

# **Commercial Bank MUGAN**

**Independent Auditors' Report and**

**Financial Statements**

Year Ended 31 December 2004

# COMMERCIAL BANK MUGAN

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## INDEPENDENT AUDITORS' REPORT

To the Owners and the Board of Directors of Commercial Bank Mugan:

We have audited the accompanying balance sheet of Commercial Bank Mugan (hereinafter - the "Bank") as of 31 December 2004 and the related profit and loss account and statements of cash flows and changes in owners' equity for the year ended 31 December 2004. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Bank as of 31 December 2004, and the results of its operations and its cash flows for the year then ended, in accordance with International Financial Reporting Standards.



8 June 2005

# COMMERCIAL BANK MUGAN

## PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 2004 (in Azerbaijan Manats and in thousands)

	Notes	2004	2003
Interest income	4, 19	8,609,810	4,598,701
Interest expense	4, 19	<u>(2,061,246)</u>	<u>(1,299,137)</u>
NET INTEREST INCOME BEFORE PROVISION FOR LOAN LOSSES		6,548,564	3,299,564
Provision for loan losses	5	<u>(6,298,487)</u>	<u>(5,544,774)</u>
NET INTEREST INCOME/(EXPENSE)		<u>250,077</u>	<u>(2,245,210)</u>
Net (loss)/gain on foreign exchange operations	6	(134,440)	920,108
Fees and commission income	7	5,569,202	5,136,164
Fees and commission expense	7	(395,560)	(319,366)
Other income		<u>14</u>	<u>27,657</u>
NET NON-INTEREST INCOME		<u>5,039,216</u>	<u>5,764,563</u>
OPERATING INCOME		5,289,293	3,519,353
Provision for losses on other transactions	5	(335,544)	-
OPERATING EXPENSES	8, 19	<u>(3,658,204)</u>	<u>(2,036,087)</u>
PROFIT BEFORE INCOME TAX		1,295,545	1,483,266
Income tax expense	9	<u>(341,237)</u>	<u>(171,500)</u>
NET PROFIT		<u><u>954,308</u></u>	<u><u>1,311,766</u></u>

**On behalf of the Management Board**

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**Chairman**

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**Financial Director**

The notes on pages 7 to 32 form an integral part of these financial statements. The Independent Auditors' Report is presented on page 1.

# COMMERCIAL BANK MUGAN

## BALANCE SHEET AS OF 31 DECEMBER 2004 (in Azerbaijan Manats and in thousands)

	Notes	2004	2003
<b>ASSETS</b>			
Cash and balances with the National Bank of Azerbaijan	10	2,799,396	3,553,270
Advances to banks, less allowance for loan losses	11	13,612,756	7,248,438
Loans and advances to customers, less allowance for loan losses	12,19	58,178,478	37,715,272
Securities available for sale		41,433	42,279
Investments in unconsolidated associate	13	1,715,000	-
Fixed and intangible assets, less accumulated depreciation	14	9,206,525	1,262,593
Other assets		131,784	32,206
<b>TOTAL ASSETS</b>		<b>85,685,372</b>	<b>49,854,058</b>
<b>LIABILITIES AND OWNERS' EQUITY</b>			
<b>LIABILITIES:</b>			
Deposits and loans from banks and other institutions	15	42,278,703	21,377,615
Customer accounts	16,19	19,254,823	13,368,754
Current income tax liabilities	9	223,708	1,978
Deferred income tax liabilities	9	23,098	36,702
Allowance for losses on other transactions	5	299,698	-
Other liabilities		80,034	43,212
<b>Total liabilities</b>		<b>62,160,064</b>	<b>34,828,261</b>
<b>OWNERS' EQUITY:</b>			
Owners' capital	17	21,938,000	14,392,797
Revenue reserves		1,587,308	633,000
<b>Total owners' equity</b>		<b>23,525,308</b>	<b>15,025,797</b>
<b>TOTAL LIABILITIES AND OWNERS' EQUITY</b>		<b>85,685,372</b>	<b>49,854,058</b>
<b>FINANCIAL COMMITMENTS AND CONTINGENCIES</b>	18	<b>14,247,198</b>	<b>11,857,045</b>

**On behalf of the Management Board**

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

\_\_\_\_\_  
**Financial Director**

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## COMMERCIAL BANK MUGAN

### STATEMENT OF CHANGES IN OWNERS' EQUITY FOR THE YEAR ENDED 31 DECEMBER 2004 (in Azerbaijan Manats and in thousands)

	<b>Owners' capital</b>	<b>Revenue reserves/ (Accumulated deficit)</b>	<b>Total owners' equity</b>
<b>31 December 2002</b>	11,960,808	(678,766)	11,282,042
Increase in owners' capital	2,431,989	-	2,431,989
Net profit	-	1,311,766	1,311,766
<b>31 December 2003</b>	14,392,797	633,000	15,025,797
Increase in owners' capital	7,545,203	-	7,545,203
Net profit	-	954,308	954,308
<b>31 December 2004</b>	<u>21,938,000</u>	<u>1,587,308</u>	<u>23,525,308</u>

On behalf of the Management Board

\_\_\_\_\_  
Chairman

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Financial Director

The notes on pages 7 to 32 form an integral part of these financial statements. The Independent Auditors' Report is presented on page 1.

# COMMERCIAL BANK MUGAN

## STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2004

(in Azerbaijan Manats and in thousands unless otherwise stated)

	Notes	2004	2003
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Profit before income taxes		1,295,545	1,483,266
Adjustments for:			
Provision for loan losses		6,298,487	5,544,774
Write-off of loans		(8,721,445)	(3,075,756)
Recovery of loans previously written-off		710,470	31,083
Provision for investment losses		35,846	-
Depreciation and amortization		292,831	89,114
Net change in accruals		<u>(108,443)</u>	<u>(582,882)</u>
Cash flow from operating activities before changes in operating assets and liabilities		(196,709)	3,489,599
Changes in operating assets and liabilities			
(Increase)/decrease in operating assets:			
Minimum reserve deposit with the National Bank of		(417,746)	(95,478)
Advances to banks and other institutions		(10,434,282)	2,405,551
Loans and advances to customers		(18,444,987)	(31,839,198)
Other assets		(99,578)	12,894
Increase/(decrease) in operating liabilities:			
Deposits and loans from banks and other institutions		20,952,867	19,172,937
Customer accounts		5,841,729	8,668,627
Other liabilities		<u>336,520</u>	<u>27,472</u>
Cash inflow from operating activities before income taxes		(2,462,186)	1,842,404
Income tax paid		<u>(133,111)</u>	<u>(144,091)</u>
Net cash (outflow)/inflow from operating activities		<u>(2,595,297)</u>	<u>1,698,313</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchase of fixed and intangible assets		(8,236,763)	(447,409)
Investments in associates		<u>(1,750,000)</u>	<u>-</u>
Net cash outflows from investing activities		<u>(9,986,763)</u>	<u>(447,409)</u>

# COMMERCIAL BANK MUGAN

## STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2004

*(in Azerbaijan Manats and in thousands unless otherwise stated)*

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### CASH FLOWS FROM FINANCING ACTIVITIES:

Increase in owners' capital		<u>7,545,203</u>	<u>2,431,989</u>
Net cash inflows from financing activities		<u>7,545,203</u>	<u>2,431,989</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS		(5,036,857)	3,682,893
CASH AND CASH EQUIVALENTS AT BEGINNING OF THE	10	<u>7,632,178</u>	<u>3,949,285</u>
CASH AND CASH EQUIVALENTS AT END OF THE PERIOD	10	<u><u>2,595,321</u></u>	<u><u>7,632,178</u></u>

Interest paid and received by the Bank in cash during the year ended 31 December 2004 amounted to AZM 2,068,685 thousand and AZM 8,508,806 thousand, respectively. Interest paid and received by the Bank in cash during the year ended 31 December 2003 amounted to AZM 1,159,470 thousand and AZM 3,876,152 thousand, respectively.

**On behalf of the Management Board**

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**Chairman**

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**Financial Director**

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# COMMERCIAL BANK MUGAN

## NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2004

*(in Azerbaijan Manats and in thousands unless otherwise stated)*

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### 1. ORGANISATION

Commercial Bank Mugan (“the Bank”) is a limited liability partnership, which was founded in the Azerbaijan Republic in 1992. The address of its registered office is 4, 28 May Street, Baku, Azerbaijan. The Bank is regulated by the National Bank of the Azerbaijan Republic (the “NBA”) and conducts its business under general license for banking activities and foreign currency operations # 29 issued on 25 November 1992 and renewed by the letter # 02-10/508 on 10 November 2000. The Bank had 14 and 13 branches in Azerbaijan as of 31 December 2004 and 2003, 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 number of employees of the Bank as of 31 December 2004 and 2003 was 177 and 158, respectively.

As of 31 December 2004 and 2003 the following individuals and legal entities owned the Bank:

Owner	2004 Ownership interest, %	2003 Ownership interest, %
Mehdiyev Elmir	73.30	-
Mehdiyev Maqbet	9.49	9.60
Veliyeva Vefa	9.35	6.60
Mehdiyeva Farida	4.44	-
Mugan Insurance	3.42	-
Other individuals	-	73.88
Other legal entities	-	9.92
Total	<u>100</u>	<u>100</u>

These financial statements were authorized for issue by the Management Board on 8 June 2005.

### 2. BASIS OF PRESENTATION

**Accounting basis** - These financial statements of the Bank have been prepared in accordance with International Financial Reporting Standards (“IFRS”). These financial statements are presented in thousands of Azerbaijan Manats (“AZM”), unless otherwise indicated. These financial statements are prepared on the accrual basis under the historical cost convention modified for the measurement at fair value of available for sale investment securities.

The Bank maintains its accounting records in accordance with Azerbaijan law which in majority complies with IFRS. These financial statements have been prepared from the Azerbaijan statutory accounting records and have been adjusted to conform to IFRS.

The preparation of financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates that are particularly susceptible to change relate to the provisions for losses on loans and impairment and the fair value of financial instruments.

**Measurement currency** - The measurement currency of these financial statements is the Azerbaijan Manat ("AZM").

### 3. SIGNIFICANT ACCOUNTING POLICIES

**Investments in unconsolidated associates** - an associate is an entity over which the Bank is in a position to exercise significant influence, but not control or joint control, through participation in the financial and operating policy decisions of the investee. Investments in corporate shares where the Bank owns more than 20% of share capital, but does not have ability or intent to control or exercise significant influence over operating and financial policies, or non-consolidation of such companies does not significantly affect the financial statements of the Bank as a whole, are accounted for at fair value or at approximate fair value. If such value cannot be estimated, investments are accounted for at cost. Management periodically assesses the realisability of the carrying values of such investments and provides valuation allowances, if necessary.

**Recognition and measurement of financial instruments** - The Bank recognizes financial assets and liabilities on its balance sheet when, and only when, it becomes a party to the contractual provisions of the instrument. Regular way purchases and sales of the financial assets and liabilities are recognized using settlement date accounting.

Financial assets and liabilities are initially recognized at cost, which is the fair value of the consideration given or received, respectively, including or net of any transaction costs incurred, respectively. 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 unrestricted balances on correspondent and time deposit accounts with the National Bank of Azerbaijan with an original maturity within 90 days, advances to banks in countries included in the Organization for Economic Co-operation and Development ("OECD"), except for margin deposits for operations with plastic cards. For the purposes of determining cash flows, the minimum reserve deposit required by the National Bank of Azerbaijan is not included as a cash equivalent due to restrictions on its availability (Note 10).

**Loans and advances to banks** - In the normal course of business, the Bank maintains advances or deposits for various periods of time with other banks. Advances to banks do not have fixed maturities and are carried at cost net of any allowance for losses.

**Originated loans** - Loans originated by the Bank are financial assets that are created by the Bank by providing money directly to a borrower.

Loans granted by the Bank are initially recognized in accordance with the policy stated below. The difference between the nominal amount of consideration given and the amortized cost of loans issued at lower than market terms is recognized in the period the loan is issued as an initial recognition adjustment discounted using market rates at inception and included in the profit and loss account as losses on origination of assets. Subsequently, the carrying amount of such loans is adjusted for amortization of the losses on origination and the related income is recorded as interest income within the profit and loss account using the effective interest method. Loans to customers that do not have fixed maturities are carried at cost. Loans to customers are carried net of any allowance for loan losses.

***Write off of loans*** - Loans are written off against the allowance for loan losses in the case of the uncollectibility of loans and advances, including through repossession of collateral. In accordance with the statutory legislation, loans may only be written off with the approval of the owners and, in certain cases, with the respective decision of the Court.

***Non-accrual loans*** - Loans are placed on a non-accrual status when interest or principal is delinquent for a period in excess of 90 days, except when all amounts due are fully secured by cash or marketable securities and collection proceedings are in process. Interest income is not recognized if recovery is doubtful. Subsequent payments by borrowers are applied to either principal or delinquent interest based on individual arrangements with the borrower. A non-accrual loan is restored to accrual status when all principal and interest amounts contractually due are reasonably assured of repayment within a reasonable period.

***Allowance for losses*** - The Bank establishes an allowance for losses of financial assets when it is probable that the Bank will not be able to collect the principal and interest according to the contractual terms of the financial assets, which are carried at cost or amortized cost. The allowance for losses is defined as the difference between the carrying amounts and the present value of expected future cash flows, including amounts recoverable from guarantees and collateral.

The determination of the allowance for 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 inherent in the risk assets. Provisions are made as a result of a detailed appraisal of risk assets.

The change in the allowance for losses is charged to profit and the total of the allowance for losses is deducted in arriving at assets as shown in balance sheet. Management's evaluation of the allowance is based upon the Bank's past loss experience, known and inherent risks in the risk assets, adverse situations that may affect the debtor's ability to repay, the estimated value of any underlying collateral and current economic conditions.

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

***Securities available for sale*** - Securities available for sale represent debt and equity investments that are intended to be held for an indefinite period of time. Such securities are initially recorded at cost which approximates the fair value of the consideration given. Subsequently the securities are measured at fair value, with such re-measurement included in the profit and loss account, plus accrued coupon income. The Bank uses quoted market prices to determine fair value for the Bank's securities available for sale. If such quotes do not exist, management estimation is used. Realised and unrealised gains and losses arising from changes in the fair value of securities available-for-sale are included in the profit and loss account as interest income on investment securities. Dividends received are included in dividend income in the profit and loss account.

**Fixed and intangible assets** - Fixed and intangible assets are carried at historical cost less accumulated depreciation and any accumulated impairment loss. Depreciation of fixed and intangible assets is designed to write off assets over their useful economic lives and is calculated on a straight line basis at the following annual rates:

	<b>31 December 2004</b>
Buildings	5%
Furniture and fixtures	20%
Computer equipment	25%
Vehicles	20%
Other fixed assets	20%
Intangible assets	10%

**Impairment loss** - If the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset is reduced to its recoverable value. The difference being an impairment loss is recognized as an expense in the profit and loss account for the year in which it arises.

**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 profit and loss account because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Bank's current tax expense is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

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

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

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

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

**Deposits from banks and customers** - Customers and bank deposits are initially recognized at cost, which amounts to the issue proceeds less transaction costs incurred. Subsequently amounts due are stated at amortized cost and any difference between net proceeds and the redemption value is recognized in the profit and loss account over the period of the borrowings using the effective interest method.

**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.

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

**Retirement and other benefit obligations** - The Bank does not incur any expenses in relation to provision of pensions to its employees. In accordance with the legal requirements of Azerbaijan, the Bank withholds pension contributions from employee salaries and transfers them into separate pension fund. Current contributions by the Bank are calculated as a percentage of current gross salary payments with the expense charged in the period in which the related salaries are earned. Upon retirement of employees, all pension payments are administered by the above pension fund.

**Contingencies** - Contingent liabilities are not recognized in the financial statements unless it is probable that an outflow of resources will be required to settle the obligation and a reliable estimate can be made. A contingent asset is not recognized in the financial statements but disclosed when an inflow of economic benefits is probable.

**Recognition of income and expense** - Interest income and expense are recognized on an accrual basis calculated using the effective yield method. The recognition of interest income is suspended when loans become overdue by more than 90 days. Interest income also includes interest income earned on investment and trading securities. Commissions and other income are credited to income when the related transactions are completed.

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

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

	<b>31 December 2004</b>	<b>31 December 2003</b>
AZM/USD	4,903	4,923
AZM/EUR	6,682	6,195

**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.

#### 4. NET INTEREST INCOME

Net interest income comprises:

	2004	2003
<b>Interest income</b>		
Interest on loans and advances to customers	8,385,626	4,163,527
Interest on advances to banks	156,343	381,977
Other interest income	<u>67,841</u>	<u>53,197</u>
Total interest income	<u><b>8,609,810</b></u>	<u><b>4,598,701</b></u>
<b>Interest expense</b>		
Interest on customer accounts	1,031,531	567,539
Interest on deposits and loans from banks and other institutions	<u>1,029,715</u>	<u>731,598</u>
Total interest expense	<u>2,061,246</u>	<u>1,299,137</u>
Net interest income before provision for loan losses	<u><b>6,548,564</b></u>	<u><b>3,299,564</b></u>

#### 5. ALLOWANCE FOR LOSSES

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

	Loans and advances to customers	Loans and advances to banks	Investment securities	Total
31 December 2002	(2,373,921)	(102,668)	-	(2,476,589)
(Provision)/Recovery	(5,592,827)	48,053	-	(5,544,774)
Write-offs of assets	3,075,756	-	-	3,075,756
Recoveries of assets previously written off	<u>(31,083)</u>	<u>-</u>	<u>-</u>	<u>(31,083)</u>
31 December 2003	(4,922,075)	(54,615)	-	(4,976,690)
(Provision)/Recovery	(6,093,760)	(204,727)	(35,846)	(6,334,333)
Write-offs of assets	8,721,445	-	-	8,721,445
Recoveries of assets previously written off	<u>(710,470)</u>	<u>-</u>	<u>-</u>	<u>(710,470)</u>
31 December 2004	<u><u>(3,004,860)</u></u>	<u><u>(259,342)</u></u>	<u><u>(35,846)</u></u>	<u><u>(3,300,048)</u></u>

Allowances for losses on assets are deducted from the related assets.

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

	<b>Guarantees and other commitments</b>
31 December 2003	-
(Provision)	<u>(299,698)</u>
31 December 2004	<u><u>(299,698)</u></u>

Allowances for losses on other transactions are included into liabilities.

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

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

	<b>2004</b>	<b>2003</b>
Dealing, net	598,844	845,681
Translation differences, net	<u>(733,284)</u>	<u>74,427</u>
<b>Total net (loss)/gain on foreign exchange operations</b>	<u><b>(134,440)</b></u>	<u><b>920,108</b></u>

## 7. FEES AND COMMISSION INCOME AND EXPENSE

Fees and commission income and expense comprise:

	<b>2004</b>	<b>2003</b>
<b>Fees and commission income:</b>		
Cash operations	2,564,920	2,409,732
Settlements	2,028,290	2,144,562
Foreign exchange operations	741,025	471,023
Other operations	<u>234,967</u>	<u>110,847</u>
Total fees and commission income	<u><b>5,569,202</b></u>	<u><b>5,136,164</b></u>
	<b>2004</b>	<b>2003</b>
<b>Fees and commission expense:</b>		
Settlements	225,475	308,410
Cash operations	130,657	-
Foreign exchange operations	487	-
Other operations	<u>38,941</u>	<u>10,956</u>
Total fees and commission expense	<u><b>395,560</b></u>	<u><b>319,366</b></u>

## 8. OPERATING EXPENSES

Operating expenses comprise:

	2004	2003
Salary and bonuses	1,537,740	1,054,228
Communication	343,993	232,269
Depreciation of fixed and intangible assets	292,831	89,114
Rent	258,759	71,915
Payroll taxes and social security costs	232,759	87,195
Professional services fees	177,312	-
Premises security	172,454	69,680
Office supplies	152,156	212,951
Taxes other than income tax	101,991	8,209
Advertising and marketing	96,190	84,964
Utilities	42,701	-
Repairs and maintenance expenses	32,379	19,945
Business travel	21,251	22,902
Other	195,688	82,715
<b>Total operating expenses</b>	<b><u>3,658,204</u></b>	<b><u>2,036,087</u></b>

## 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 which may differ from International Financial Reporting Standards. During the years ended 31 December 2004 and 2003, Azerbaijan's tax rate for corporations' profits was 24% and 25%, respectively.

Tax assets and liabilities consist of the following:

	2004	2003
Current income tax liabilities	(223,708)	(1,978)
Deferred income tax liabilities	<u>(23,098)</u>	<u>(36,702)</u>
Income tax liabilities	<b><u>(246,806)</u></b>	<b><u>(38,680)</u></b>

The Bank is subject to certain permanent tax differences due to the non-deductibility of certain expenses under local tax regulations.

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 of 31 December 2004 and 2003 relate mostly to different methods of income and expense recognition as well as to recorded values of certain assets.



Temporary differences as of 31 December 2004 and 2003 comprise:

	<b>2004</b>	<b>2003</b>
<b>Deferred assets:</b>		
Loans to banks	-	54,615
	<u>-</u>	<u>54,615</u>
Total deferred assets	<u>-</u>	<u>54,615</u>
<b>Deferred liabilities:</b>		
Fixed assets	(96,242)	(123,295)
Loans to customers	-	(84,244)
	<u>-</u>	<u>(84,244)</u>
Total deferred liabilities	<u>(96,242)</u>	<u>(207,539)</u>
Net deferred liabilities	<u><b>(96,242)</b></u>	<u><b>(152,924)</b></u>
Deferred income tax liability at statutory rate 24% (2003: 25%)	<u><b>(23,098)</b></u>	<u><b>(36,702)</b></u>

Relationships between tax expenses and accounting profit for the year ended 31 December 2004 and 2003 are explained as follows:

	<b>2004</b>	<b>2003</b>
Profit before income taxes	<u><b>1,295,545</b></u>	<u><b>1,483,266</b></u>
Statutory tax rate	24%	25%
Theoretical tax at the statutory tax rate	310,931	370,817
Tax effect of permanent differences	30,306	(200,846)
Effect of changes in income tax rate	-	1,529
	<u>-</u>	<u>1,529</u>
Income tax expense	<u><b>341,237</b></u>	<u><b>171,500</b></u>
Current income tax expense	354,841	134,798
Deferred income tax (benefit)/expense	<u>(13,604)</u>	<u>36,702</u>
Income tax expense	<u><b>341,237</b></u>	<u><b>171,500</b></u>
<b>Deferred income tax liabilities</b>		
At beginning of the period	(36,702)	-
Decrease/(Increase) in deferred income tax liabilities for the period	<u>13,604</u>	<u>(36,702)</u>
At end of the period	<u><b>(23,098)</b></u>	<u><b>(36,702)</b></u>

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

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

	<b>2004</b>	<b>2003</b>
Cash on hand	1,366,285	1,567,980
Balances with the National Bank of Azerbaijan	<u>1,433,111</u>	<u>1,985,290</u>
Total cash and balances with the National Bank of Azerbaijan	<u><b>2,799,396</b></u>	<u><b>3,553,270</b></u>

The balances with the NBA as of 31 December 2004 and 2003 include AZM 913,953 thousand and AZM 496,207 thousand, respectively, which represent the minimum reserve deposits required by the NBA. The Bank is required to maintain the reserve balance at the NBA at all times.

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

	<b>2004</b>	<b>2003</b>
Cash and balances with the National Bank of Azerbaijan	2,799,396	3,553,270
Advances to banks in OECD countries	<u>709,878</u>	<u>4,575,115</u>
	3,509,274	8,128,385
Less minimum reserve deposit with the National Bank of Azerbaijan	<u>(913,953)</u>	<u>(496,207)</u>
Total cash and cash equivalents	<u><b>2,595,321</b></u>	<u><b>7,632,178</b></u>

## 11. ADVANCES TO BANKS, LESS ALLOWANCE FOR LOAN LOSSES

Advances to banks comprise:

	<b>2004</b>	<b>2003</b>
Advances to banks	13,872,098	7,303,053
Less allowance for loan losses	<u>(259,342)</u>	<u>(54,615)</u>
Total advances to banks, net	<u><b>13,612,756</b></u>	<u><b>7,248,438</b></u>

Movements in allowances for loan losses for the years ended 31 December 2004 and 2003 are disclosed in Note 5.

As of 31 December 2004 the Bank had 2 loans and advances totalling AZM 12,948,823 thousand, which individually exceeded 10% of the Bank’s equity.

## 12. LOANS AND ADVANCES TO CUSTOMERS, LESS ALLOWANCE FOR LOAN LOSSES

Loans and advances to customers comprise:

	2004	2003
Originated loans	60,162,582	41,717,595
Accrued interest income on loans and advances to customers	1,020,756	919,752
	<u>61,183,338</u>	<u>42,637,347</u>
Less allowance for loan losses	(3,004,860)	(4,922,075)
	<u>58,178,478</u>	<u>37,715,272</u>
Loans collateralized by corporate guarantees	971,594	11,015,092
Loans collateralized by real estate	19,607,809	8,525,743
Loans collateralized by bank guarantees	4,143,035	7,977,080
Loans collateralized by inventories	20,706,128	6,291,124
Loans collateralized by vehicles	184,721	4,083,317
Loans collateralized by deposits	3,171,998	1,325,085
Unsecured loans	10,523,717	652,168
Loans collateralized by equipment	-	247,090
Loans collateralized by securities	780,035	-
Loans collateralized by others	73,545	1,600,896
Accrued interest income on loans and advances to customers	1,020,756	919,752
	<u>61,183,338</u>	<u>42,637,347</u>
Less allowance for loan losses	(3,004,860)	(4,922,075)
	<u>58,178,478</u>	<u>37,715,272</u>

Movements in allowances for loan losses for the years ended 31 December 2004 and 2003 are disclosed in Note 5.

As of 31 December 2004 and 2003 included in loans and advance to customers are non-accrual loans amounting to AZM 927,966 thousand and AZM 2,527,087 thousand, respectively, on which interest was not accrued.

Analysis by industry	2004	2003
Individuals	30,145,933	30,931,937
Trading	10,200,664	3,360,155
Manufacturing	9,317,746	3,321,641
Agriculture	3,256,392	2,686,712
Construction	6,364,480	1,142,150
Transportation	-	275,000
Other	877,367	-
Accrued interest income on loans and advances to customers	1,020,756	919,752
	<u>61,183,338</u>	<u>42,637,347</u>
Less allowance for loan losses	(3,004,860)	(4,922,075)
	<u>58,178,478</u>	<u>37,715,272</u>

### 13. INVESTMENTS IN UNCONSOLIDATED ASSOCIATE

	Held %	2004	Held %	2003
Mugan Sigorta Insurance Co.	26.67%	1,750,000	-	-
Allowance for investment losses	-	<u>(35,000)</u>	-	<u>-</u>
		<u><b>1,715,000</b></u>		<u><b>-</b></u>

The investment in Mugan Sigorta Insurance Co. has not been consolidated with the results of the Bank, nor accounted for under the equity method, as the Bank does not execute control or significant influence over the associate and the effect would not materially alter the financial position of the Bank as of 31 December 2004 or the results of its operations or cash flows of the Bank for the period then ended.

### 14. FIXED AND INTANGIBLE ASSETS, LESS ACCUMULATED DEPRECIATION

	Buildings	Furniture and fixtures	Computer equipment	Vehicles	Other fixed assets	Intangible assets	Total
<b>At cost</b>							
31 December 2003	1,180,000	109,504	156,140	54,780	45,644	70,023	1,616,091
Additions	6,860,000	799,309	327,198	-	9,899	240,357	8,236,763
Transfers	-	54,265	(9,472)	-	(44,793)	-	-
31 December 2004	<u>8,040,000</u>	<u>963,078</u>	<u>473,866</u>	<u>54,780</u>	<u>10,750</u>	<u>310,380</u>	<u>9,852,854</u>
<b>Accumulated depreciation</b>							
31 December 2003	183,714	67,425	60,452	34,669	2,107	5,131	353,498
Charge for the year	168,914	57,732	41,761	10,956	451	13,017	292,831
Transfers	-	3,551	(1,666)	-	(1,780)	(105)	-
31 December 2004	<u>352,628</u>	<u>128,708</u>	<u>100,547</u>	<u>45,625</u>	<u>778</u>	<u>18,043</u>	<u>646,329</u>
<b>Net book value</b>							
31 December 2004	<u><b>7,687,372</b></u>	<u><b>834,370</b></u>	<u><b>373,319</b></u>	<u><b>9,155</b></u>	<u><b>9,972</b></u>	<u><b>292,337</b></u>	<u><b>9,206,525</b></u>
<b>Net book value</b>							
31 December 2003	<u><b>996,286</b></u>	<u><b>42,079</b></u>	<u><b>95,688</b></u>	<u><b>20,111</b></u>	<u><b>43,537</b></u>	<u><b>64,892</b></u>	<u><b>1,262,593</b></u>

## 15. DEPOSITS AND LOANS FROM BANKS AND OTHER INSTITUTIONS

Deposits and loans from banks and other institutions comprise:

	<b>2004</b>	<b>2003</b>
Loans from banks	19,709,000	14,769,000
Amount due to the State Fund for Support of Entrepreneurs	9,058,033	4,739,900
Demand deposits	13,511,670	1,816,936
Accrued interest	-	51,779
	<u>42,278,703</u>	<u>21,377,615</u>
Total deposits from banks and other institutions	<u><b>42,278,703</b></u>	<u><b>21,377,615</b></u>

The Bank receives loans from the State Fund for Support of Entrepreneurs as a means of support of small and medium-sized entrepreneurs in Azerbaijan. Under the agreement with the Fund as of 31 December 2004 and 2003 the Bank obtained loans for AZM 9,058,033 thousand and AZM 4,739,900 thousand, respectively with maturity periods from 2 to 5 years and bearing annual interest rates ranging from 0.5% to 4%. Subsequently, these funds were used by the Bank to issue loans with the same maturity periods to the individual entrepreneurs in Azerbaijan at annual interest rates from 5% to 7%.

## 16. CUSTOMER ACCOUNTS

Customer accounts comprise:

	<b>2004</b>	<b>2003</b>
Time deposits	12,922,731	7,161,975
Repayable on demand	6,173,466	6,092,493
Accrued interest expense on customer accounts	158,626	114,286
	<u>19,254,823</u>	<u>13,368,754</u>
Total customer accounts	<u><b>19,254,823</b></u>	<u><b>13,368,754</b></u>

Analysis of customer accounts by industry:

	<b>2004</b>	<b>2003</b>
Individuals	12,317,690	7,776,254
Trade	3,816,725	3,636,321
Insurance	1,910,922	1,005,248
Construction	188,594	591,826
Energy and chemical	4,363	105,135
Agriculture	537,055	21,053
Manufacturing	132,619	9,857
Transport and communications	3,011	374
Other	185,218	108,400
Accrued interest expense on customer accounts	158,626	114,286
	<u>19,254,823</u>	<u>13,368,75</u>
Total customer accounts	<u><b>19,254,823</b></u>	<u><b>13,368,75</b></u>

## 17. OWNERS' CAPITAL

The owners' capital of the Bank has been contributed by the owners in both AZM and USD. Owners are entitled to dividends and capital distributions in the currency in which their contribution was made.

During 2004 and 2003 owners' capital of the Bank was increased by AZM 7,545,203 thousand and AZM 2,431,989 thousand, respectively.

As of 31 December 2004 and 2003 the Bank's owners' capital amounted to AZM 21,938,000 thousand and AZM 14,392,797 thousand, respectively, and comprised contributions made by individuals and legal entities, all of which were fully paid.

## 18. 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 sheet operations.

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

As of 31 December 2004 and 2003, the nominal or contract amounts and the risk weighted credit equivalents of instruments with off-balance sheet risks were:

	2004		2003	
	Nominal Amount	Risk Weighted Amount	Nominal Amount	Risk Weighted Amount
<b>Contingent liabilities and credit commitments</b>				
Guarantees issued and similar commitments	8,082,296	8,082,296	3,289,561	3,289,561
Commitments on credits and unused credit lines	6,164,902	-	8,567,484	-
Total contingent liabilities and credit commitments	<u>14,247,198</u>	<u>8,082,296</u>	<u>11,857,045</u>	<u>3,289,561</u>

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

**Capital commitments** - The Bank had no material commitments for capital expenditures outstanding as of 31 December 2004.

**Insurance** - As of 31 December 2004 and 2003 the Bank's fixed assets were insured for AZM 68,286 thousand and AZM 550,000 thousand, respectively.

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

**Taxes** - Due to the presence in Azerbaijan commercial legislation, and tax legislation in particular, of provisions allowing more than one interpretation, if a particular treatment based on management's judgment of the Bank's business activities was to be challenged by the tax authorities, the Bank may be assessed additional taxes, penalties and interest. The Bank believes that it has already made all tax payments, and therefore no allowance has been made in the financial statements. Tax years remain open to review by the tax authorities for three years.

**Pensions and retirement plans** - Employees receive pension benefits from the Republic of Azerbaijan in accordance with the laws and regulations of the country. As of 31 December 2004 and 2003, the Bank was not liable for any supplementary pensions, post-retirement health care, insurance benefits, or retirement indemnities to its current or former employees.

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

## 19. TRANSACTIONS WITH RELATED PARTIES

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

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

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:

	<b>Related party transactions</b>	<b>Total category as per financial statements caption</b>	<b>Related party transactions</b>	<b>Total category as per financial statements caption</b>
Loans to customers, gross	46,262	61,183,338	9,030	42,637,347
Allowance for loans to customers	<u>(925)</u>	<u>3,004,860)</u>	<u>(699)</u>	<u>(4,922,075)</u>
Loans to customers, net	<u><b>45,337</b></u>	<u><b>58,178,478</b></u>	<u><b>8,331</b></u>	<u><b>37,715,272</b></u>
Customer accounts	<u><b>1,221,998</b></u>	<u><b>19,254,823</b></u>	<u><b>543,030</b></u>	<u><b>13,368,754</b></u>

During the year ended 31 December 2004 and 2003 the Bank originated loans and advances to related party customers amounting to AZM 58,704 thousand and AZM 9,472 thousand, and received loans and advances repaid of AZM 21,472 thousand and AZM 3,965 thousand respectively. The Bank had interest income accrued in respect of loans and advances granted to related parties totaling AZM 26 thousand and AZM 70 thousand as of 31 December 2004 and 2003.

During the year ended 31 December 2004 and 2003 the Bank received deposits from related party customers of AZM 777,410 thousand and AZM 2,321,634 thousand and repaid deposits totaling AZM 98,442 thousand and AZM 2,287,748 thousand respectively.

Included in the profit and loss account for the year ended 31 December 2004 and 2003 are the following amounts which arose due to transactions with related parties:

	<b>2004</b>		<b>2003</b>	
	<b>Related party transactions</b>	<b>Total category as per financial statements caption</b>	<b>Related party transactions</b>	<b>Total category as per financial statements caption</b>
Interest income		8,609,810		4,598,701
- directors	1,266		329	
Interest expense		(2,061,246)		(1,299,137)
- directors	30,073		-	
- related companies	76,767		(93,806)	-
Operating expenses		(3,658,204)		(2,036,087)
- related companies	(468,286)	-	(672,040)	
- directors	-	-	(223,557)	

Transactions with related parties entered into by the Bank during the years ended 31 December 2004 2003 and outstanding as of 31 December 2004 and 2003 were made in the normal course of business and mostly under arm-length conditions.



## 20. FAIR VALUE OF FINANCIAL INSTRUMENTS

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

As of 31 December 2004 and 2003 the following methods and assumptions were used by the Bank to estimate the fair value of each class of financial instrument for which it is practicable to estimate such value:

***Cash and balances with the NBA*** - For these short-term instruments the management consider that the carrying amount is a reasonable estimate of fair value.

***Advances to banks*** - As of 31 December 2004 and 2003, the management consider that the carrying amount of short-term deposits and advances given is a reasonable estimate of their fair value.

***Loans and advances to customers*** - The fair value of the loan portfolio is based on the credit and interest rate characteristics of the individual loans within each sector of the portfolio. The estimation of the provision for loan losses includes consideration of risk premiums applicable to various types of loans based on factors such as the current situation of the economic sector in which each borrower operates, the economic situation of each borrower and guarantees obtained. Accordingly, the provision for loan losses is considered a reasonable estimate of the discount required to reflect the impact of credit risk.

***Securities available-for-sale*** - As of 31 December 2004 and 2003 equity investments are stated at fair value amounting to AZM 1,006,433 and AZM 42,279 thousand respectively. Since there is no active market for these securities and no market prices of securities with similar characteristics exist, management estimation was used.

***Deposits and loans from banks and other institutions*** - As of 31 December 2004 and 2003 the carrying amount of short-term deposits and deposits repayable on demand of AZM 33,329,109 thousand and AZM 16,637,715 thousand, respectively, is a reasonable estimate of their fair value. As of 31 December 2004 and 2003 long-term borrowings are stated at cost of AZM 8,949,600 thousand and AZM 4,739,900 thousand, respectively, which management considers approximates fair value.

***Customer accounts*** - As of 31 December 2004 and 2003 the carrying amount of short-term deposits and current accounts of the Bank’s customers of AZM 13,583,511 thousand and AZM 9,867,208 thousand, respectively, is a reasonable estimate of their fair value. As of 31 December 2004 and 2003 long-term customer accounts are stated at cost of AZM 5,512,686 thousand and AZM 3,387,260 thousand, respectively, which approximates fair value.

## 21. SUBSEQUENT EVENTS

On 15 January 2005 the Shareholders’ Meeting of the Bank approved the additional contribution of AZM 5,062,000 thousand into the capital of the Bank. The Bank was re-registered with the Ministry of Justice of Azerbaijan on 18 March 2005. In April 2005 the Bank was reorganized into an Open Joint Stock Company and issued 27,000 ordinary shares with a par value of AZM 1,000 thousand each.

## 22 REGULATORY MATTERS

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

The capital is calculated as the amount of restricted and free components of the shareholders' capital plus the Bank's provisions for the principal risks on the condition that the general provision for losses does not exceed 1.25% of the risk weighted assets.

The ratio was calculated according to the principles employed by the Basle Committee by applying the following risk estimates:

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

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

Capital amounts and ratios	Actual Amount in AZM thousand	For Capital Adequacy purposes Amount in AZM thousand	Ratio For Capital Adequacy purposes	Minimum Required Ratio
<b>As of 31 December 2004</b>				
Total capital	23,525,308	22,775,308	32%	8%
Tier 1 capital	23,525,308	23,525,308	33%	4%
<b>As of 31 December 2003</b>				
Total capital	15,025,797	15,440,135	47%	8%
Tier 1 capital	15,025,797	15,025,797	45%	4%

## 23 RISK MANAGEMENT POLICIES

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

The Bank manages the following risks:

### Liquidity risk

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

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

### Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect the value of the financial instruments. The following table presents an analysis of interest rate risk and thus the potential of the Bank for gain or loss. Effective interest rates are presented by categories of financial assets and liabilities to determine interest rate exposure and effectiveness of the interest rate policy used by the Bank.

	2004			2003		
	AZM	USD	Other currencies	AZM	USD	Other currencies
<b>ASSETS</b>						
Loans and advances to customers	8.82%	20.84%	24%	9.5%	18.2%	26.0%
<b>LIABILITIES</b>						
Deposits and loans from banks and other institutions	2.11%	1.79%	-	6.9%	3.2%	-
Customer accounts	7.82%	10.61%	10.33%	12.0%	11.7%	14.0%

The Bank receives loans from the State Fund for Support of Entrepreneurs as a means of support of small and medium-sized entrepreneurs in Azerbaijan. Under the agreement with the Fund as of 31 December 2004 and 2003 the Bank obtained loans for AZM 9,058,033 thousand and AZM 4,739,900 thousand, respectively with maturity periods from 2 to 5 years bearing the annual interest rates ranging from 0.5% to 4%. Subsequently, these funds were used by the Bank to issue loans with the same maturity periods to the individual entrepreneurs in Azerbaijan at annual interest rates from 5% to 7%. These rates are prescribed by the State Fund for Support of Entrepreneurs and the Bank cannot exceed them. These rates are significantly lower than market rates. This resulted in a decrease in the effective interest rates on loans and advances to customers granted in AZM and deposits from banks and other institutions.

As disclosed in the maturity analysis below, the maturity dates applicable to the majority of the Bank's assets and liabilities are relatively short-term. The Bank monitors its interest rate margin and consequently does not consider itself exposed to significant interest rate risk or consequential cash flow risk.

The following tables present an analysis of the liquidity risk on the balance sheet.

	Up to 1 month	1 month to 3 months	3 months to 1 year	1 year to 5 years	Over 5 years	Overdue	Maturity undefined (incl. allowance for losses and impairment)	2004 AZM thousand Total
<b>ASSETS</b>								
<b>Fixed interest bearing</b>								
Advances to banks, net	13,872,098	-	-	-	-	-	(259,342)	13,612,756
Loans and advances to customers, net	2,391,181	7,453,099	26,945,774	22,262,190	489,000	621,338	(3,004,860)	57,157,722
Total fixed interest bearing assets	<u>16,263,279</u>	<u>7,453,099</u>	<u>26,945,774</u>	<u>22,262,190</u>	<u>489,000</u>	<u>621,338</u>	<u>(3,264,202)</u>	<u>70,770,478</u>
Cash and balances with the NBA	2,799,396	-	-	-	-	-	-	2,799,396
Available for sale securities, net	-	-	-	-	42,279	-	(846)	41,433
Investments in associates, net	-	-	-	-	1,750,000	-	(35,000)	1,715,000
Interest accrued on interest bearing assets	465,027	500,715	-	-	-	55,014	-	1,020,756
Fixed and intangible assets, net	-	-	-	-	9,206,525	-	-	9,206,525
Other assets	131,784	-	-	-	-	-	-	131,784
Total non-interest bearing assets	<u>3,396,207</u>	<u>500,715</u>	<u>-</u>	<u>-</u>	<u>10,998,804</u>	<u>55,014</u>	<u>(35,846)</u>	<u>14,914,894</u>
<b>TOTAL ASSETS</b>	<b><u>19,659,486</u></b>	<b><u>7,953,814</u></b>	<b><u>26,945,774</u></b>	<b><u>22,262,190</u></b>	<b><u>11,487,804</u></b>	<b><u>676,352</u></b>	<b><u>(3,300,048)</u></b>	<b><u>85,685,372</u></b>
<b>LIABILITIES</b>								
Deposits and loans from banks and other institutions	13,511,670	11,333	19,806,100	8,949,600	-	-	-	42,278,703
Customer accounts	<u>2,110,937</u>	<u>1,102,930</u>	<u>4,196,178</u>	<u>5,512,686</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>12,922,731</u>
Total fixed interest rate bearing liabilities	<u>15,622,607</u>	<u>1,114,263</u>	<u>24,002,278</u>	<u>14,462,286</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>55,201,434</u>
Customer accounts	6,173,466	-	-	-	-	-	-	6,173,466
Interest accrued on interest bearing liabilities	158,626	-	-	-	-	-	-	158,626
Current income tax liabilities	223,708	-	-	-	-	-	-	223,708
Deferred income tax liabilities	-	-	-	23,098	-	-	-	23,098
Other liabilities	<u>379,732</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>379,732</u>
Total non-interest bearing liabilities	<u>6,935,532</u>	<u>-</u>	<u>-</u>	<u>23,098</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>6,958,630</u>
<b>TOTAL LIABILITIES</b>	<b><u>22,558,139</u></b>	<b><u>1,114,263</u></b>	<b><u>24,002,278</u></b>	<b><u>14,485,384</u></b>	<b><u>-</u></b>	<b><u>-</u></b>	<b><u>-</u></b>	<b><u>62,160,064</u></b>
Liquidity gap	<u>(2,898,653)</u>	<u>6,839,551</u>	<u>2,943,496</u>	<u>7,776,806</u>	<u>11,487,804</u>			
Interest sensitivity gap	<u>640,672</u>	<u>6,338,836</u>	<u>2,943,496</u>	<u>7,799,905</u>	<u>489,000</u>			
Cumulative interest sensitivity gap	<u>640,672</u>	<u>6,979,508</u>	<u>9,923,004</u>	<u>17,722,908</u>	<u>18,211,908</u>			
Cumulative interest sensitivity gap as a percentage of total assets	<u>1%</u>	<u>8%</u>	<u>12%</u>	<u>21%</u>	<u>21%</u>			

	Up to 1 month	1 month to 3 months	3 months to 1 year	1 year to 5 years	Over 5 years	Overdue	Maturity undefined (incl. allowance for losses and impairment)	2003 AZM thousand Total
<b>ASSETS</b>								
<b>Fixed interest bearing</b>								
Advances to banks, net	7,303,053	-	-	-	-	-	(54,615)	7,248,438
Loans and advances to customers, net	10,090,717	8,953,809	10,064,825	8,866,807	-	-	(992,022)	36,984,136
Total fixed interest bearing assets	<u>17,393,770</u>	<u>8,953,809</u>	<u>10,064,825</u>	<u>8,866,807</u>	<u>-</u>	<u>-</u>	<u>(1,046,637)</u>	<u>44,232,574</u>
Cash and balances with the NBA	3,553,270	-	-	-	-	-	-	3,553,270
Loans and advances to customers, net	-	-	-	-	-	3,741,437	(3,741,437)	-
Available for sale securities, net	-	-	-	-	42,279	-	-	42,279
Interest accrued on interest bearing assets	661,498	11,506	-	-	-	246,748	(188,616)	731,136
Fixed and intangible assets, net	-	-	-	201,415	1,061,178	-	-	1,262,593
Other assets	17,437	-	-	14,769	-	-	-	32,206
Total non-interest bearing assets	<u>4,232,205</u>	<u>11,506</u>	<u>-</u>	<u>216,184</u>	<u>1,103,457</u>	<u>3,988,185</u>	<u>(3,930,053)</u>	<u>5,621,484</u>
<b>TOTAL ASSETS</b>	<b><u>21,625,975</u></b>	<b><u>8,965,315</u></b>	<b><u>10,064,825</u></b>	<b><u>9,082,991</u></b>	<b><u>1,103,457</u></b>	<b><u>3,988,185</u></b>	<b><u>(4,976,690)</u></b>	<b><u>49,854,058</u></b>
<b>LIABILITIES</b>								
Deposits and loans from banks and other institutions	1,868,715	-	14,769,000	4,739,900	-	-	-	21,377,615
Customer accounts	469,938	364,302	2,940,475	3,387,260	-	-	-	7,161,975
Total fixed interest rate bearing liabilities	<u>2,338,653</u>	<u>364,302</u>	<u>17,709,475</u>	<u>8,127,160</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>28,539,590</u>
Customer accounts	6,092,493	-	-	-	-	-	-	6,092,493
Interest accrued on interest bearing liabilities	35,740	1,786	25,929	50,831	-	-	-	114,286
Current income tax liabilities	1,978	-	-	-	-	-	-	1,978
Deferred income tax liabilities	-	-	-	36,702	-	-	-	36,702
Other liabilities	43,212	-	-	-	-	-	-	43,212
Total non-interest bearing liabilities	<u>6,173,423</u>	<u>1,786</u>	<u>25,929</u>	<u>87,533</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>6,288,671</u>
<b>TOTAL LIABILITIES</b>	<b><u>8,512,076</u></b>	<b><u>366,088</u></b>	<b><u>17,735,404</u></b>	<b><u>8,214,693</u></b>	<b><u>-</u></b>	<b><u>-</u></b>	<b><u>-</u></b>	<b><u>34,828,261</u></b>
Liquidity gap	<u>13,113,899</u>	<u>8,599,227</u>	<u>(7,670,579)</u>	<u>868,298</u>	<u>1,103,457</u>			
Interest sensitivity gap	<u>15,055,117</u>	<u>8,589,507</u>	<u>(7,644,650)</u>	<u>739,647</u>	<u>-</u>			
Cumulative interest sensitivity	<u>15,055,117</u>	<u>23,644,624</u>	<u>15,999,974</u>	<u>16,739,621</u>	<u>16,739,621</u>			
Cumulative interest sensitivity gap as a percentage of total	<u>30%</u>	<u>47%</u>	<u>32%</u>	<u>34%</u>	<u>34%</u>			

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

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

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

### Currency risk

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

	<b>AZM</b>	<b>USD</b> 1 USD= AZM 4,903	<b>EUR</b> 1 EUR= AZM 6,682	<b>Other currencies</b>	<b>Currency undefined (incl. allowance for losses and impairment)</b>	<b>2004 AZM thousand Total</b>
<b>ASSETS</b>						
Cash and balances with the NBA	1,556,720	1,170,485	72,057	134	-	2,799,396
Advances to banks, net	-	13,847,839	24,126	133	(259,342)	13,612,756
Loans and advances to customers, net	43,770,429	16,936,496	476,413	-	(3,004,860)	58,178,478
Available for sale securities, net	42,279	-	-	-	(846)	41,433
Investments in associates	1,750,000	-	-	-	(35,000)	1,715,000
Fixed and intangible assets, net	9,206,525	-	-	-	-	9,206,525
Other assets	34,228	97,556	-	-	-	131,784
<b>TOTAL ASSETS</b>	<b>56,360,181</b>	<b>32,052,376</b>	<b>572,596</b>	<b>267</b>	<b>(3,300,048)</b>	<b>85,685,372</b>
<b>LIABILITIES</b>						
Deposits and loans from banks and other institutions	14,058,033	28,220,670	-	-	-	42,278,703
Customer accounts	5,526,365	13,521,055	206,351	1,052	-	19,254,823
Current income tax liabilities	223,708	-	-	-	-	223,708
Deferred income tax liabilities	23,098	-	-	-	-	23,098
Other liabilities	375,801	3,931	-	-	-	379,732
<b>TOTAL LIABILITIES</b>	<b>20,207,005</b>	<b>41,745,656</b>	<b>206,351</b>	<b>1,052</b>	<b>-</b>	<b>62,160,064</b>
<b>OPEN POSITION</b>	<b>36,153,176</b>	<b>(9,693,280)</b>	<b>366,245</b>	<b>(785)</b>		

	<b>AZM</b>	<b>USD</b> 1 USD= AZM 4,923	<b>EUR</b> 1 EUR= AZM 6,195	<b>Other currencies</b>	<b>Currency undefined (incl. allowance for losses and impairment)</b>	<b>2003 AZM thousand Total</b>
<b>ASSETS</b>						
Cash and balances with the NBA	2,063,261	1,480,545	9,337	127	-	3,553,270
Advances to banks, net	-	7,250,351	3,653	49,049	(54,615)	7,248,438
Loans and advances to customers, net	9,093,765	33,258,786	284,796	-	(4,922,075)	37,715,272
Available for sale securities, net	42,279	-	-	-	-	42,279
Fixed and intangible assets, net	1,262,593	-	-	-	-	1,262,593
Other assets	-	400	31,806	-	-	32,206
<b>TOTAL ASSETS</b>	<b><u>12,461,898</u></b>	<b><u>41,990,082</u></b>	<b><u>329,592</u></b>	<b><u>49,176</u></b>	<b><u>(4,976,690)</u></b>	<b><u>49,854,058</u></b>
<b>LIABILITIES</b>						
Deposits and loans from banks and other institutions	4,740,163	16,636,317	1,135	-	-	21,377,615
Customer accounts	5,664,950	7,586,106	67,868	49,830	-	13,368,754
Current income tax liabilities	1,978	-	-	-	-	1,978
Deferred income tax liabilities	36,702	-	-	-	-	36,702
Other liabilities	42,375	837	-	-	-	43,212
<b>TOTAL LIABILITIES</b>	<b><u>10,486,168</u></b>	<b><u>24,223,260</u></b>	<b><u>69,003</u></b>	<b><u>49,830</u></b>	<b><u>-</u></b>	<b><u>34,828,261</u></b>
<b>OPEN POSITION</b>	<b><u>1,975,730</u></b>	<b><u>17,766,822</u></b>	<b><u>260,589</u></b>	<b><u>(654)</u></b>		

## **Market Risk**

Market risk is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices whether those changes are caused by factors specific to the individual security or its issuer or factors affecting all securities traded in the market. The Bank is exposed to market risks on its products which are subject to general and specific market fluctuations. The Bank manages market risk through periodic estimations of potential losses that could arise from adverse changes in market conditions and establishing and maintaining appropriate stop-loss limits and margin and collateral requirements. With respect to undrawn loan commitments the Bank is potentially exposed to loss in an amount equal to the total amount of such commitments. However, the likely amount of loss is less than that, since most commitments are contingent upon certain conditions set out in the loan agreements.

## **Credit risk**

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

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

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

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



## Geographical concentration

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

	Azerbaijan	Other CIS countries	OECD countries	Other non-OECD countries	Undefined (incl. allowance for losses and impairment)	2004 AZM thousand Total
<b>ASSETS</b>						
Cash and balances with the NBA	2,799,396	-	-	-	-	2,799,396
Advances to banks, net	12,958,771	67,546	709,878	135,903	(259,342)	13,612,756
Loans and advances to customers, net	61,183,338	-	-	-	(3,004,860)	58,178,478
Available for sale securities, net	42,279	-	-	-	(846)	41,433
Investments in associates	1,750,000	-	-	-	(35,000)	1,715,000
Fixed and intangible assets, net	9,206,525	-	-	-	-	9,206,525
Other assets	131,784	-	-	-	-	131,784
<b>TOTAL ASSETS</b>	<b>88,072,093</b>	<b>67,546</b>	<b>709,878</b>	<b>135,903</b>	<b>(3,300,048)</b>	<b>85,685,372</b>
<b>LIABILITIES</b>						
Deposits and loans from banks and other institutions	42,278,703	-	-	-	-	42,278,703
Customer accounts	19,254,823	-	-	-	-	19,254,823
Current income tax liabilities	223,708	-	-	-	-	223,708
Deferred tax liabilities	23,098	-	-	-	-	23,098
Other liabilities	379,732	-	-	-	-	379,732
<b>TOTAL LIABILITIES</b>	<b>62,160,064</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>62,160,064</b>
<b>NET POSITION</b>	<b>25,912,029</b>	<b>67,546</b>	<b>709,878</b>	<b>135,903</b>		

	<b>Azerbaijan</b>	<b>Other CIS countries</b>	<b>OECD countries</b>	<b>Other non-OECD countries</b>	<b>Undefined (incl. allowance for losses and impairment)</b>	<b>2003 AZM thousand Total</b>
<b>ASSETS</b>						
Cash and balances with the NBA	3,553,270	-	-	-	-	3,553,270
Advances to banks, net	37,471	277,285	4,575,115	2,413,182	(54,615)	7,248,438
Loans and advances to customers, net	42,637,347	-	-	-	(4,922,075)	37,715,272
Available for sale securities, net	42,279	-	-	-	-	42,279
Fixed and intangible assets, net	1,262,593	-	-	-	-	1,262,593
Other assets	17,437	14,769	-	-	-	32,206
<b>TOTAL ASSETS</b>	<b><u>47,550,397</u></b>	<b><u>292,054</u></b>	<b><u>4,575,115</u></b>	<b><u>2,413,182</u></b>	<b><u>(4,976,690)</u></b>	<b><u>49,854,058</u></b>
<b>LIABILITIES</b>						
Deposits and loans from banks and other institutions	21,377,615	-	-	-	-	21,377,615
Customer accounts	13,368,754	-	-	-	-	13,368,754
Current income tax liabilities	1,978	-	-	-	-	1,978
Deferred income tax liabilities	36,702	-	-	-	-	36,702
Other liabilities	43,212	-	-	-	-	43,212
<b>TOTAL LIABILITIES</b>	<b><u>34,828,261</u></b>	<b><u>-</u></b>	<b><u>-</u></b>	<b><u>-</u></b>	<b><u>-</u></b>	<b><u>34,828,261</u></b>
<b>NET POSITION</b>	<b><u>12,722,136</u></b>	<b><u>292,054</u></b>	<b><u>4,575,115</u></b>	<b><u>2,413,182</u></b>		