628
Cash and balances with NBA		4,539	-	-	-	-	4,539
Due from banks		2,519	-	-	-	-	2,519
Other assets		215	-	-	-	-	215
<b>TOTAL ASSETS</b>		<b>12,583</b>	<b>1,373</b>	<b>6,321</b>	<b>20,624</b>	<b>-</b>	<b>40,901</b>
<b>LIABILITIES</b>							
Loans from banks other financial institutions	9.12%	2,451	101	497	8,823	199	12,071
Customer accounts	14.62%	2,748	942	6,218	4,707	-	14,615
Total interest bearing liabilities at fixed rates		5,199	1,043	6,715	13,530	199	26,686
Total interest bearing liabilities		5,199	1,043	6,715	13,530	199	26,686
Loans from banks other financial institutions		1,776	-	-	-	-	1,776
Customer accounts		3,390	-	-	-	-	3,390
Current income tax payable		-	97	-	-	-	97
Other liabilities		9	49	87	106	-	251
Guarantees issued		741	1,435	2,401	573	-	5,150
Commitments on loans and unused credit lines		-	-	469	-	-	469
<b>TOTAL LIABILITIES</b>		<b>11,115</b>	<b>2,624</b>	<b>9,672</b>	<b>14,209</b>	<b>199</b>	<b>37,819</b>
Liquidity gap		1,468	(1,251)	(3,351)	6,415	(199)	
Interest sensitivity gap for fixed rate instruments		111	330	(394)	7,094	(199)	
Interest sensitivity gap for variable rate instruments		-	-	-	-	-	
Interest sensitivity gap		111	330	(394)	7,094	(199)	
Cumulative interest sensitivity gap		<b>111</b>	<b>441</b>	<b>47</b>	<b>7,141</b>	<b>6,942</b>	

### Market Risk

Market risk covers interest rate risk, currency risk and other pricing risks to which the Bank is exposed. There have been no changes as to the way the Bank measures risk or to the risk it is exposed in 2007.

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.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) *(in New Azerbaijan Manats and in thousands)*

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### Interest rate risk

The Bank manages fair value interest rate risk through periodic estimation of potential losses that could arise from adverse changes in market conditions. The Department of Financial Control 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.

The following table presents a sensitivity analysis of interest rate risk, which has been determined based on "reasonably possible changes in the risk variable". The level of these changes is determined by management and is contained within the risk reports provided to key management personnel.

Impact on profit before tax:

	As at 31 December 2007		As at 31 December 2006	
	Interest rate +1%	Interest rate -1%	Interest rate +1%	Interest rate -1%
<b>Assets:</b>				
Due from banks	94	(94)	28	(28)
Loans to customers	486	(486)	240	(240)
Investments available-for-sale	34	(34)	6	(6)
<b>Liabilities:</b>				
Loan from banks and other financial institutions	(330)	330	-	-
Customer accounts	(176)	176	(100)	100
Debt securities issued	(42)	42	-	-
<b>Net impact on profit before tax</b>	<b>66</b>	<b>(66)</b>	<b>174</b>	<b>(174)</b>

### 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 ALMC controls currency risk by management of the open currency position on the estimated basis of AZN devaluation and other macroeconomic indicators, which gives the Bank an opportunity to minimize losses from significant currency rates fluctuations toward its national currency. The Treasury Department performs daily monitoring of the Bank's open currency position with the aim to match the requirements of NBA.

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

The Bank's exposure to foreign currency exchange rate risk is presented in the table below:

	AZN	USD USD 1 = 0.8453 AZN	EUR EUR 1 = 1.2450 AZN	Other currency	31 December 2007 Total
<b>ASSETS</b>					
Cash and balances with the National Bank of Azerbaijan	7,203	1,365	32	86	8,686
Due from banks	-	10,435	1,365	21	11,821
Investments available-for-sale	3,402	-	-	-	3,402
Loans to customers	29,659	18,501	58	-	48,218
Property and equipment	7,560	-	-	-	7,560
Other assets	184	352	-	34	570
<b>TOTAL ASSETS</b>	<b>48,008</b>	<b>30,653</b>	<b>1,455</b>	<b>141</b>	<b>80,257</b>
<b>LIABILITIES</b>					
Loan from banks and other financial institutions	21,188	14,192	1,547	-	36,927
Customer accounts	12,819	11,422	436	5	24,682
Debt securities issued	-	4,162	-	-	4,162
Current income tax payable	134	-	-	-	134
Deferred income tax liability	258	-	-	-	258
Other liabilities	294	108	50	1	453
<b>TOTAL LIABILITIES</b>	<b>34,693</b>	<b>29,884</b>	<b>2,033</b>	<b>6</b>	<b>66,616</b>
<b>OPEN BALANCE SHEET POSITION</b>	<b>13,315</b>	<b>769</b>	<b>(578)</b>	<b>135</b>	

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) (in New Azerbaijan Manats and in thousands)

	AZN	USD USD 1 = 0.8714 AZN	EUR EUR 1 = 1.1471 AZN	Other currency	31 December 2006 Total
<b>ASSETS</b>					
Cash and balances with the National Bank of Azerbaijan	3,547	969	9	14	4,539
Due from banks	-	5,309	8	20	5,337
Investments available-for-sale	646	-	-	-	646
Loans to customers	16,279	7,775	74	-	24,128
Property and equipment	5,014	-	-	-	5,014
Other assets	136	196	-	-	332
<b>TOTAL ASSETS</b>	<b>25,622</b>	<b>14,249</b>	<b>91</b>	<b>34</b>	<b>39,996</b>
<b>LIABILITIES</b>					
Loan from banks and other financial institutions	8,088	4,608	-	-	12,696
Customer accounts	7,187	9,070	299	20	16,576
Current income tax payable	97	-	-	-	97
Deferred income tax liability	266	-	-	-	266
Other liabilities	109	105	47	4	265
<b>TOTAL LIABILITIES</b>	<b>15,747</b>	<b>13,783</b>	<b>346</b>	<b>24</b>	<b>29,900</b>
<b>OPEN BALANCE SHEET POSITION</b>	<b>9,875</b>	<b>466</b>	<b>(255)</b>	<b>10</b>	

### Currency risk sensitivity

The following table details the Bank's Sensitivity to a 10% increase and decrease in the USD and EUR against the AZN. 10% is the sensitivity rate used when reporting foreign currency risk internally to key management personnel and represents management's assessment of the possible change in foreign currency exchange rates. The sensitivity analysis includes only outstanding foreign currency denominated monetary items and adjusts their translation at the end of the period for a 10% change in foreign currency rates. The sensitivity analysis includes external loans as well as loans to foreign operations within the Bank where the denomination of the loan is in a currency other than the currency of the lender or the borrower.

	As at 31 December 2007		As at 31 December 2006	
	AZN/USD +10%	AZN/USD -10%	AZN/USD +10%	AZN/USD -10%
Impact on profit or loss	77	(77)	46	(46)
	As at 31 December 2007		As at 31 December 2006	
	AZN/EUR +10%	AZN/EUR -10%	AZN/EUR +10%	AZN/EUR -10%
Impact on profit or loss	(57)	57	(26)	26

# OPEN JOINT STOCK COMPANY MUGANBANK

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2007 (CONTINUED) *(in New Azerbaijan Manats and in thousands)*

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### **Limitations of sensitivity analysis**

The above tables demonstrate the effect of a change in a key assumption while other assumptions remain unchanged. In reality, there is a correlation between the assumptions and other factors. It should also be noted that these sensitivities are non-linear, and larger or smaller impacts should not be interpolated or extrapolated from these results.

The sensitivity analyses do not take into consideration that the Bank's assets and liabilities are actively managed. Additionally, the financial position of the Bank may vary at the time that any actual market movement occurs. For example, the Bank's financial risk management strategy aims to manage the exposure to market fluctuations. As investment markets move past various trigger levels, management actions could include selling investments, changing investment portfolio allocation and taking other protective action. Consequently, the actual impact of a change in the assumptions may not have any impact on the liabilities, whereas assets are held at market value on the balance sheet. In these circumstances, the different measurement bases for liabilities and assets may lead to volatility in shareholder equity.

Other limitations in the above sensitivity analyses include the use of hypothetical market movements to demonstrate potential risk that only represent the Bank's view of possible near-term market changes that cannot be predicted with any certainty; and the assumption that all interest rates move in an identical fashion.

### **Other price risks**

The Bank is exposed to equity price risks arising from equity investments. Equity investments are held for strategic rather than trading purposes. Equity investments form insignificant part of the Bank's investment portfolio.