

**FUND FOR LOCAL AUTHORITIES AND
GOVERNMENT IN BULGARIA – FLAG JSC**

ANNUAL CONSOLIDATED DIRECTORS' REPORT
AND CONSOLIDATED FINANCIAL STATEMENTS
31 December 2013

**FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN
BULGARIA – FLAG JSC**

**CONSOLIDATED ANNUAL DIRECTORS' REPORT AND
CONSOLIDATED FINANCIAL STATEMENTS**

31 December 2013

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General information

Board of Directors:

Dobromir Prodanov Simidchiev - Chairperson
Yoanna Vladimirova Hristova – Deputy Chairperson
Emil Rumenov Savov – member
Daniel Bryan Berg – member
Nadya Yordanova Dankinova – member and Executive Director
Snezhina Slavcheva Petrova – member
Yulia Petkova Tsolova–Ilieva – member

Registered address

Sofia, 17-19 St. Saint Cyril and Methodius Street

Business address

1 Sixth September Street, Fourth Floor, Sofia

Legal advisor

Law Firm „Lozanova and Atanasov”

Servicing banks

UniCredit Bulbank AD
Raiffeisenbank EAD
MKB Unionbank AD

Auditor

Baker Tilly Klitou and Partners Ltd
1612 Sofia
104 Akademik Ivan Geshov, Seventh Floor

CONSOLIDATED REPORT
on the principal activities of
Fund for Local Authorities and Governments in Bulgaria – FLAG JSC in 2013

This Report has been drawn up in compliance with the requirements laid down in Article 23 of the Regulation laying down the rules for exercising the rights of the government in state-owned commercial undertakings and the Commercial Act.

1. Business Program

1.1. Equity and Loan Resource

The share capital of the group amounts to BGN 60,000 thousand and was paid in three installments in 2008 and 2009. The contracted long-term credit resource amounts to EUR 70,000 thousand as negotiated in two Loan contracts No 37525 dated 22 December 2008 and 31 October 2013 with the European Bank for Reconstruction and Development. Since the date of the last loan agreement as at 31 December 2013 a partial disbursement of BGN 15,392 thousand has been made. The loan will be fully disbursed at the beginning of 2014. According to an operational agreement between European Investment Bank, Fund for Sustainable Urban Development of Sofia EAD and Fund for Local Authorities and Governments in Bulgaria – FLAG EAD, signed on 30.05.2012, a contingent loan in the amount of BGN 24,600 thousand was granted for financing urban development projects under the JESSICA initiative. As at 31.12.2013 the unutilized amount of BGN 23,963 thousand, intended for sub-loans, has been deposited into the special account.

1.2. Management

The affairs of the Fund are managed by a Board of Directors (BoD), which is composed of seven members and is responsible for all ongoing activities of the Fund. In 2013 sixteen board meetings were held.

During the reporting period the following changes in the composition of the BoD were made pursuant to a decision of the sole shareholder:

- On 12 March 2013 by Protocol No TZ-29 of 12 March 2013 the Minister of Regional Development, acting in the capacity as sole shareholder, approved changes to the composition of the BoD and Ivelina Veselinova Vasileva was replaced as Board member by Yoana Vladimirova Hristova.
- On 23 July 2013 by Protocol TZ-45 of 23 July 2013 the Minister of Regional Development, acting in the capacity as sole shareholder, approved changes to the composition of the BoD and Denitsa Plamenova Nikolova was replaced as Board member by Snezhina Slavcheva Petrova.
- As at the end of 2013 the Board of Directors has the following members: Dobromir Simidchiev – Chairperson; Yoana Hristova – Deputy Chairperson; Snezhina Petrova – member; Emil Savov – member; Yulia Tsoleva – member; Daniel Berg – member, and Nadya Dankinova – member and Executive Director.

According to the Bulgarian legislation, the Management is required to prepare annual consolidated financial statements that provide a true and fair view on the financial positions of the Group as at the year end, its financial results and cash flows.

Management confirms that adequate accounting policies have been consistently applied in preparing the annual consolidated financial statements as of 31 December 2013, and reasonable and prudent judgments, assumptions and estimates have been made.

Management also acknowledges that it has applied the existing accounting standards and the consolidated financial statements have been prepared under the going concern principle.

Management is responsible for the proper keeping of accounting records, for the appropriate asset management and for the undertaking of all necessary measures for avoidance and detection of fraud and other irregularities.

1.3. Human resources

The Group's staff has the appropriate qualifications for performing the lending activities in 2013. The structure and number of staff are presented in the table below.

Position	Approved number for 2013	Actual number as at 31 December 2013
Director, Projects and Monitoring Directorate	1	1
Director, Lending Directorate	1	1
Director, Finance and Risk Management Directorate	1	1
Experts, Projects and Monitoring Directorate	3	3
Experts, Lending Directorate	4	4
Experts, Finance and Risk Management Directorate	1	1
Chief Accountant	1	1
Internal auditor	1	1
Office manager	1	1
Total	14	14

The legal services, as well as the maintenance of the computer network, are outsourced.

1.4. External auditor for 2013

At its meeting held on 29 August 2013 the Board of Directors approved the outcome of a tender for the selection of an auditor of the company for 2013 and awarded a contract to Baker Tilly Klitou and Partners OOD. The approval was subsequently confirmed by Protocol No TZ-73 of 8 October 2013 of the Minister of Regional Development acting in the capacity as sole shareholder.

1.5. Loan Agreements with EBRD and EIB

In 2013, the credit resource under the Loan Agreement No 37525/22 December 2008 with the European Bank for Reconstruction and Development amounting to EUR 35,000 thousand is fully utilised. In 2013, the repayment of the loan continued, and two instalments were paid on 3 February 2013 and 3 August 2013 amounting to BGN 5,705 thousand in total.

On 30 October 2013 a new Loan Agreement for the amount of EUR 35,000 thousand was signed with the EBRD. As at the end of the year, EUR 15,392 thousand has been utilized.

Under an Operational Agreement signed between Fund for Local Authorities and Governments in Bulgaria – FLAG EAD, Fund for Sustainable Urban Development of Sofia EAD and European Investment Bank, a contingent loan was granted to the subsidiary company, Fund for Sustainable Urban Development of Sofia EAD, for financing urban development projects under the JESSICA initiative, that is to be utilized until 2015.

As at 31.12.2013 the Operational Agreement between European Investment Bank, Fund for Sustainable Urban Development of Sofia EAD and Fund for Local Authorities and Governments in Bulgaria – FLAG EAD, dated 30.05.2012 for a contingent loan, amounting to BGN 24,600 thousand, is unchanged. The entire loan has been utilized. As at 31.12.2013 the amount held in the Disbursement account, which is not distributed under sub-loans is BGN 23,963 thousand.

1.6. Managing Bank

In 2013 UniCredit Bulbank AD remains as a Managing Bank of the Fund for Local Authorities and Governments in Bulgaria – FLAG EAD. It was selected with an open public procurement procedure and the contract was signed on 21 November 2011 for a three-year period.

The agreement concluded with Raiffeisenbank Bulgaria EAD – the partner bank of the subsidiary, Fund for Sustainable Urban Development of Sofia EAD, selected on the basis of a conducted tender under the Public Procurement Act by a decision of the Managing Board dated 19 June 2012 remains in force. A contract that contains special provisions on the bank accounts held with Raiffeisenbank Bulgaria EAD has been concluded in line with the requirements laid down in the Operational Agreement.

1.7. Main results of the lending activity in 2013

In 2013, 260 applications were received from 108 municipalities amounting to BGN 263,400 thousand.

In the same year 248 loans in the total amount of BGN 235,056 thousand were approved by the Fund for Local Authorities and Governments in Bulgaria – FLAG EAD, in support of the implementation of projects with a total value of BGN 763,600 thousand. The average percent of a loan granted in the total amount of the project is 31 percent. A “typical” loan granted to municipalities is of the so called bridge financing, amounting to BGN 940 thousand with a repayment period of 21 months.

The table below presents loans made in 2012 and 2013 by loan type and source of repayment of the principal.

Type of loans	Number of loans in 2012	Value of the loans granted in 2012 in BGN'000	Number of loans in 2013	Value of the loans granted in 2013 in BGN'000
Long-term	55	42,398	95	117,170
<i>Incl. Bridge financing</i>	25	29,779	49	85,613
<i>Incl. Own contribution</i>	30	12,619	46	31,557
Short-term	98	94,162	153	117,886
<i>Incl. Bridge financing</i>	96	92,804	143	116,854
<i>Incl. Own contribution</i>	2	1,358	10	1,032
Total	153	136,560	248	235,056

The following two tables present the structure of the lending operations of the fund for 2013 by project type, operational programme and source of repayment of the principal.

By Operational programme	Number of loans	Total amount in BGN'000	Amount in BGN'000			Maturity in months		
			Min.	Max.	Average	Min.	Max.	Average
Regional Development(OPRD)	189	123,455	20	3,418	650	6	109	20
Environmental (OPE)	26	77,907	130	9,662	2,996	9	120	41
Rural Development (RDP)	7	5,198	102	2,026	743	6	17	12
Cross-border Cooperation (CBP)	26	28,496	57	7,209	1,055	7	78	16

By source of repayment	Number of loans	Total amount in BGN'000	Amount in BGN'000			Maturity in months		
			Min.	Max.	Average	Min.	Max.	Average
Operational programmes	192	202,468	52	9,662	1,054	6	108	13
Own contribution	56	32,588	20	3,770	581	10	120	49

In 2013, the funds utilised under the concluded loan agreements with municipalities amounted to BGN 147,885 thousand while the repayments amounted to BGN 127,120 thousand.

In 2013, a number of annexes to concluded loan agreements were reviewed mainly in respect of the rescheduling of repayments. Out of 149 approved annexes eight concerned a change in the source of loan repayment. The remaining annexes concern the rescheduling of the period of absorption and repayment of the loan or change in the budget accounts. During 2013 125 loans to municipalities for the amount of BGN 116,900 thousand have been fully repaid.

In 2013 the loans granted under the JESSICA initiative amount to BGN 1,806 thousand.

As at 31.12.2013 there are 269 active loans on the books whose outstanding principal amounts to BGN 134,977 thousand.

As at the end of 2013 there are no loans, overdue more than 30 days.

In 2013 financing, management and monitoring rules and policies were developed and approved in the subsidiary, FSUDS EAD. A large-scale campaign to promote the JESSICA financial instrument and the opportunities that it provides was conducted. Assistance was granted to potential beneficiaries with regard to the structuring of eligible projects. Dozens of bilateral meetings were held to discuss project ideas and the possibilities to finance them under the JESSICA financial instrument. Twenty projects with a total value of over BGN 105 million were submitted for review and evaluation into the register kept by the company by 31.12.2013.

In 2013, two of the projects were reviewed and approved by the Investment Committee and one financing agreement has been concluded under which a disbursement in the amount of BGN 1,806 thousand has been made.

1.8. Changes to the Lending and Pricing Policy of FLAG

In 2013 no changes to the pricing policy of the Fund were made.

➤ By a decision No 27 set out in Protocol No 88 of 26 April 2013 the Board of Directors approved a new risk assessment methodology for the activities of FLAG EAD, which replaced the previous methodology approved by the Board of Directors on 21 July 2010. The maximum risk premium remained 3 percent. The changes made do not alter the underlying rationale and structure of the methodology but introduce greater detail and expand it on the basis of the experience gained and in light of the changes to the structure of the portfolio and the increase in the share of long-term loans.

1.9. Information and publicity

It is a tradition for representatives of the Fund to participate in major events of the municipalities organized by the National Association of Municipalities in Republic of Bulgaria, on which the Fund represents itself and conducts consultations with municipalities. During the year representatives of the Fund actively participated in national and regional events relating to the new programming period and in meetings of the Regional Development Councils. FLAG maintains a website and updates the information published on the site on a regular basis.

Representatives of the FSUDS participated in the work of the Monitoring Committees of OP Regional Development and in monthly local meetings of the Managing Authorities with representatives of the municipalities. More than 30 eligible urban development projects have been identified and meetings with the potential beneficiaries were held to aid the structuring of project ideas and assist with other pre-financing activities.

2. Financial condition

2.1 Consolidated statement and structure of income and expenditure of the group

i. Consolidated statement of income and expenditure

EXPENDITURE, BGN'000		3,260
1	Remunerations	521
2	Social securities	61
3	Accounting and audit services	39
4	Legal and consulting services	45
5	Other hired services (hardware and software maintenance, translation, insurances)	22
6	Rent	46
5	Communication services	8
6	Expenses for materials	29
7	Other expenses (cleaning, maintenance, car wash, subscription)	67
8	Depreciation charge	18
15	Bank fees	580
16	Interest expense on EBRD loan	1,730
18	Impairment	94

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC

Consolidated Directors' Report

INCOME, BGN'000		6,248
1	Interest income on loans	4,690
2	Default interest income	54
3	Fee income	599
4	Interest on deposits, charged but not received in 2013	1
5	Interest on deposits, charged and received in 2013	904

DEPOSITS, BGN'000		18,394
1	Raiffeisenbank	670
2	Unionbank	17,724

ii. Structure of expenditure

Group of expenses	Amount in BGN'000	Share in total expenditure
Maintenance costs	150	5%
Hired services	106	3%
Acquisition of assets and depreciation	18	1%
Remunerations – staff, BoD	582	18%
Unicredit Management fee, other bank fees	510	16%
EBRD loans – interest	1,730	53%
EBRD loans – fees	70	2%
Impairment/provisions	94	3%
	3,260	100%

iii. Income

The total income of the fund for the period amounts to BGN 6,248 thousand, set out by type below:

Income (in BGN'000)	2013	Share
Interest and fees on loans and other income	5,343	85.55%
Interest on deposits	905	14.45%
Total	6,248	100%

From loans granted – at an average interest rate of 4.544%, the income, including interest rate and commitment fee, amounts to BGN 5,183 thousand.

From management of temporarily free resources – as at 31.12.2013 FLAG has signed two agreements with banks for open deposits. The total income from deposits amounts to BGN 905 thousand, divided by source as follows:

Source	Paid in 2013 (BGN'000)	Accrued as at 31.12.2013 (BGN'000)	Total (BGN'000)
Raiffeisenbank EAD	238	1	239
Unicredit Bulbank AD	131	-	131
Unicredit Bulbank AD – reserve account	157	-	157
MKB Unionbank AD	378	-	378
Total:	904	1	905

2.2 Results for the current period

The profit before tax of the Group for 2013 is BGN 2,988 thousand, and the net profit – BGN 2,691 thousand.

2.3 Dividends and distribution of profit

In 2013, the Board of Directors approved the establishment of "Reserve Fund" in the amount of 10% of net profit for 2012 (BGN 292 thousand). The remaining retained earnings are then distributed as dividend to the state in the amount of 80% (BGN 2,102 thousand), which was paid during the year.

2.4 Subsidiaries

As at 31 December 2013 FLAG EAD is the sole shareholder in the Fund for Sustainable Urban Development of Sofia EAD (FSUDS), which was registered in the Registry Agency on 23 April 2012. As at 31 December 2013 FSUDS has concluded 1 loan agreement in respect of an urban development project under which the amount of BGN 1,805,657 has been disbursed.

3. Most likely development of the Group in 2014

The 2014 Business Plan has been drawn up on the basis of:

- The loan agreements concluded in 2013 and previous years that will remain active in 2014;
- Expected parameters of loan applications, which are submitted and processed as at the end of December 2013;
- Indicative lists and repayment schedules of OPRD and OPE, information about RDP, meetings with representatives of the Managing Authorities of OPE and OPRD, and a study conducted in 264 municipalities to estimate the demand for FLAG loans;
- A set of assumptions, based on FLAG's accumulated experience for the period 2009-2013.

3.1 Overall assessment of loan demand

The table below sets out a summary estimate of the expected new loans in 2014 in BGN million.

By Operational program /Type of loans	Bridge financing (million BGN)	Municipal co-financing (million BGN)	Total (million BGN)
Regional Development (OPRD)	116	27	143
Environmental (OPE)	134	67	201
Rural Development (RDP)	7	-	7
Cross-border Cooperation (CBP)	26	-	26
Total:	283	94	377

In order to satisfy loan demand in 2014 the Fund will utilize the entire loan under the new agreement concluded with the EBRD.

In respect of FSUDS, the plans for 2014 set out that at least BGN 38,000 thousand are to be contracted as follows - BGN 19,000 thousand from the loan received under the Operational Agreement with the European Investment Bank and BGN 19,000 thousand from the credit line available from FLAG. The loans granted are planned to be in the amount of BGN 30,000 thousand.

3.2 Financial Proceeds and Results

In 2014, total cash inflow is projected at BGN 7.2 million with a share of 91% of interest income from loans granted to municipalities.

3.3 Information as per art. 187 d and art. 247 of the Commercial Act

In 2013 no shares were acquired or transferred.

3.4 Branches of the Enterprise

In 2012, the Company has established a subsidiary - Fund for Sustainable Urban Development of Sofia EAD, 100% owned by the Fund for Local Authorities and Governments – FLAG EAD with a capital of BGN 500 thousand. As at 31 December 2013, the capital of the company remains BGN 500 thousand. The capital has been fully paid up.

Prepared by: Nadya Dankinova – Executive Director

26 May 2014

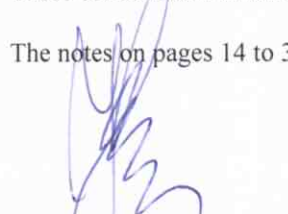
FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
 CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the year ended 31 December 2013

	Notes	2013 BGN '000	2012 BGN '000
Interest income	3.1	5,649	6,875
Interest expense and charges	3.2	(2,310)	(3,029)
Other operating income, net	3.3	599	277
Net operating income		3,938	4,123
Loan loss provisioning	9	(94)	(221)
Payroll expenses	3.4	(582)	(454)
Depreciation and amortization expenses	7	(18)	(17)
Other operating expenses	3.5	(256)	(200)
Profit before tax		2,988	3,231
Income tax expense	4	(297)	(325)
Profit for the year		2,691	2,906
Other comprehensive income for the year, net of taxes		-	-
Total comprehensive income for the year, net of taxes		2,691	2,906

These consolidated financial statements were authorized for issue by the Board of Directors on 26 May 2014.

The notes on pages 14 to 36 are an integral part of these consolidated financial statements.



Nadya Yordanova Dankinova
 Executive Director




Kalinka Ruskova Todorova
 Chief Accountant

Initialed for identification purposes in reference to the auditor's report:

Handwritten initials and date:
 26.05.2014



**FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
CONSOLIDATED STATEMENT OF FINANCIAL POSITION**

As at 31 December 2013

	Notes	31 December	
		2013 <i>BGN'000</i>	2012 <i>BGN'000</i>
ASSETS			
Cash and cash equivalents	5	42,488	39,980
Receivables on overpaid corporate tax	12	-	80
Receivables and prepayments	6	27	9
Loans granted	9	134,454	112,944
Deferred tax assets	4	1	-
Plant and equipment	7	28	21
Software	7	-	4
TOTAL ASSETS		176,998	153,038
LIABILITIES AND EQUITY			
Liabilities			
Payroll and social security payables	11	49	31
Tax liabilities	12	13	-
Other liabilities	13	170	104
Loan payables	10	111,563	88,289
Total liabilities		111,795	88,424
Equity			
Share capital	14.1	60,000	60,000
Statutory reserves	14.2	1,431	1,139
Retained earnings		3,772	3,475
Total equity		65,203	64,614
TOTAL LIABILITIES AND EQUITY		176,998	153,038

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Nadya Yordanova Dankinova
Executive Director




Kalinka Ruskova Todorova
Chief Accountant

Initialed for identification purposes in reference to the auditor's report:



Registered auditor

26.05.2014



**FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY**

For the year ended 31 December 2013

	Share capital	Retained earnings	Statutory reserves	Total
	BGN'000	BGN'000	BGN'000	BGN'000
As at 1 January 2012	60,000	4,805	823	65,628
Profit for the year	-	2,906	-	2,906
Total comprehensive income	-	2,906	-	2,906
Distribution of dividends	-	(3,920)	-	(3,920)
Transfer to reserves	-	(316)	316	-
As at 31 December 2012	60,000	3,475	1,139	64,614
As at 1 January 2013	60,000	3,475	1,139	64,614
Profit for the year	-	2,691	-	2,691
Total comprehensive income	-	2,691	-	2,691
Distribution of dividends	-	(2,102)	-	(2,102)
Transfer to reserves	-	(292)	292	-
As at 31 December 2013	60,000	3,772	1,431	65,203

These consolidated financial statements were authorized for issue by the Board of Directors on 26 May 2014.

The notes on pages 14 to 36 are an integral part of these consolidated financial statements.


Nadya Yordanova Dankinova
Executive Director


Kalinka Ruskova Todorova
Chief Accountant

Initialed for identification purposes in reference to the auditor's report:



Registered auditor

26.05.2014



**FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
CONSOLIDATED CASH FLOW STATEMENT**

For the year ended 31 December 2013

	Notes	2013 <i>BGN'000</i>	2012 <i>BGN'000</i>
Cash flows from operating activity			
Proceeds from interest on bank deposits		904	2,521
Loans granted to municipalities		(148,777)	(132,153)
Loans repaid by municipalities		127,120	85,395
Interest received on loans granted		4,732	4,323
Payments to suppliers		(767)	(509)
Payments to personnel and for social security		(571)	(474)
Other (payments)/receipts, net		526	173
Income tax paid		(202)	(295)
Net cash flows used in operating activity		(17,035)	(41,019)
Cash flows from investing activity			
Purchase of equipment and other long term assets		(23)	(21)
Net cash flows used in investing activity		(23)	(21)
Cash flows from financing activity			
Loans received		30,542	24,614
Loans repaid		(5,709)	(5,705)
Dividends paid		(2,102)	(3,920)
Paid interest on loans		(2,236)	(2,639)
Paid fees and commissions on loans		(929)	(20)
Net cash flows from financing activity		19,566	12,330
Net increase/(decrease) in cash and cash equivalents		2,508	(28,710)
Cash and cash equivalents at the beginning of the period	5	39,980	68,690
Cash and cash equivalents at the end of the period	5	42,488	39,980

These consolidated financial statements were authorized for issue by the Board of Directors on 26 May 2014.

The notes on pages 14 to 36 are an integral part of these consolidated financial statements.


Nadya Yordanova Dankinova
Executive Director

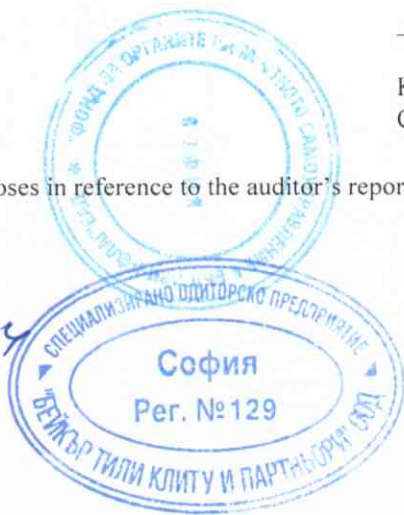

Kalinka Ruskova Todorova
Chief Accountant

Initialed for identification purposes in reference to the auditor's report:



Registered auditor

26.05.2014



FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC

NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

1. Corporate information

The consolidated financial statements of FLAG JSC (“the Company”) and its subsidiary (“the Group”) for the year ended 31 December 2013 were authorized for issue by a decision of the Board of Directors dated 26 May 2014.

FLAG JSC is a joint-stock company incorporated by virtue of Decision No 1 dated 4 July 2007 under company file 10151/2007 of the Sofia City Court, having its seat in the city of Sofia, Sofia Region, Bulgaria. The financial year of the Company ends on 31 December.

In the consolidated financial statements, the investment in subsidiary (where the Group has a direct or indirect control over the operations of the Entities) has been consolidated.

These consolidated financial statements have been prepared in accordance with the requirements of the law effective in Bulgaria.

The core activity of the Company includes financing of municipal infrastructure and other projects for consideration and co-financing the development and implementation of projects of the European Union.

As at 31 December 2013, the shareholders of the Company include:
Republic of Bulgaria, represented by the Minister of Regional Development and Public Works – 100.00%.

2.1 Basis of preparation of the consolidated financial statements

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the European Union (EU). They have been prepared under the historical cost convention.

The preparation of the financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying the Company’s accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in Note 2.2o).

New and amended standards and interpretations

In 2013 the Group has adopted all new and revised standards and interpretations that are relevant to its operations and are effective for accounting periods beginning on 1 January 2013. This adoption did not have a material effect on the accounting policies of the Group.

Certain new standards, amendments to standards and interpretations, which are effective for financial periods beginning after 1 January 2014, have not been early adopted in the preparation of these consolidated financial statements. The Board of Directors expects that the adoption of these accounting standards in future periods will not have a material effect on the consolidated financial statements of the Group.

Standards and interpretations, issued by IASB/IFRIC, which have not been early adopted:

- IAS 27 Separate Financial Statements (revised) – the standard is effective for accounting periods beginning on or after 1 January 2014.
- IAS 28 Investments in Associates and Joint Ventures (revised) – the standard is effective for accounting periods beginning on or after 1 January 2014.
- IAS 32 Financial Instruments (revised): Offsetting financial assets and financial liabilities – the amendment is effective for accounting periods beginning on or after 1 January 2014.
- IAS 36 Recoverable amount of nonfinancial assets – Amendment to IAS 36 Impairment of assets – the amendment is effective for accounting periods beginning on or after 1 January 2014.
- Amendment to IAS 39 regarding derivatives and hedge accounting - the amendment is effective for accounting periods beginning on or after 1 January 2014.
- IFRS 10 Consolidated Financial Statements (new) – the new standard is effective for accounting periods beginning on or after 1 January 2014. IFRS 10 replaces part of IAS 27 Separate Financial Statements that addresses accounting in consolidated financial statements. This standard also covers matters addressed in SIC 12 Consolidation: Special Purpose Entities.

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

2.1 Basis of preparation of the consolidated financial statements (continued)

- IFRS 11 Joint Arrangements (new) – the new standard is effective for accounting periods beginning on or after 1 January 2014. IFRS 11 replaces part of IAS 31 Interests in Joint Ventures and SIC 13 – Jointly Controlled Entities – Non-monetary Contributions by Venturers.
- IFRS 12 Disclosure of Interests in Other Entities (new) – the new standard is effective for accounting periods beginning on or after 1 January 2014. IFRS 12 includes all disclosure requirements related to consolidated financial statements, which were included in IAS 27 Separate Financial Statements, as well as all disclosures, which were previously included in IAS 31 Interests in Joint Ventures and IAS 28 Investments in Associates.
- Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27) – effective for accounting periods beginning on or after 1 January 2014.

Standards and interpretations, issued by IASB, but not yet endorsed by the European Commission

- IAS 19 Employee Benefits (revised) – effective from 2015. This amendment has not yet been endorsed by the European Union.
- IFRS 9 Financial Instruments: Classification and Measurement (revised) – the amendment is effective for accounting periods beginning on or after 1 January 2015. This amendment has not yet been endorsed by the European Union.
- IFRS 14 Regulatory Deferral Accounts – the new standard is effective for accounting periods beginning on or after 1 January 2016. This standard has not yet been endorsed by the European Union.
- IFRIC Interpretation 21 Levies – Effective for accounting periods beginning on or after 1 January 2014. IFRIC 21 is not yet endorsed by the European Union.
- Improvements to IFRS 2010-2012 – effective for accounting periods beginning on or after 1 January 2015. The improvements to IFRS – Cycle – 2010 – 2012 have not yet been endorsed by the European Union.
- Improvements to IFRS 2011 – 2013 – effective for accounting periods beginning on or after 1 January 2015. The improvements to IFRS – Cycle – 2011 – 2013 have not yet been endorsed by the European Union.

Statement of compliance

The consolidated financial statements of FLAG JSC have been prepared in accordance with International Financial Reporting Standards, as adopted by the European Union (IFRS, adopted by EU).

2.2 Summary of significant accounting policies

a) Foreign currency conversion

The financial statements are presented in Bulgarian Levas (BGN), which is the Group's functional and presentation currency. Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are retranslated into the functional currency at the end of each month by applying the closing exchange rate published by the Bulgarian National Bank for the last working day of the respective month. All foreign currency differences are recognised in the statement of comprehensive income. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated into the functional currency using the exchange rate as at the date of the initial transaction (acquisition).

b) Revenue recognition

Revenue is recognised to the extent that it is probable that economic benefits will flow to the Group and the revenue can be reliably measured regardless of when the payment is being made.

Revenue is measured at the fair value of the consideration received or due based on the agreed payment terms, net of discounts, rebates, and other sales taxes or customs duties. The Group analyses its selling arrangements against specific criteria to determine whether it acts as a principal or as an agent. It has concluded that it acts as principal in all such arrangements. The following specific recognition criteria must also be met before revenue is recognised:

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NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

2.2 Summary of significant accounting policies (continued)

b) Revenue recognition (continued)

Interest income

Interest income is recognised using the effective interest rate, i.e. the interest rate that discounts exactly the estimated future cash flows over the estimated useful life of the financial instrument, or a shorter period where appropriate, to the carrying amount of the financial asset.

The calculation includes all fees and consideration paid or received to/from the parties to the contract that are an integral part of the effective interest rate, transaction costs and any other premiums or discounts.

Interest income is included in finance income in the statement of comprehensive income.

Service delivery

The income from service delivery is recognised in the period in which the services were delivered.

c) Taxes

Current income tax

Current income tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantially enacted by the reporting date. Management analyses the individual items of the tax return for which the applicable tax provisions are subject to interpretation and recognises provisions where appropriate.

Current income tax is recognised directly in the equity (and not in the statement of comprehensive income) where the tax relates to items that have been recognised directly in the equity.

Deferred income tax

Deferred income tax is provided using the liability method on temporary differences at the reporting date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred income tax liabilities are recognised for all taxable temporary differences, except:

- when the deferred tax liability arises from the initial recognition of goodwill or an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of taxable temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, when the timing of the reversal of the temporary differences can be controlled by the Group and it is probable that the temporary differences will not reverse in the foreseeable future.

Deferred income tax assets are recognised for all deductible temporary differences, carry forward of unused tax credits and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences, and the carry forward of unused tax credits and unused tax losses can be utilised, except:

- when the deferred tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- in respect of deductible temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, deferred tax assets are recognised only to the extent that it is probable that the temporary differences will reverse in the foreseeable future and taxable profit will be available against which the temporary differences can be utilised.

The carrying amount of deferred income tax assets is reviewed by the Group at each reporting date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilised.

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC

NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

2.2 Summary of significant accounting policies (continued)

c) Taxes (continued)

Unrecognised deferred income tax assets are reassessed at each reporting date and are recognised to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the year when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted at the reporting date.

Deferred tax relating to items recognised outside profit or loss is recognised outside profit or loss. Deferred tax items are recognised in correlation to the underlying transaction either in other comprehensive income or directly in equity.

Deferred income tax assets and deferred income tax liabilities are offset by the Group only if a legally enforceable right exists to set off current tax assets against current income tax liabilities and the deferred income taxes relate to the same taxable entity and the same taxation authority.

d) Financial instruments – initial recognition and subsequent measurement

- **Financial assets**

Initial recognition

Financial assets within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* are classified as either financial assets at fair value through profit or loss, or loans and receivables, or held-to-maturity investments, or available-for-sale financial assets, or derivatives designated as hedging instruments in an effective hedge, as appropriate. The Group determines the classification of its financial assets at initial recognition.

Financial assets are recognised initially at fair value, plus, in the case of investments not at fair value through profit or loss, directly attributable transaction costs.

Purchases or sales of financial assets that require delivery of assets within the period generally established by regulation or convention in the market place (regular purchases) are recognised on the trade (transaction) date, which is the date that the Group commits to purchase or sell the asset.

Financial assets of the Group include cash and cash equivalents, loans granted, trade and other receivables.

Subsequent measurement

The subsequent measurement of financial assets depends on their classification, as follows:

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. After initial measurement loans and receivables are subsequently carried at amortised cost using the effective interest method (EIR), less any allowance for impairment. Amortised cost is calculated taking into account any discount or premium on acquisition and fees and costs that are an integral part of the EIR. The EIR amortisation is included in finance income in the statement of comprehensive income. The losses arising from impairment are recognised as other expenses in the statement of comprehensive income.

Derecognition

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

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

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For the year ended 31 December 2013

2.2 Summary of significant accounting policies (continued)

d) Financial instruments – initial recognition and subsequent measurement (continued)

• **Financial assets (continued)**

Where the Group has transferred its rights to receive cash flows from an asset and has neither transferred nor retained substantially all the risks and rewards of the asset or transferred control of the asset, the asset is recognised to the extent of the Group's continuing involvement in the asset. In that case the Group also recognises as associated liability. The transferred asset and the related liability are recognised on a basis that reflects the rights and obligations that the Group has retained.

Continuing involvement that takes the form of a guarantee over the transferred asset is measured at the lower of the original carrying amount of the asset and the maximum amount of consideration that the Group could be required to repay.

Impairment of financial assets

Financial assets carried at amortised cost

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

If there is objective evidence that an impairment loss has incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future expected credit losses that have not yet been incurred). The present value of the estimated future cash flows is discounted at the financial asset's original effective interest rate. If a loan has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate (EIR).

Evidence of impairment may include indications that the debtors or a group of debtors are experiencing significant financial difficulty, default or delinquency in interest or principal payments, the probability that they will enter bankruptcy or other financial reorganisation, and where observable data indicate that there is a measurable decrease in the estimated future cash flows, such as changes in arrears or economic conditions that correlate with defaults.

Financial assets at amortised cost

Due to its specific activity, the Group accrues allowance for impairment as follows:

Specific impairment

The purpose of the specific impairment is to adjust the value of specific loans granted, for which objective evidence of impairment exists, to their recoverable amount and to set aside provisions reflecting the risk of non-repayment of the respective loans.

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For the year ended 31 December 2013

2.2 Summary of significant accounting policies (continued)

d) Financial instruments – initial recognition and subsequent measurement (continued)

• **Financial assets (continued)**

Impairment on a portfolio basis

Impairment is charged in consideration of the common risk nature of the portfolio and takes into account the overall structure of the loan portfolio, the amount of receivables overdue as at the reporting date and the management's expectations as to the recoverable amount of loans granted.

The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognised in the statement of comprehensive income. Interest income continues to be accrued on the reduced carrying amount and is accrued using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

Loans granted and the related allowances are written off when there is no realistic prospect of future recovery and all collateral has been realised or has been transferred to the Group. If, in a subsequent year, the amount of the estimated impairment loss increases or decreases because of an event occurring after the impairment was recognised, the previously recognised impairment loss is increased or reduced by adjusting the allowance account. If a future write-off is later recovered, the recovery is recognised in the statement of comprehensive income.

• **Financial liabilities**

Initial recognition and measurement

Financial liabilities within the scope of IAS 39 are classified as financial liabilities at fair value through profit or loss, loans and borrowings, or as derivatives designated as hedging instruments in an effective hedge, as appropriate. The Group determines the classification of its financial liabilities at initial recognition.

Financial liabilities are recognised initially at fair value and in the case of loans and borrowings, plus directly attributable transaction costs.

The Group's financial liabilities include interest-bearing loans, trade and other liabilities.

Subsequent measurement

The subsequent valuation of financial liabilities depends on their classification as follows:

Loans and borrowings

After initial recognition, interest-bearing loans are subsequently measured by the Group at amortised cost using the EIR method. Gains and losses relating to loans and borrowings are recognised in the statement of comprehensive income for the period when the liabilities are derecognised as well as through the amortisation process.

Amortised cost is calculated by taking into account any discounts or premiums on acquisition and fees or costs that are an integral part of the EIR. The EIR amortisation is included in interest expenses in the statement of comprehensive income.

Derecognition

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

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

e) Offsetting of financial instruments

Financial assets and financial liabilities are offset and the net amount reported in the statement of financial position if, and only if, there is a currently enforceable legal right to offset the recognised amounts and the Group intends to settle on a net basis, or to realise the assets and settle the liabilities simultaneously.

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
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For the year ended 31 December 2013

2.2 Summary of significant accounting policies (continued)

f) IFRS 13 Fair value measurement

At each reporting date the Group applies IFRS 13 Fair value measurement to the financial instruments and non-financial assets measured at fair value.

The fair value is that, which would be obtained for the sale of an asset or paid for the transfer of a liability in an arm's length transaction between market participants.

Fair market measurement is based on the assumption that the sale of the asset or the transfer of the liability takes place on:

- the principal market of the asset or liability,
- in the absence of such market, the market that is most advantageous for the asset or liability.

The main or the most favourable market should be accessible to the Group.

The fair value of the asset or liability is determined by assuming that market participants will use this value in the valuation of the asset or liability and will act in line with their best economic interest.

The fair value of the non-financial assets is determined by taking into account the ability of the participants to generate economic benefits by using the asset or selling it to another contractor in the market who will use it with maximum efficiency.

The Group is applying evaluation techniques that are appropriate in the circumstances, maximizing the use of observable parameters and minimizing the use of ones that cannot be observed.

All assets and liabilities for the purposes of whose valuation a fair market value is used or disclosed are arranged into the following three hierarchical levels on the basis of the hypotheses underlying valuation techniques:

- Level 1 — Quoted (unadjusted) prices on active markets of identical assets or liabilities;
- Level 2 — Valuation techniques, which allow all fair value parameters to be observed directly or indirectly;
- Level 3 — Valuation techniques, which do not allow fair value techniques to be observed directly or indirectly.

As at each balance sheet date the Management carries out an analysis of the changes to the fair market value of the assets and liabilities and monitors their impact on the financial reports in line with the approved accounting policy. The Group must ascertain whether or not a change has occurred in the categorization of assets or liabilities in accordance with the hypotheses underlying valuation techniques. With the assistance of certified valuers the management compares each change in the fair value of assets or liabilities with observable parameters in order to ascertain that the changes are reasonable.

The Group determines the assets and liabilities whose fair value should be disclosed on the basis of their nature, risk and level in the hierarchy as noted above.

g) Share capital

The share capital is presented at the par value of shares issued and paid. The Company is obliged to set aside a **Reserves Fund** in accordance with the Commercial Act. Sources for the fund may include:

- portion of the profit set by the sole owner of the capital, but no less than 1/10 until the funds in the Reserves Fund reach 1/10 of the capital;
- funds, received in excess of par value of shares at issue thereof;
- other sources in accordance with a decision of the General Meeting.

The Reserves Fund may be used only to cover current and prior year losses. When the Reserves Fund reaches the minimum amount set out in the Articles of Association, the excess may be used to increase the share capital.

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
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For the year ended 31 December 2013

2.2 Summary of significant accounting policies (continued)

h) Plant and equipment

Items of plant and equipment are stated at cost, net of accumulated depreciation and any accumulated impairment losses. Such cost includes the cost of replacing parts of the plant and equipment and borrowing costs for long-term construction projects if the recognition criteria are met. When a major inspection of an item of plant and/or equipment is performed, its cost is recognised in the carrying amount of the respective assets as a replacement if the recognition criteria are satisfied. All other repair and maintenance costs are recognised in the statement of comprehensive income for the period in which they have been incurred.

Depreciation is calculated on a straight line basis over the estimated useful life of the assets, as follows:

Computers	2 years
Plant and equipment	5 years
Motor vehicles	4 years
Fixtures and fittings	5 years

An item of plant and equipment is derecognised upon disposal or when no future economic benefits are expected from its use or disposal. Any gain or loss arising on derecognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is included in the statement of comprehensive income for the year in which the asset is derecognised.

i) Software

Software is measured on initial recognition at cost, less any accumulated amortisation and accumulated impairment losses.

Amortisation is calculated on a straight line basis over the estimated useful life of the assets, as follows:

Software	2 years
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The assets residual values, useful lives and methods of depreciation/amortisation are reviewed at each financial year end, and adjusted prospectively, if appropriate.

j) Impairment of fixed tangible assets (FTAs)

Assets that are subject to depreciation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units).

k) Leases

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the income statement on a straight-line basis over the period of the lease.

l) Subsidiaries and consolidation

Subsidiaries are all entities (including special purpose entities) over which the Company has the power to govern the financial and operating policies generally accompanying a shareholding of more than one half of the voting rights. The Company also assesses existence of control where it does not have more than 50% of the voting power but is able to govern the financial and operating policies by virtue of de-facto control.

All intra-group transactions, account balances and unrealized gains, arising from to intra-group transactions, are eliminated in the consolidation. The unrealized losses are also eliminated, unless the transaction provides an evidence of impairment of the asset transferred. Where necessary, the accounting policies of the subsidiaries have been changed in order to be consistent with those applied by the Group.

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

2.2 Summary of significant accounting policies (continued)

m) Cash and cash equivalents

Cash and short-term deposits in the statement of financial position comprise cash in bank accounts, cash on hand, and short-term deposits with an original maturity of twelve months or less that are available to the Group on demand without incurring significant financial losses.

For the purposes of the cash flow statement, cash and cash equivalents consist of cash and cash equivalents as defined above.

n) Provisions

General

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Where the Group expects some or all of a provision to be reimbursed, for example under an insurance contract, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain.

The expense relating to any provision is presented in the statement of comprehensive income net of any reimbursement. If the effect of the time value of money is material, provisions are discounted using a current pre-tax rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognised as a finance cost.

o) Significant accounting judgments, estimates and assumptions

The preparation of the consolidated financial statements requires management to make judgments, estimates and assumptions that affect the reported amounts of revenues, expenses, assets and liabilities, and the disclosure of contingent liabilities, at the reporting date. However, uncertainty about these assumptions and estimates could result in outcomes that could require a material adjustment to the carrying amount of the asset or liability affected in the future.

Estimates and assumptions

The key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below:

Impairment of financial receivables

The Group uses an allowance account to report the provision for impairment of doubtful and bad debts. Management assesses the adequacy of this impairment based on an ageing analysis of the receivables, historical experience as to the write-off rates of bad debts, as well as solvency analysis of the respective municipality, changes in the contractual payment terms, etc. If the financial position and financial performance of municipalities deteriorate (more than expected), the amount of the receivables to be written off in the next reporting periods may be higher than the one estimated at the date of the statement of financial position. At 31 December 2013, the best estimate of management for the necessary impairment of receivables amounted to BGN 523 thousand (2012: BGN 429 thousand). Further details are given in Note 9.

Corporate income tax

A significant judgement is required to determine the overall tax provision. There are many transactions and calculations, for which the final tax cannot be determined precisely in the normal course of activity. The Group recognises liabilities for estimated tax payables in the event of future tax audits based on the management's judgement as to whether additional taxes will be assessed or not. When the tax finally set as due as a result of such events differs from the one initially reported, the corresponding differences will be reported in the short-term corporate income tax payables and will have an effect on the deferred taxes for the period in which this clarification has been made.

Estimated useful lives of property, plant and equipment

Management uses significant accounting estimates and judgements for the purpose of determining the useful lives of its property, plant and equipment, which are based on a study and judgements of the technical staff that assesses the useful lives of tangible and intangible assets.

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

3. Income and expenses

3.1 Income from interest

	<u>2013</u>	<u>2012</u>
	<i>BGN'000</i>	<i>BGN'000</i>
Interest income on deposits and bank accounts	905	2,522
Income on loans granted and receivables	<u>4,744</u>	<u>4,353</u>
Total interest income	<u>5,649</u>	<u>6,875</u>

3.2 Interest expenses and charges

	<u>2013</u>	<u>2012</u>
	<i>BGN'000</i>	<i>BGN'000</i>
Interest expenses on loans and borrowings	1,730	2,645
Expenses on fees and commissions and FX differences	<u>580</u>	<u>384</u>
Total interest expenses and charges	<u>2,310</u>	<u>3,029</u>

During 2012 interest expenses on loans include BGN 245 thousand additional interest which relate to: 2010 - BGN 71 thousand and 2011 – BGN 174 thousand, respectively. Pursuant to the loan agreement, FLAG JSC has met the conditions to be granted a reduced interest rate, but it was not allowed to use this reduction before February 2013. Interest amounts were calculated by using supplementary interest rate sheets.

3.3 Other operating income

	<u>2013</u>	<u>2012</u>
	<i>BGN'000</i>	<i>BGN'000</i>
Management fee and commitment fee	591	277
Other	<u>8</u>	<u>-</u>
Total other operating income	<u>599</u>	<u>277</u>

3.4 Payroll costs

	<u>2013</u>	<u>2012</u>
	<i>BGN'000</i>	<i>BGN'000</i>
Salaries and wages	522	409
Social securities	<u>60</u>	<u>45</u>
Total payroll costs	<u>582</u>	<u>454</u>

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
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For the year ended 31 December 2013

3. Income and expenses (continued)

3.5 Other operating expenses

	2013	2012
	<i>BGN'000</i>	<i>BGN'000</i>
Accounting and audit services	29	50
Rent	46	49
Materials	29	16
Legal services	18	16
Translation and interpretation services	5	8
Communication services	8	7
Hardware maintenance	5	6
Consulting services	48	7
Social expenditure	2	2
Insurances	1	2
Other	65	37
Total other operating expenses	256	200

4. Income tax

The main components of the income tax expense for the years ended 31 December 2013 and 2012 include:

	2013	2012
	<i>BGN'000</i>	<i>BGN'000</i>
Current income tax expense	296	325
Deferred income tax expense	1	-
Income tax expense	297	325

In 2013 the applicable statutory tax rate is 10% (2012: 10%).

The reconciliation between the income tax expense and the accounting profit multiplied by the statutory tax rate for the years ended 31 December 2013 and 31 December 2012 is presented as follows:

	2013	2012
	<i>BGN'000</i>	<i>BGN'000</i>
Accounting profit before taxes	2,988	3,231
Income tax expense at statutory tax rate of 10% for 2013 (2012: 10%)	299	323
Other	(2)	2
Income tax expense	297	325

At 31 December 2013 the Group owes corporate income tax amounting to BGN 13 thousand (2012: prepaid income tax amounting to BGN 80 thousand).

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

4. Income tax (continued)

Deferred income tax is linked to the following headings in the balance sheet:

	Temporary difference	Tax	Temporary difference	Tax
	31.12.2013	31.12.2013	31.12.2012	31.12.2012
	BGN '000	BGN '000	BGN '000	BGN '000
Unpaid income to individuals and related social security expense	8	1	4	-

5. Cash and cash equivalents

	31 December	
	2013	2012
	<i>BGN'000</i>	<i>BGN'000</i>
Cash in hand and in current accounts	131	34
Short-term bank deposits	18,394	15,332
Cash at special account	23,963	24,614
Total cash and cash equivalents	42,488	39,980

Cash in bank accounts bears floating interest rates based on the daily interest rates on bank deposits. The term of short-term deposits is one year, but the amounts therein can be changed depending on the liquidity needs of the Group. They bear the agreed interest rates, which vary from 3.00 to 5.75 % p.a. (2012: 3.75-5.75 %). The balances of interest receivables on deposits are included in cash and cash equivalents since the amounts accrued are available to the Group on demand. The fair value of cash and short-term deposits equals their carrying amount.

The cash equivalents at the special account are designated for financing urban development projects under the JESSICA initiative under certain conditions determined in the Operational Agreement between the EIB, FLAG and FSUDS. The cash equivalents in the special account are under a pledge in favor of the European Investment Bank (EIB).

6. Receivables and prepayments

	31 December	
	2013	2012
	<i>BGN'000</i>	<i>BGN'000</i>
Advances to suppliers	10	-
Deferred expenses	8	-
Other receivables	9	9
Total receivables and prepayments	27	9

Other receivables comprise guarantees provided and non-financial prepayments for future periods.

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
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For the year ended 31 December 2013

7. Plant and equipment, software

	Hardware <i>BGN'000</i>	Fixtures and fittings <i>BGN'000</i>	Plant and equipment <i>BGN'000</i>	Vehicles <i>BGN'000</i>	Software <i>BGN'000</i>	Other Fixed assets <i>BGN'000</i>	Total <i>BGN'000</i>
Book value:							
As at 1 January 2012	19	7	2	36	10	-	74
Additions	19	-	1	-	1	-	21
As at 31 December 2012	38	7	3	36	11	-	95
Additions	-	-	16	-	-	5	21
As at 31 December 2013	38	7	19	36	11	5	116
Depreciation:							
As at 1 January 2012	(19)	(4)	(1)	(27)	(2)	-	(53)
Depreciation charge	(1)	(2)	-	(9)	(5)	-	(17)
As at 31 December 2012	(20)	(6)	(1)	(36)	(7)	-	(70)
Depreciation charge	(9)	(1)	(3)	-	(4)	(1)	(18)
As at 31 December 2013	(29)	(7)	(4)	(36)	(11)	(1)	(88)
Net book value:							
As at 1 January 2012	-	3	1	9	8	-	21
As at 31 December 2012	18	1	2	-	4	-	25
As at 31 December 2013	9	-	15	-	-	4	28

8. Subsidiary company

By a decision dated 3 April 2012 of the sole owner of FLAG JSC, the MRDPW, and after a meeting of the Board of Directors of the Fund, a new company was incorporated - Fund for Sustainable Urban Development of Sofia EAD, with capital of BGN 500 thousand. The company was registered on 23 April 2012 with the Registry Agency and the capital was paid in full by FLAG JSC. The purpose of the newly established subsidiary is to implement financing under the European programme Jessica in accordance with a trilateral agreement among EIB, FLAG JSC and FSUDS EAD. As at the end of 2013, the subsidiary had made a disbursement under one loan, which has been consolidated in the current financial statements.

9. Loans granted to third parties

	31 December	
	2013 <i>BGN'000</i>	2012 <i>BGN'000</i>
Loans granted to municipalities	133,171	113,373
Impairment of receivables from loans granted to municipalities	(523)	(429)
Net loans granted to municipalities	132,648	112,944
Loans granted for urban development projects under Jessica initiative	1,806	-
Total loans granted	134,454	112,944

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

9. Loans granted to third parties (continued)

Loans granted represent loans extended to municipalities and a loan under a Jessica project. Most of the loans granted – BGN 107,553 thousand are used as bridge financing under European programmes. The utilized loan under the JESSICA initiative, amounting to BGN 1,806 thousand, has been consolidated for the purposes of the financial statements. The remaining amount of BGN 25,095 thousand is intended for lending funds for municipalities' own activities.

In 2012, bridge financing loans amounted to BGN 93,749 thousand and those for lending funds for own activities amounted to BGN 19,442 thousand.

Receivables on loans granted have been impaired in accordance with the portfolio-based impairment policy adopted by FLAG JSC. As at 31 December 2013, the impairment of bridge financing loans amounted to BGN 269 thousand (2012: BGN 235 thousand) and the impairment of loans repaid by own funds at 31 December 2013 amounted to BGN 254 thousand (2012: BGN 194 thousand).

Loans granted are secured mainly with specific pledges over the future receivables of the municipalities under the grant agreements and the future own revenue of the municipalities.

The movements in the impairment loss provisions of loans granted in 2013 and 2012 are as follows:

	<i>Impairment of receivables on loans granted</i>
As at 1 January 2012, incl.	(208)
- for bridge financing	(152)
- for own financing	(56)
Charged for the year – incl.	(221)
- for bridge financing	(83)
- for own financing	(138)
Net change in 31 December 2012, incl.	(429)
- for bridge financing	(235)
- for own financing	(194)
Charged for the year – incl.	(94)
- for bridge financing	(34)
- for own financing	(60)
Net change in 31 December 2013, incl.	(523)
- for bridge financing	(269)
- for own financing	(254)

Provisions accrued are not specific provisions, by specific loans, but portfolio loans in accordance with the adopted policy for impairment in the event of credit losses.

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

10. Loan payables

	Maturity	31 December	
		2013	2012
		<i>BGN'000</i>	<i>BGN'000</i>
Long term			
Payables under EBRD loan 1	August 2023	57,045	62,750
Payables to EBRD under Loan 3 T1	August 2018	15,350	-
Payables to EBRD under Loan 3 T2	August 2023	14,753	-
Deferred fees under EBRD loans		(1,111)	(251)
Accrued interest due		671	1,176
Total payables under EBRD loan		86,708	63,675
Payables under EIB loan			
	June 2035	24,855	24,614
Total payables under EIB loan		24,855	24,614
Total loan payables		111,563	88,289

Loan payables of the Group to the European Bank for Reconstruction and Development (EBRD) result from the utilisation of funds under two loan agreements.

The first loan with a limit of EUR 35,000 thousand (BGN 68,454 thousand), which amount has two components:

1. Loan "a" – amounting to EUR 18,000 thousand (BGN 35,205 thousand)
2. Loan "b" – amounting to EUR 17,000 thousand (BGN 33,249 thousand).

The term of the loan is 15 years with a 3-year grace period. For the period following the grace period, two equal instalments a year are to be made, from February 2012 to August 2023. The contractual interest rate is based on the six-month EURIBOR plus a floating margin based on the amount of bad debts within the Group's loan portfolio. Additional fees are envisaged: (a) annual commitment fee; (b) one-off Front - End Fee; (c) annual administration fee.

As at 31 December 2013 the Group has utilised the full amount of the loan - EUR 35,000 thousand (BGN 68,454 thousand) – of the resource granted and is not in violation of any covenants of the agreement with EBRD on capital and financial adequacy. The year of 2013 is the second year of loan repayment. Two instalments were repaid amounting to BGN 5,705 thousand in total.

The second loan has a limit of EUR 35,000 thousand, which has two components:

1. Tranch 1 (Loan 3 T1) – in the amount of EUR 20,000 thousand (BGN 39,117 thousand)
2. Tranch 2 (Loan 3 T2) - in the amount of EUR 15,000 thousand (BGN 29,337 thousand).

The term of Tranch 1 is 5 years without a grace period with two equal instalments a year are to be made, from February 2014 to August 2018. The contractual interest rate is based on the six-month EURIBOR plus a floating margin based on the amount of bad debts within the Group's loan portfolio. Additional fees are envisaged: (a) annual commitment fee; (b) one-off Front - End Fee; (c) annual administration fee; and (d) a syndication fee;

The term of Tranch 2 is 10 years with a one-year grace period. After the grace period two equal instalments a year are to be made, from February 2015 to August 2023. The contractual interest rate is based on the six-month EURIBOR plus a floating margin based on the amount of bad debts within the loan portfolio of Fund for Local Authorities and Governments in Bulgaria – FLAG. Additional fees are envisaged: (a) annual commitment fee; (b) one-off Front - End Fee; (c) annual administration fee; and (d) a syndication fee.

As at December 2013 the Group has utilized a part of the loan in the amount of EUR 15,392 thousand (BGN 30,103 thousand) and is not in breach of capital and financial adequacy requirements set out in the EBRD loan agreement. In 2013 no repayment under this loan were made.

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

10. Loan payables (continued)

On May 30, 2012 an operational agreement was signed between the European Investment Bank (EIB), "Fund for Sustainable Urban Development of Sofia" (FSUDS) EAD and "Fund for Local Authorities and Governments in Bulgaria - FLAG", under which the EIB provides FSUDS a contingent loan of BGN 24,600 thousand. The purpose of the loan is to provide funding for suitable urban development projects under the "JESSICA" initiative (Joint European Support for Sustainable Investment in City Areas).

FSUDS should keep the loan in disbursement account until funds are granted for suitable projects for urban development through Contracts for project financing. An annual interest rate agreed between EIB and FSUDS shall be accrued on the funds in the disbursement account. This interest should be capitalised and added to the resources that can be provided to final recipients under Contracts for project financing.

The loan funds can be used only to finance urban development projects. All amounts paid by final recipients under On-lending agreements and/or returns under Equity investment agreements are deposited in a "Reserve account" and are kept there by FSUDS till a payment date to the EIB. FSUDS pays the EIB on each payment date an amount equal to the positive balance of the reserve account. Payment dates are the last day of each six-month period following the date of loan issue to maturity.

The reserve account should be charged an annual interest rate of not less than the 3-month SOFIBOR.

FSUDS and FLAG are required to ensure that the Co-financing provided to each final recipient is at least equal to the funds provided to the same recipient under the EIB loan through a Contract for project financing.

11. Payroll and social security payables

Payables to personnel and for social security at 31 December 2013 relate to the accrued additional remuneration (bonuses) and are allocated as follows:

	31 December	
	2013	2012
	<i>BGN '000</i>	<i>BGN '000</i>
Payables to personnel	34	25
Payables for social security	15	6
Total payables to personnel and for social security	49	31

12. Tax receivables (payables)

Tax liabilities as at 31 December 2013 stand at BGN 13 thousand.

The movements in tax liabilities for 2013 and 2012 are as follows:

	31 December	
	2013	2012
	<i>BGN '000</i>	<i>BGN '000</i>
Tax receivable / (payable) as at 31 January	80	110
Tax paid throughout the year	204	295
Tax accrued for the year (Note 4)	(297)	(325)
Tax receivable/(payable) as at 31 December	(13)	80

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

13. Other liabilities

	31 December	
	2013	2012
	<i>BGN'000</i>	<i>BGN'000</i>
Other liabilities	170	104
<i>incl. Contingent fee for loan applicants</i>	139	79
<i>Good performance guarantee</i>	16	16
<i>Payables to suppliers</i>	11	9
<i>Advances received</i>	4	-
Total other liabilities	170	104

14. Share capital and reserves

14.1 Share capital

	31 December	
	2013	2012
	<i>BGN'000</i>	<i>BGN'000</i>
60,000 ordinary shares with a nominal value of BGN 1,000 each	60,000	60,000
Total share capital	60,000	60,000

At 31 December 2013 and 31 December 2012 the issued registered capital was fully paid-in.

14.2 Statutory reserves

Statutory reserves are formed by FLAG JCS as a distribution of the profit as provided for under Article 246 of the Commercial Act. They are set aside until the amount reaches one tenth or more of the capital. Sources to form the statutory reserves include at least one tenth of the net profit, share premiums and funds set out in the Articles of Association or in accordance with a decision of the General Meeting of Shareholders.

The statutory reserves may only be used to cover current and prior reporting period losses. As at 31 December 2013 statutory reserves amount to BGN 1,431 thousand (2012: BGN 1,139 thousand).

15. Dividend distribution

In accordance with Article 23(1)(2) of Decree No 1 of the Council of Ministers of 9 January 2013 in 2013 dividends were distributed to the sole shareholder in the amount of BGN 2,102 thousand. In 2012 in accordance with Article 28 of Decree No 367 of the Council of Ministers of 29 December 2011 dividends were distributed to the sole shareholder in the amount of BGN 2,276 thousand. Under the same decree the retained earnings for 2008, 2009, 2010 in the total amount of BGN 1,644 thousand were distributed as dividends. The dividend per share is BGN 35,03 (2012: BGN 37,93).

16. Commitments and contingencies

Legal claims

As at 31 December 2013 and 31 December 2012 there were no litigations against the Group.

Guarantees

As at 31 December 2013 and 31 December 2012 the Group has not extended guarantees.

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

16. Commitments and contingencies (continued)

Loan commitments

As at 31 December 2013 the Group has taken loan commitments amounting to BGN 41,864 thousand on 23 loan agreements signed with municipalities; no funds were utilized at the year-end. The number of contracts for the previous year was 9 totaling to BGN 5,738 thousand.

Commitments related to rents / operating leases

The Group has a rental contract concluded for the rent of an office for a term of four years, which comes into force on 1 March 2013.

17. Related party disclosure

Composition of the related parties

Shareholder – sole owner

The Republic of Bulgaria through the Ministry of Regional Development and Public Works is the sole owner of the shares of FLAG JSC.

Fund for Sustainable Urban Development of Sofia EAD is a fully-owned subsidiary of FLAG EAD with a capital of BGN 500 thousand fully paid by the shareholder in 2012.

Remuneration of management staff

In 2013, the remuneration of management staff amounted to BGN 165 thousand (2012: BGN 75 thousand).

18. Financial risk management objectives and policies

The major financial liabilities of the Group comprise interest-bearing loans and borrowings, and trade payables. The main objective of these financial instruments is to secure financing of the Group's operations. The Group has various financial assets such as loans granted, cash and cash equivalents and short term deposits, which arise directly from its operations.

In 2013 and 2012, the Group neither owned nor traded in derivative financial instruments.

The main risks arising from the Group's financial instruments are interest rate risk, liquidity risk, currency risk and credit risk. The management reviews and agrees policies for managing each of these risks which are summarised below.

Interest-rate risk

The Group's exposure to the risk of changes in market interest rate relates primarily to the Group's long-term financial liabilities with variable (floating) interest rates. The Group's policy is to manage its interest expenses through providing loans with floating interest rates.

Sensitivity to possible changes in interest rates (through the effect on loans and borrowings with floating interest rates) of the Group's profit before tax, with all other variable held constant is presented below:

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

18. Financial risk management objectives and policies (continued)

Interest-rate risk (continued)

	<u>Increase/Decrease in interest rates</u>	<u>Effect on pre-tax profit</u> <i>BGN'000</i>
2013		
In EUR	+0.5%	(436)
In BGN	+0.5%	670
In EUR	-1%	871
In BGN	-1%	(1,340)
2012		
In EUR	+0.5%	(447)
In BGN	+0.5%	566
In EUR	-1%	894
In BGN	-1%	(1,132)

Liquidity risk

The effective management of the Group's liquidity presumes that sufficient working capital will be ensured mainly through maintaining a given amount of money on deposit. A cash flow movement plan is elaborated based on short-term budgets, and also on long-term planning.

As at 31 December the maturity structure of the Group's financial and other liabilities, based on the agreed undiscounted payments, is presented below:

Liabilities

As at 31 December 2013

	<u>On demand</u> <i>BGN '000</i>	<u>< 3 months</u> <i>BGN '000</i>	<u>3-12 months</u> <i>BGN '000</i>	<u>1-5 years</u> <i>BGN '000</i>	<u>> 5 years</u> <i>BGN '000</i>	<u>Total</u> <i>BGN '000</i>
Interest-bearing loans and borrowings	-	5,239	5,484	48,171	64,399	123,293
Trade and other payables	-	166	-	-	-	166
	-	5,405	5,484	48,171	64,399	123,459

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

18. Financial risk management objectives and policies (continued)

Liquidity risk (continued)

As at 31 December 2012

	<u>On demand</u>	<u>< 3 months</u>	<u>3-12</u>	<u>1-5</u>	<u>> 5 years</u>	<u>Total</u>
	<i>BGN '000</i>	<i>BGN '000</i>	<i>months</i>	<i>years</i>	<i>BGN '000</i>	<i>BGN '000</i>
Interest-bearing loans and borrowings	-	3,873	3,873	30,980	46,470	85,196
Trade and other payables	-	104	-	-	-	104
	<u>-</u>	<u>3,977</u>	<u>3,873</u>	<u>30,980</u>	<u>46,470</u>	<u>85,300</u>

The maturity structure of the Group's assets and liabilities at 31 December 2013 has been developed based on the expectations of management regarding the recoverability/settlement of amounts:

Assets	<i>Within 1 year</i>	<i>Over 1 year</i>	<i>Total amount</i>
Cash and cash equivalents	42,488	-	42,488
Receivables	9	-	9
Loans granted	92,396	42,058	134,454
Total assets	134,893	42,058	176,951
Liabilities	<i>Within 1 year</i>	<i>Over 1 year</i>	<i>Total amount</i>
Other liabilities	166	-	166
Payables on the EBRD loan	9,257	77,451	86,708
Payables on the EIB loan	-	24,855	24,855
Total liabilities	9,423	102,306	111,729

The maturity structure of the Group's assets and liabilities as at 31 December 2012 has been developed based on the expectations of management regarding the recoverability/settlement of amounts:

Assets	<i>Within 1 year</i>	<i>Over 1 year</i>	<i>Total amount</i>
Cash and cash equivalents	15,366	24,614	39,980
Receivables on overpaid income tax	80	-	80
Receivables and prepayments	9	-	9
Loans granted	63,335	49,609	112,944
Plant, equipment and software	-	25	25
Total assets	78,790	74,248	153,038

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

18. Financial risk management objectives and policies (continued)

Liquidity risk (continued)

Liabilities	<u>Within 1 year</u>	<u>Over 1 year</u>	<u>Total amount</u>
Payables to personnel and for social security	31	-	31
Other liabilities	104	-	104
Payables on the EBRD loan	6,858	56,817	63,675
Payables on the EIB loan	-	24,614	24,614
Total liabilities	6,993	81,431	88,424

Currency risk

The Group has no purchases, sales and does not grant loans denominated in foreign currencies and the loans received are denominated in EUR. Since the exchange rate of BGN / EUR is fixed at the rate of 1.95583, the currency risk arising out of the Group's exposures in EUR is immaterial.

Credit risk

Credit risk is the risk that the clients/counterparties will not be able to pay in full the amounts due to the Group within the envisaged/agreed deadlines. As at the end of 2013 the remaining liability of municipalities to the Group amounted to BGN 133,043 thousand and at the end of 2012 it stood at BGN 113,191 thousand.

Credit risk management in 2013 was carried out by the "Lending" Directorate and was monitored simultaneously by the Executive Director and the Board of Directors. The credit risk management function is to ensure the implementation of an appropriate investment policy in respect of the funds available and respectively, the compliance of this policy with the related procedures and controls for current monitoring of the respective loan, deposit or receivable.

The credit risk exposure is managed through a current analysis of the ability of the counterparties/servicing banks to comply with their contractual obligations to pay interest and principal, as well as through setting appropriate credit limits. Cash deposits are placed with prime banks having good reputation at the Bulgarian market. In compliance with the adopted internal rules for contracting cash deposits, invitations to submit an offer are sent only to banks that have the right to operate in the territory of the Republic of Bulgaria and have an assigned and not withdrawn (valid at the time of offer submission) credit rating not lower than a) BB+ assigned by the rating agencies Standard and Poor's or Fitch, or b) Ba1 assigned by Moody's.

Furthermore, subject to current monitoring is also the existence of concentration of receivables from a particular counterparty, and if such is found – the respective counterparty is subject to special current supervision. The impairment accrued on loans granted as at 31 December 2013 is portfolio based, and not in respect of specific exposures.

The maximum exposure of the Group to credit risk as at 31 December 2013 and 31 December 2012 is as follows:

	<u>2013</u>		<u>2012</u>	
	<u>Gross maximum exposure</u>	<u>Net maximum exposure</u>	<u>Gross maximum exposure</u>	<u>Net maximum exposure</u>
Exposure				
Cash and cash equivalents	42,488	42,488	39,980	39,980
Loans granted	134,977	134,454	113,373	112,944
Receivables and prepayments	9	9	9	9
Total balance sheet items	177,474	176,951	153,362	152,860

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

18. Financial risk management objectives and policies (continued)

Credit risk (continued)

The Group allocates its financial assets in several classification groups with the aim to assess their credit risk. The table below shows the classification of the gross amount of financial assets from the consolidated statement of financial position depending on their arrears at 31 December 2013:

	<i>Neither overdue nor impaired</i>	<i>Overdue but not impaired</i>	<i>Impaired, on an individual base</i>	<i>Total</i>
Cash and cash equivalents	42,488	-	-	42,488
Loans granted	134,977	-	-	134,977
Receivables and prepayments	9	-	-	9
	<u>177,474</u>	<u>-</u>	<u>-</u>	<u>177,474</u>

As at the end of 2013 no loans were overdue. As at 31 December 2013 eight restructured loans were active, in the amount of BGN 2,232 thousand or 1.67 % of the total loan portfolio.

The classification of the gross amount of financial assets from the balance sheet depending on their arrears as at 31 December 2012 is as follows:

	<i>Neither overdue nor impaired</i>	<i>Overdue but not impaired</i>	<i>Impaired, on an individual base</i>	<i>Total</i>
Cash and cash equivalents	39,980	-	-	39,980
Loans granted	113,305	68	-	113,373
Receivables and prepayments	9	-	-	9
	<u>153,294</u>	<u>68</u>	<u>-</u>	<u>153,362</u>

Receivables overdue, but not impaired have been overdue for up to 40 days. As at 31 December 2012 fourteen restructured loans were active in the total amount of BGN 6,259 thousand or 5,5 % of the total credit portfolio.

Capital management

The primary objective of the Group's capital management is to ensure that it maintains a strong credit rating and healthy capital ratios to support its business and maximise shareholder value.

The Group manages its capital structure and adjusts it, where necessary, depending on the changes in the economic environment. The Group is subject to the Council of Ministers Decrees for dividend distribution to the Ministry of Regional Development and Public Works. In 2013 and in 2012 there have been no changes in the objectives, policies or processes related to the Group's capital management.

The Group monitors its equity through the financial result achieved for the reporting period as follows:

	2013	2012
	<u>BGN'000</u>	<u>BGN'000</u>
Net profit in thousand BGN	<u>2,691</u>	<u>2,906</u>

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC
NOTES TO THE FINANCIAL STATEMENTS

For the year ended 31 December 2013

18. Financial risk management objectives and policies (continued)

Capital management (continued)

The Group is obliged to follow externally imposed capital requirements in accordance with the concluded bank loan contract. They include the observance of certain financial ratios, such as the debt to equity ratio. This ratio must not exceed the ratio of 7:3. The Group complied with these externally imposed capital requirements as at 31 December 2013 and 31 December 2012.

19. Financial instruments

Fair values

Fair value is the amount at which a financial instrument may be exchanged or settled in an arm's length transaction as best proof of its market value in an active market.

The fair value of these financial instruments is determined according to measurement methodology corresponding to Level 3 as per fair value hierarchy described in note 2.2 e) Summary of significant accounting policies, IFRS 13 Fair Value Measurement.

The estimated fair value of the financial instruments is determined by the Group on the basis of available market information, if any, or proper valuation models. The fair value of financial instruments that are actively traded in organised financial markets is determined by reference to quoted market bid prices at the close of business on the last working date of the reporting period. For financial instruments where there is no active market, fair value is determined using valuation techniques. Such techniques include using recent arm's length market transactions; reference to the current market value of another instrument, which is substantially the same; discounted cash flow analysis or other valuation models.

Management of FLAG JSC believes that the fair values of financial instruments comprising cash and short-term deposits, trade and other receivables, interest-bearing loans and borrowings, trade and other payables, do not differ significantly from their current carrying amounts, especially when they are short-term in nature or their interest rates are changing in line with the change in the current market conditions. The Group has analysed the fair values of fixed interest rate deposits and is of the opinion that they approximate their carrying amounts.

20. Events after the reporting period

Besides the disclosed above, no other events have occurred after 31 December 2013, which require additional adjustments and/or disclosures in the Group's consolidated financial statements for the year ended 31 December 2013.



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Independent Auditor's Report

To the sole owner of FUND FOR LOCAL AUTHORITIES AND GOVERNMENT - FLAG EAD

Report on the consolidated financial statements

We have audited the accompanying consolidated financial statements of FUND FOR LOCAL AUTHORITIES AND GOVERNMENT - FLAG EAD and its subsidiary (the "Group") which comprise the consolidated statement of financial position as of 31 December 2013 and the consolidated statements of comprehensive income, 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 consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these consolidated 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 about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated 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 Group's preparation of consolidated financial statements that give a true and fair view 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 Group'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 consolidated financial statements.

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

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Registered in Bulgaria (ID - 131 349 346). List of directors can be found at the Company's Registered Office.

An independent member of Baker Tilly International



Opinion


In our opinion, the consolidated financial statements give a true and fair view of the consolidated financial position of FUND FOR LOCAL AUTHORITIES AND GOVERNMENT - FLAG EAD as of 31 December 2013, and of its consolidated financial performance and its cash flows for the year then ended in accordance with IFRS, as adopted by the European Union.

Other matters

The consolidated financial statements of FUND FOR LOCAL AUTHORITIES AND GOVERNMENT- FLAG EAD as of and for the year ended 31 December 2012 have been audited by other auditor, who has issued an unqualified auditor's report dated 14 May, 2013.

Other Reports on regulatory requirements – Annual consolidated activity report of the Group according to article 33 of the Accountancy Act

Pursuant to the requirements of the Bulgarian Accountancy Act, article 38, paragraph 4, we have read the accompanying Annual consolidated activity report of FUND FOR LOCAL AUTHORITIES AND GOVERNMENT - FLAG EAD. The Annual consolidated activity report of the Group, prepared by the Group's management is not a part of the consolidated financial statements. The historical financial information, presented in the Annual consolidated activity report of the Group, prepared by the management is consistent, in all material respects, with the financial information, disclosed in the consolidated financial statements of the Group as of December 31, 2013 prepared in accordance with IFRS, as adopted by the EU. Management is responsible for the preparation of the Annual consolidated activity report of the FUND FOR LOCAL AUTHORITIES AND GOVERNMENT – FLAG EAD.


Krassimira Radeva
Registered auditor

Managing Director
Baker Tilly Klitou and Partners Ltd



26 May 2014
Sofia, Bulgaria

**FUND FOR LOCAL AUTHORITIES AND
GOVERNMENT IN BULGARIA – FLAG JSC**

FINANCIAL RATIOS COMPLIANCE REPORT
AND INDEPENDENT ASSURANCE OPINION
31 December 2013

Fund for Local Authorities and Government – FLAG EAD

17-19 Sv. Sv. Kiril i Metody Str.

Sofia, Bulgaria

Independent Assurance Report to Fund for Local Authorities and Government – FLAG EAD

Independent assurance report to Fund for Local Authorities and Government – FLAG EAD's (the "Company") compliance with the requirements contained in the following loan agreements:

- *Loan Agreement dated 22 December 2008 between the Company and European Bank for Reconstruction and Development ("EBRD") and supplemented by Amendment Agreement 1 signed on 25 November 2009 and Amendment Agreement 2 signed on 25 November 2013, and*
- *Loan Agreement dated 30 October 2013 between the Company and European Bank for Reconstruction and Development ("EBRD"),*

both treated as (the "Contracts") regarding certain Financial Ratios for the year ended 31 December 2013, detailed calculation of which is prepared by management based on the consolidated financial statements of Fund for Local Authorities and Government – FLAG EAD, and is presented in the attached Financial Ratios Compliance Report.

The subject matter information of our work is the compliance of the financial ratios of the Company with the requirements of the Contracts regarding certain Financial Ratios described in Appendix 1.

Identification of the criteria

The criteria against which the subject matter information was measured were:

- The way of calculation of the financial ratios as described in the Contracts, and
- Whether the value of the financial ratios as at 31 December 2013 calculated by the Management of the Company is within the limits defined in the Contracts.

Identification of the responsible party

The responsible party is the management of Fund for Local Authorities and Government – FLAG EAD.

Responsible party's responsibility for the subject matter information provided

Management is responsible for the preparation of Financial Ratios Compliance Report and compliance with the requirements contained in the Contracts.

Practitioner's Responsibility

Our responsibility is to express a conclusion on the subject matter information provided based on our non-audit assurance engagement.

Our engagement was performed in accordance with International Standards on Assurance Engagements 3000 "Assurance Engagements other than audits or reviews of historical financial information". This Standard requires that we plan and perform the engagement to obtain an understanding of the subject matter and other engagement circumstances, sufficient to identify and assess the risks of the subject matter information being materially misstated, and sufficient to design and perform further evidence-gathering procedures. We have not performed an audit and, accordingly, we do not express an audit opinion.

Summary of work performed

Our work involved the following activities:

1. We have obtained the detailed calculation of the described in Appendix 1 Financial Ratios performed by the management of the Company;
2. We have recalculated the described in Appendix 1 Financial ratios based on the audited by us, Baker Tilly Klitou and Partners OOD, financial information as at 31 December 2013;
3. We have compared the calculated by us, Baker Tilly Klitou and Partners OOD, financial ratios to the calculation of the financial ratios performed by the management of the Company;
4. We have compared the calculation of the financial ratios performed by the management of the Company to the requirements of the Contracts;
5. We have obtained a management representation letter from the management of Fund for Local Authorities and Government related to the performed engagement.

Practitioner's conclusion

In our opinion the reported financial ratios for the year ended 31 December 2013 as included in Fund for Local Authorities and Government – FLAG EAD Appendix 1 are in compliance, in all material respects, with the financial ratios requirements contained in the Contracts.



Krassimira Radeva

Registered auditor

Baker Tilly Klitou and Partners OOD

26 May 2014



Fund for Local Authorities and Government – FLAG EAD

Appendix 1

Financial Ratios Compliance Report

31 December 2013

a) Loans in arrears ratio

	Year ended 31 December 2013
Loans in arrears	-
Loan portfolio balance	134,454
Loans in arrears ratio	0%

b) Debt to Equity ratio

	Year ended 31 December 2013
Debt	87,148
Equity	65,203
Debt to Equity ratio	1,34

*The figure corresponds to a ratio of 4 /3

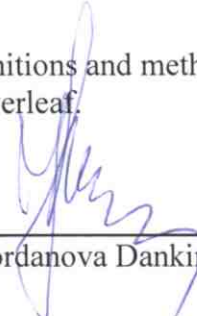
c) Liquid assets to Total assets ratio

	Year ended 31 December 2013
Liquid assets	18,525
Total assets	176,998
Liquid assets to total assets ratio	10,47%

d) Open Credit Exposure Ratio

	Year ended 31 December 2013
Problem exposures	2,232
Equity	65,203
Open Credit exposure ratio	3,42%

The definitions and methods for calculations of the Financial Ratios are presented below overleaf.



Nadya Jordanova Dankinova
CEO

26 May 2014





Kalinka Ruskova Todorova
Chief Accountant

Financial Ratios - definitions

(a) **Loans in arrears ratio.** The Borrower shall, at all times, maintain a ratio of outstanding loans 90 days or more in arrears in the Borrower's loan portfolio to the aggregate of all outstanding loans in the Borrower's loan portfolio of not greater than 5%.

(b) **Debt to Equity ratio.** The Borrower shall, at all times, maintain a ratio of (i) Debt, to (ii) Equity, of not more than 7:3. For the purposes of this Section:

(1) "Debt" means the Financial Debt of the Borrower.

(2) "Equity" means the Capital of the Borrower.

For the purpose of computing this ratio, Financial debt includes only obligations for the payment or repayment of money borrowed where there is full recourse to the Borrower.

(c) **Liquid assets to total assets ratio.** The Borrower shall, at all times, maintain a ratio of (i) Liquid Assets to (ii) Total Assets of not less than 5%.

(d) **Open Credit Exposure Ratio.** The Borrower shall, at all times, maintain an Open Credit Exposure Ratio of not greater than 15%.

Mrs. Nadya Dankinova
CEO

Fund for Local Authorities and Government – FLAG EAD
17-19 Sv. Sv. Kiril i Metody Str.
Sofia, Bulgaria

26 May 2014

Dear Mrs Dankinova,

Internal Control Report

We set out as an Appendix to this letter a matter arising from our audit of Fund for Local Authorities and Government – FLAG EAD for the year ended 31 December 2013.

The principal objective of our audit procedures is to enable us to express our opinion on the truth and fairness of the financial statements as a whole. An audit opinion is based on the concept of reasonable assurance. It is not a guarantee that the financial statements are free of misstatements. We explained our responsibilities, and their limitations, in our engagement letter dated 18 October 2013.

Our audit procedures are tailored to our assessment of risk of material misstatement taking into account the inherent risk of error or fraud and our assessment of the effectiveness of controls in eliminating or reducing those risks.

We have prepared this report solely for your use and within your organization. It is not intended to include every matter that came to our attention. For this reason, we believe that it would be inappropriate to be made available to third parties. If such a third party were to obtain copy without our prior written consent, we would not accept any responsibility for any reliance that they might place on it.

We consider controls primarily at the corporate level and in overall terms. We cannot in practice examine every operating activity or accounting procedure in the organization, nor can we substitute for management's responsibility to maintain adequate controls at all levels of the operation. Our work cannot, therefore, be expected to identify all weaknesses in your systems and procedures which a special investigation directed at these systems and procedures might reveal.

We have classified all weaknesses according to their importance i.e. high, medium, low together with their cost to implement of high, medium, low.

As to the possibility of fraud, we plan our audit to have a reasonable expectation of this disclosure if the potential effects of the fraud would be material to the financial statements. However, there are many kinds of fraudulent activity, particularly those involving forgery, collusion and management override of control systems, which it would be unreasonable to expect the normal audit to uncover.

We wish to express our appreciation for the co-operation and courtesy extended to us by the management and employees of Fund for Local Authorities and Government – FLAG EAD during the course of the work.

Yours faithfully,



Krassimira Radeva
Managing Director

Appendix 1

Weakness	Risk	Relative importance	Recommendation	Relative cost to implement	Management comments
<p>1. <u>Loss provisioning</u></p> <p>We have noted that the adopted policy for calculating loss provisioning is based on whether the loan will be repaid by:</p> <ul style="list-style-type: none"> - own resources - loss provision equals 1% of the loan receivable or - Managing Authority – loss provision equals 0.25% of the loan receivable 	<p>There is a risk of overstatement/ understatement of loss provisioning.</p> <p>This risk is significantly mitigated by the current aging structure of the portfolio in which there are no overdue loans receivables. However this risk could possibly have a material impact in the future in case of deterioration of the loan portfolio.</p>	<p>Medium</p>	<p>Management should prepare and adopt loss provisioning policy which is in full compliance with the requirements of IAS 39. The entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets are impaired. If there is objective evidence that an impairment loss on loans has been incurred, the amount on loss is to be measured as the difference between the assets carrying amount and the present value of future estimated cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognized in profit or loss.</p>	<p>Low</p>	<p>The policy on impairments for credit losses is adopted by the Board of Directors of FLAG. We consider that the Policy reflects the specifics in the company's activities. We have no basis to consider that the loss of provisioning is underestimated.</p>

-END-