



**ФОНД ЗА ОРГАНИТЕ
НА МЕСТНО
САМОУПРАВЛЕНИЕ
В БЪЛГАРИЯ - ФЛАГ ЕАД**

**FUND FOR LOCAL
AUTHORITIES AND
GOVERNMENTS - FLAG**

2008 Annual Financial Statements and Activity Report of FLAG EAD



FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA -FLAG JSC

Board of Directors:

Dimcho Mihalevski (Chairman)
Lyubomir Datzov (Deputy Chairman)
Emil Savov
Iskra Mihaylova-Koparova
Dimitar Peytchev
Atanas Kostadinov
Michael Neumayr

Executive Director:

Emil Savov

Accountants:

Fiscalia EOOD

Address of Management:

Sofia, 17-19, Sv. Sv. Kiril I Metodiy Str.

Servicing Banks:

UniCredit Bulbank
Raiffeisenbank
DSK Bank
Eurobank EFG Bulgaria

Auditors:

AFA OOD

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ANNUAL REPORT

on the activities of the
Fund for Local Authorities and Governments in Bulgaria – FLAG JSC
for year 2008

This report has been prepared in accordance with:

- the requirements of the Bulgarian Accountancy Act (Art. 38, para 4)
 - the requirements of Art. 23 of the Rules on the Procedures for Exercising the Powers of the State in Commercial Companies with State Participation in the Capital.
-

Business program

In 2008 the main activities of the company were directed to creating conditions for the start-up of its operations – development and adoption of work rules and regulations for granting of loans, clarification of the parameters of loan agreements with the World Bank and the European Bank for Reconstruction and Development (EBRD), concluding agreements with a Managing Bank and EBRD, increasing the capital of the company, furnishing of a suitable office and recruitment of a team of experts.

- **Management and capital**

In March 2008 an agreement was concluded between the principal – the Minister of Regional Development and Public Works Assen Gagauzov – and the Board of Directors for assigning the management of the company. Operational budget was approved at the amount of BGN 600 thousand for the period April – September 2008. A decision was taken in May for management of company's capital of BGN 30 million.

Within the frame of the budget procedure for year 2009, the Minister of the Regional Development and Public Works initiated a proposal to the Ministry of Finance for increasing the capital of the company by BGN 30 million and for establishing a budget mechanism for full or partial compensation of expenses incurred by municipalities for the servicing of a debt assumed by FLAG at the amount of BGN 25 million.

With the Law on the Budget of the Republic of Bulgaria for 2009 it was decided that BGN 50 million would be provided to FLAG for capital increase including funds for the compensatory mechanism.

- Sessions of the Board of Directors

The Fund is managed by a Board of Directors composed of seven members: Dimcho Mihalevski and Ikra Mihaylova (representatives of the Ministry of Regional Development and Public Works); Lyubomir Datzov (a representative of the Ministry of Finance); Dimitar Peytchev (a representative of the Ministry of Agriculture and Food); Atanas Kostadinov (a representative of the Ministry of Environment and Water); Emil Savov (a representative of the National Association of Municipalities of Republic of Bulgaria and Executive Director of FLAG) and Henry Russell/Arthur Schankler (a representative of the European Bank for reconstruction and development).

The Board of Directors organizes and governs the current activities of the Fund in executing all of its activities. During the reviewed period the Board of Directors took decisions on the current administration of the Fund, chose servicing banks, conducted a competition and choice of a consultant and a Managing Bank, accepted the Terms and Conditions for Financing and the loan agreement with EBRD. The Board of Directors reviews, makes adjustments and approves the documents presented by the consultants referring to the administration of FLAG and the choice of a Managing Bank. In October the Board of Directors approved the final rules for the performance of the activities of the Fund - rules and regulations on the activities, rules for project financing, price policy, credit portfolio management, and rules for the choice of depository bank(s). In addition, it approved the forms for loan requests for both types of projects including application form, other necessary documents, collaterals, terms, etc.

In 2008, the Board of Directors held 10 sessions in total with the following participation: Dimcho Mihalevski (Chairman of the Board of Directors – 10 sessions); Lyubomir Datzov (Deputy Chairman of the Board of Directors – 6 sessions); Emil Savov (Executive Director – 10 sessions); Iskra Mihaylova (6 sessions); Dimitar Peytchev (3 sessions); Atanas Kostadinov (8 sessions); Henry Russell/Arthur Schankler (4 sessions).

- **Administrative activities**

- Human resources

In March 2008 the job descriptions of the main positions in the company were approved. On 30 July 2008, the Board approved Rules and Regulations on Personnel, the formation of the funds for work salaries and other remunerations in the company. The Rules and Regulations are based on Art. 9 of the Ordinance on the formation of funds for work salaries in commercial

companies with over 50% state or municipal participation in 2007, which allows the financial institutions to operate by their own rules provided that they have been approved by the principal and the Minister of Labour and Social Policy.

In the months of August and September experts were recruited based of advertisements published in Capital newspaper and in the electronic employment exchange JobTiger. As a result of the conducted competitions and interviews the following specialists were assigned:

- ✓ Administrative assistance and office manager - one
- ✓ Project experts - three
- ✓ Financing and risk assessment expert - one
- ✓ Internal auditor – one.

In December two new employees with experience in the banking sector were chosen for the position of Credit expert, which would start work on 5 January 2009.

- Office

On 16 July 2008, the Board chose the premises at 1, 11th August Street to be rented for the needs of the company. That decision was reached after exhausting the possibilities for finding state-owned premises. In the end of August a refreshing repair was performed and then 10 work places were furnished with office furniture and computers. In addition, for the common needs of the office the Fund purchased: Opel Vectra vehicle, two network printers, two scanners, two notebooks, a fax/scanner/copy machine and file server.

- Consulting services

In April 2008 terms of reference were developed and accepted for the scope of consulting services directed to achieving the functionality of the company in accordance with the objectives set in the government decision for its establishment. A commission was created for the selection of a consultant under the terms of references for assisting the administration of the company. In May 2008 a public procurement procedure was held and as a result thereof a consultant was approved – Consortium Cooperation Sofia Consulting Group – Club Economy 2000. In June 2008 an agreement was concluded for providing a consulting assistance and by 15 September 2008 the Consortium Cooperation Sofia Consulting Group – Club Economy 2000 was obliged to develop Rules and Regulations on the Activities of FLAG, policy of FLAG for assets management, strategy for the choice of a Managing Bank for FLAG and documentation for the procedure for choosing of a Managing Bank, to assist in the management of FLAG for the assessment and the selection of the bank, to prepare recommendations on the admissibility criteria.

In the course of the execution of the contract with the consortium, the Board of Directors was periodically informed about the draft reports and policies before their final approval. In the

period the Board held three sessions in each of them accepting decisions related to the activities of the consortium. By the end of December, the work of the consultants was generally completed and only the Policy of FLAG for Assets Management will be finalised in January 2009.

- **Managing Bank (MB)**

In August the company announced a public procurement for the choice of a Managing Bank. The term for presenting proposals was 1 October 2008. The proposals of the three participating banks – UBB, DSK and UniCredit Bulbank – were opened in the beginning of October, assessed a commission assigned for the selection and the results were disclosed on 15 October. According to the decision, UniCredit Bulbank was chosen as assignee, followed by DSK while UBB was eliminated due to lack of grounding for the proposed price. UBB appealed the decision and asked imposing a temporary measure for not signing the agreement with the assignee. Following two decisions of CPC and HAC in favour of FLAG, the agreement with UniCredit was signed on 22 December 2008.

- **Loan agreements**

- with the European Bank for Reconstruction and Development (EBRD)

In May 2008, the Board of Directors reviewed the Terms and Conditions for Financing of the Project “Fund for Local Authorities” of the European Bank for Reconstruction and Development. At a session held in June 2008 the Board of Directors accepted the proposed Terms and Conditions while the loan agreement would be subject to discussion and clarification. In accordance with the terms and conditions, the bank will finance FLAG by a syndicated loan amounting to EUR 35 million with a repayment term of 15 years at interest basis of 6-month EURIBOR plus a margin ranging between 2.25% and 2.75% depending on the presence of bad credits.

On 22 December 2008, the loan agreement with EBRD was signed. Immediately before that the Government took a separate decision in support of the agreement, which authorised the minister of Regional Development and Public Works to sign a letter of support of the agreement. By virtue of that agreement, FLAG has the right to receive EUR 35 million for 15 years with a three-year grace period. Municipalities with particular level of creditworthiness, which is not sufficient for independent use of market credit resources, will be granted credits with the funds of the loan.

- with the World Bank

The negotiations for a loan agreement with the World Bank were held in various formats with the participation of representatives of the Ministry of Finance, the Ministry of Regional Development and Public Works, the Association of Municipalities and the company. In the

end of July 2008 a Memorandum was prepared describing the conclusions made and the arrangements achieved:

- ✓ **Purpose** – to facilitate the use of the EU structural funds by providing the most undeveloped municipalities with appropriate managing and technical instruments and short-term financial mechanisms, which to assist them in meeting the requirements of the various operational programs of the EU;
- ✓ **Plan** – the project includes two components: (i) Financing component; and (ii) Component for development of skills and management of municipalities in order to help the municipalities with limited human and financial resources, to improve their technical abilities for access to the fund for projects available under various operational programs; The project is directed to about 100 poorer municipalities and supplements the activities for funding and capacity building, which are executed with other sources of financing;
- ✓ **Financing** – the total expenses under the project are estimated at the equivalent of 60 million euro-equivalent in USD while equivalent of 50 million euro-equivalent in USD will be provided as a loan by the World Bank and the equivalent of 10 million euro-equivalent in USD will be the participation of the Bulgarian government. The financing component will be not more than 91% while the second component, namely the component for development of skills and management of municipalities, will be up to 9% from the planned financing under the project;
- ✓ **Coordination team** – the coordination team will include team coordinator, control and assessment specialist, and administrator, who will chosen through a competition under an assignment agreed between the Ministry of Regional development and Public Works, FLAG and the World Bank. The team coordinator will be responsible for day-to-day work and the procedure for the assigning thereof in FLAG should start before the end of the project assessment. The coordination team will be accountable to the Executive Director of FLAG on daily basis and will be subject to overall supervision by the Board of Directors of FLAG.

At the end of 2008, the signing of the loan agreement in that form is unclear due to the change in the priorities of the State with regard to the external debt management.

- **Agreement with the National Association of Municipalities of Republic of Bulgaria**

In June 2008 an agreement was signed between the company and the National Association of Municipalities of Republic of Bulgaria with two major objectives: creating maximum good environment for Bulgarian municipalities for access to European funds and application of efficient financial instruments in the execution of municipal projects. The commitments assumed by the agreement were fulfilled.

- **Legislative initiative**

The main problem, which seriously impedes the access of municipalities to FLAG resources, is the existing requirement in the Municipal Debt Act (MDA) that municipalities shall carry out procedures following the rules of the Public Procurement Act (PPA) for the choice of a financial institution for debt financing. In September/October 2008, a proposal for amending MDA was developed and presented to the National Assembly and was passed as Art. 19a of MDA. This provides an option to municipalities to contact FLAG directly for the funding of projects, which are financed or are subject to financing under operational programs.

Financial position

The Board of Directors has taken a decision that company's capital shall be managed in the following manner until the time for lending comes:

1. Quarterly deposits at the amount of BGN 9,800,000 each shall be placed in three of the banks in Group A as per the classification of BNB. Following an invitation sent to the five banks of the Group, term deposit agreements were concluded on 23 June with Raiffeisenbank, Post Bank and DSK Bank. Subsequently, the agreements were extended several times with increasing yield, which reached BGN 1,067 thousand as at 31 December 2008.
2. UniCredit Bulbank was chosen to manage the operational budget, amounting to BGN 600 thousand, because of the favourable conditions offered and the functionalities of the Internet banking.

As at 31 December 2008, the company has BGN 321 thousand in its operational budget account.

3. Summarised data from the income statement is presented in the tables below:

The following income is reported for year 2008:

Types of FLAG income for the year ended 31 December 2008:	BGN '000
Interest income under opened deposits with banks	1,067
Other income	2
Total income:	<u>1,069</u>

The following expenses are reported for year 2008:

- Personnel costs

	BGN '000
Remunerations to members of the Board of Directors and the Executive Director	69
Remunerations to personnel and for social security	23
Total personnel costs:	<u>92</u>

- Other operating expenses

	BGN '000
Consulting services	226
Office rent	29
Accounting services	9
Repair services	6
Public procurement fees and public advertisements	5
Stationery	5
Registration fees for establishment	3
Translation services	3
Office furnishing	3
Brokers' commissions	3
Other	14
Total other operating expenses:	<u>306</u>

- Income tax expense

BGN '000

Accounting profit for the year	669
Tax calculated at nominal tax rate of 10%	67
Income tax expense:	67

4. Key indicators review for year 2008:

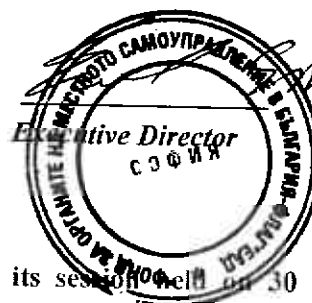
No.	Indicator	2008
I. Profitability indicators		
1	Net profit margin	0.56
2	Return on equity	0.02

The return on equity shows the efficiency of owner's capital use by the company. Since the activities of the company have started in 2008, the indicator is still low but positive, which is due to the achieved positive financial result for year 2008.

The net profit margin shows the high profitability of the company, which is due to the significant amount of its profit.

II. Liquidity indicators		31 Dec 2008
1	Current ratio	236.5
2	Cash ratio	235.6

The liquidity indicators that reveal the ability of the company to settle on timely basis its obligations show high level both of current ratio and cash ratio. The high coefficients are due to the significant amount of available cash in the company intended for granting loans to municipalities in 2009.



This Report was approved by the Board of Directors at its session held on 30 May 2009.

INDEPENDENT AUDITOR'S REPORT

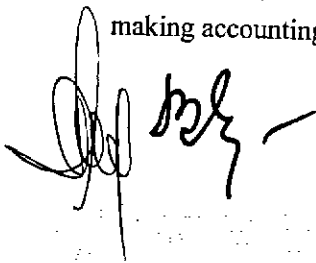
**TO
THE SOLE OWNER
OF THE FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS
IN BULGARIA – FLAG JSC**

Report on the Financial Statements

We have audited the accompanying statutory financial statements of the Fund for Local Authorities and Governments in Bulgaria – FLAG JSC (the Fund), which comprise the balance sheet as at 31 December 2008, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

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



Auditor's Responsibility

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

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

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

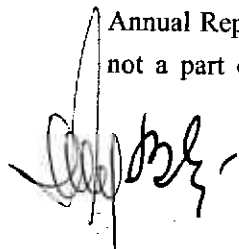
Opinion

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

Report on Other Legal and Regulatory Requirements

Annual Report on the activities of the Fund under the Bulgarian Accountancy Act (Art. 33)

Pursuant to the requirements of the Bulgarian Accountancy Act (Art. 38, para 4), we have read the Annual Report of the management on the Fund's activities for the reporting year 2008. This Report is not a part of the annual financial statements for the same period. The management of the Fund is



responsible for the preparation of this Annual Report on the activities dated 30 May 2009. The historical financial information presented in the Annual Report on the activities is consistent, in all material respects, with the information disclosed in the Fund's financial statements as at 31 December 2008, prepared in accordance with the International Financial Reporting Standards, accepted by the Commission of the European Union.

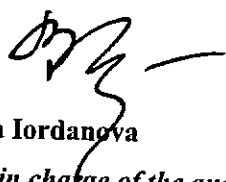
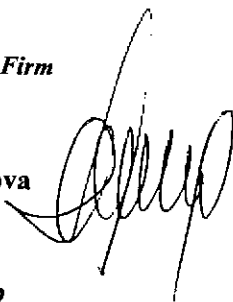
AFA

AFA OOD

Registered Specialised Audit Firm

Renny Georgieva Iordanova

General Manager



Valia Iordanova Iordanova

Registered CPA in charge of the audit

30 May 2009

**38, Oborishte Street
1504-Sofia, Bulgaria**

This is a translation from Bulgarian of the Independent Auditor's Report on the statutory financial statements of the Fund for Local Authorities and Governments in Bulgaria – FLAG JSC. for the year ended 31 December 2008.

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC

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FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA -FLAG JSC
INCOME STATEMENT

for the year ended 31 December 2008

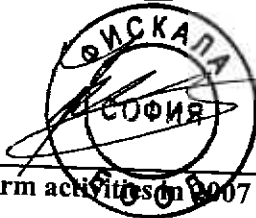
	Notes	for the period 1 Jan-31 Dec 2008 BGN'000	*
Interest income			
Other operating income, net	3	1,067 2	
Personnel costs	4	(92)	
Depreciation and amortisation expense	9	(2)	
Other operating expenses	5	(306)	
Profit from operations before taxes		<u>669</u>	
Income tax expenses	6	67	
Net profit for the year		<u><u>602</u></u>	

The accompanying notes on pages 3 to 32 form an integral part of these financial statements.

Executive Director:



Preparer:
(Fiscalia EOOD)



* FLAG did not perform activities in 2007

[Handwritten signature]
AUDITED BY AEA

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA - FLAG JSC

BALANCE SHEET

as at 31 December 2008

	Notes	31 December 2008 BGN'000	31 December 2007 BGN'000
ASSETS			
Cash and cash equivalents	7	30,620	30,000
Receivables and prepayments	8	52	-
Equipment and other fixed assets	9	57	-
Deferred tax assets	10	2	-
TOTAL ASSETS		30,731	30,000
LIABILITIES			
Payables to personnel and for social security	11	38	-
Tax payables	12	72	-
Other liabilities	13	19	-
TOTAL LIABILITIES		129	-
EQUITY			
Share capital		30,000	30,000
Retained earnings		602	-
TOTAL EQUITY	14	30,602	30,000
TOTAL LIABILITIES AND EQUITY		30,731	30,000

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

The financial statements on pages 1 to 31 were approved for issue by the Board of Directors and signed on 30 May 2009 by:

Executive Director:



Preparer:
(Fiscal EOOD)



[Handwritten signature]
AUDITED BY AEA

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA -FLAG JSC

CASH FLOW STATEMENT

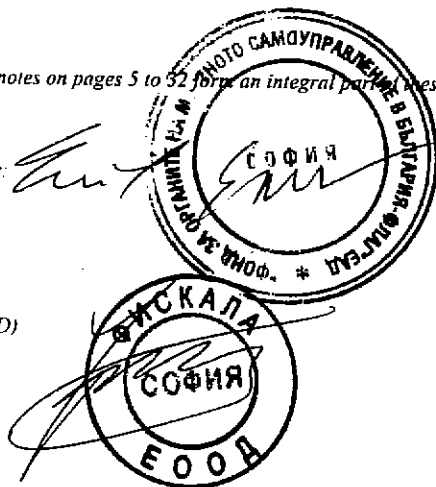
for the year ended 31 December 2008

	Notes	for the period	for the period
		1 Jan-31 Dec 2008	4 Jul-31 Dec 2007
		BGN'000	BGN'000
Cash flows from operating activities			
Interest received on deposits with banks		845	-
Cash paid to suppliers		(345)	-
Cash paid to personnel and for social security		(60)	-
Other proceeds / (payments), net		17	-
Net cash flows from operating activities		<u>457</u>	<u>-</u>
Cash flows from investing activities			
Purchases of equipment and other fixed assets		(59)	-
Net cash flows used in investing activities		<u>(59)</u>	<u>-</u>
Cash flows from financing activities			
Share capital contributions		-	30,000
Net cash flows from financing activities		<u>-</u>	<u>30,000</u>
Net increase in cash and cash equivalents		<u>398</u>	<u>30,000</u>
Cash and cash equivalents at the beginning of the period		30,000	-
Cash and cash equivalents at the end of the period,	7	<u>30,398</u>	<u>30,000</u>
<i>including blocked cash</i>		-	30,000

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

Executive Director:

Preparer:
(Fiscal EOOD)



AUDITED BY

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA -FLAG JSC

STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December 2008

	Notes	Share capital BGN'000	Retained earnings BGN'000	Total equity BGN'000
Balance at 4 July 2007		-	-	-
Share capital paid-in		30,000	-	30,000
Balance at 31 December 2007		30,000	-	30,000
Net profit for the year		-	602	602
Balance at 31 December 2008	14	30,000	602	30,602

The accompanying notes on pages 5 to 9 form an integral part of these financial statements.

Executive Director:

A circular stamp with the text "ОБЩО САМОУПРАВЛЕНИЕ В БУЛГАРИЯ" (General Administration in Bulgaria) around the perimeter. In the center, there is a signature and the word "СОНЯ" (SONYA).

Preparer:
(Fiscal EOOD)

A circular stamp with the text "ОИСКАНА СОФИА" (OISKANA SOFIA) around the perimeter and "ЕООД" (EOOD) at the bottom.

A signature and the text "AUDITED BY" followed by a logo consisting of the letters "AA" inside a square.

1. BACKGROUND CORPORATE INFORMATION

1.1. Incorporation

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC ('FLAG' or 'the Fund') was established on the basis of Council of Minister's Order No. 4 of 7 March 2007. The Fund was registered by virtue of Decision No. 1 of 4 July 2007 under Company File 10151/2007 of Sofia City Court.

The address of management of the Fund is at 17-19, Sv. Sv. Kiril I Metodiy Str., Sofia, Bulgaria.

1.2. Ownership and management

The Republic of Bulgaria, represented by the Ministry of Regional Development and Public Works, is the sole shareholder of the Fund. FLAG is represented by the Executive Member of the Board of Directors – Emil Savov.

FLAG has one-tire management system with a Board of Directors of seven members and term of office of 3 years. The composition of the Board of Directors as at 31 December 2008 is as follows:

Board of Directors:

Dimcho Mihalevski – Chairman;
Lyubomir Datzov – Deputy Chairman;
Emil Savov – Member;
Iskra Mihaylova-Koparova – Member;
Dimitar Peytchev – Member;
Atanas Kostadinov – Member;
Henry Russell – Member.

1.3. Principal activities

FLAG was established for the special purpose of gratuitous funding of municipal infrastructure and other projects and co-funding in the preparation and execution of European Union projects.

At 31 December 2008, FLAG has 6 employees (31 December 2007: none).

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

for the period ended 31 December 2008

1.4. Main indicators of the economic environment

The main economic indicators of the economic environment that have affected the Fund's activities in year 2008, are presented in the table below:

Indicator	2007	2008
GDP in million levs ¹	56,520	66,728
Actual growth of GDP	6.2%	6.0%
Year-end inflation	12.50%	7.8%
Average exchange rate of USD for the year	1.41982	1.33682
Exchange rate of the USD at the year-end	1.33122	1.38731
Basic interest rate at the year-end	4.58%	5.77%
Unemployment rate at the year-end	6.91%	6.27%

¹ New, denominated levs

Source: NSI, BNB

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

2.1. Basis for the preparation of the financial statements

The financial statements of FLAG JSC have been prepared in accordance with all International Financial Reporting Standards (IFRS), which comprise Financial Reporting Standards and the International Financial Reporting Interpretations Committee (IFRIC) interpretations, approved by the International Accounting Standards Board (IASB), as well as the International Accounting Standards (IAS) and the Standing Interpretations Committee (SIC) interpretations, approved by the International Accounting Standards Committee (IASC), which are effectively in force as of 1 January 2008 and have been accepted by the Commission of the European Union.

For the current financial year the Fund has adopted all new and/or revised standards and interpretations, issued by IASB and respectively, by IFRIC, which are relevant to its activities.

At the date when these financial statements have been issued for approval, there are several new standards, amended/revised standards and interpretations issued but not yet in force, which have not been adopted by FLAG for early application. The management has judged that out of them the following are likely to have a potential impact in the future resulting in changes in the accounting policies and the financial statements of the Fund.

- *IAS 1 (revised) "Presentation of Financial Statements" (in force for annual periods beginning on or after 1 January 2009).* This standard introduces a statement of comprehensive income by focusing on the separation of the changes in equity resulting from transactions with owners (capital transactions) and non-owner changes in equity. Total comprehensive income may be presented in either a single statement of comprehensive income (combining both the income statement and all non-owner changes in equity) or in two statements – an income statement and a separate statement of comprehensive income. Additionally, the name of the balance sheet is changed to a performance statement. The management of FLAG has chosen to apply both statements in presenting comprehensive income;
- *IFRS improvements – improvements of IAS 1, 8, 10, 16, 19, 20, 27 (except those related to the changes in IFRS 3), 28 (except those related to the changes in IFRS 3 and the respective changes in IAS 27), 36, 38, 39 and 40, IAS 7 in relation to IAS 16 (in force for annual periods beginning on or after 1 January 2009).* These improvements introduce partial amendments in the respective standards primarily with a view to remove existing inconsistency in the rules and requirements of individual standards and set up more precise terminology. The management has done research and has concluded that these amendments would not affect materially the accounting policies of the Fund, or its assets, liabilities and performance, except for refining the used terminology, expanding disclosures and/or including new ones.

Additionally, in regard of the stated below new standards, amended/revised standards and new interpretations that have been issued but not yet in force as at 1 January 2008, the management has judged that they are unlikely to have potential impact in the future resulting in changes in the accounting policies and the financial statements of FLAG:

- *IFRS 8 "Operating Segments" (in force for annual periods beginning on or after 1 January 2009).* This standard will replace IAS 14 and is mandatory for companies holding securities, which are traded in a stock exchange. The standard requires a 'management approach' in segment defining and presentation of segment information in the public financial statements on the same basis as that used for internal management purposes;
- *IAS 23 (amended) "Borrowing Costs" (in force for annual periods beginning on or after 1 January 2009).* The amended version of this standard requires an entity to capitalise borrowing costs, directly attributable to the acquisition, construction or production of a qualifying asset, as part of the cost of that asset for the period of construction/production;
- *IFRS 32 (amended) "Financial Instruments: Presentation" and IAS 1 (amended) "Presentation of Financial Statements" regarding puttable financial instruments and obligations arising on liquidation (in force for annual periods beginning on or after 1 January 2009).* The amendments in these standards require puttable financial instruments and instruments, which impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation, to be classified as equity components provided that certain conditions are met;
- *IFRS 2 (amended) "Share-based Payment" (in force for annual periods beginning on or after 1 January 2009) – dealing with vesting conditions and cancellations.* These amendments clarify the definitions of vesting conditions, and introduce the concept of non-vesting conditions by requiring non-vesting conditions to be reflected in the fair value. on the grant date. They also provide rules for the accounting treatment of non-vesting conditions and cancellations.
- *IFRIC 13 "Customer Loyalty Programs" (in force for annual periods beginning on or after 1 July 2008).* This interpretation clarifies that when goods and services are sold together with a customer loyalty incentive, these relations represent a multiple-component arrangement, and the consideration receivable from the customer is allocated between the components on fair value basis;
- *IFRIC 15 "Agreements for Construction of Real Estates" (in force for annual periods beginning on or after 1 January 2009 – still not accepted by EC).* This interpretation clarifies when and how revenue and costs to sell real estate shall be recognised if the agreement between the buyer and the builder has been concluded before the completion of the real estate, including the application of IAS 11 and IAS 18;

- *IFRIC 16 “Hedges of a Net Investment in a Foreign Operation” (in force for annual periods beginning on or after 1 January 2009 – still not accepted by EC).* This interpretation clarifies the hedging of a net investment in a foreign operation providing primarily guidance for the identification of currency risk for the qualification of net investment hedge accounting as well as how the entity shall determine the amount of profit and loss related to the net investment and with the hedge instrument for the purposes of its recognition on disposal of the investment;
- *IFRIC 17 “Distribution of Non-cash Assets to Owners” (in force for annual periods beginning on or after 1 January 2010 – still not accepted by EC).* This interpretation clarifies the recognition of a dividend payable and its measurement, especially where the distribution is to be made through non-cash assets; and
- *IFRIC 18 “Transfers of Assets from Customers” (in force for annual periods beginning on or after 1 January 2010 – still not accepted by EC).* This interpretation clarifies the accounting treatment of received assets from entities in the utility sector, from their clients or third parties, which provide access to and services related to supply of gas, water, electricity and other similar. These assets are being received in relation to the provision of an access or supply of such type of services/goods.

The management has judged that the above stated amended/new standards and/or interpretations are unlikely to have impact on the accounting policies of FLAG as far as its activities are not included in these business segments neither do they include similar transactions, operations and policies nor such reporting items.

The financial statements of FLAG have been prepared on historical cost basis except for financial instruments, which in accordance with their classification under IFRS, should be measured and presented at amortised cost at the balance sheet date.

The Fund maintains its accounting books in Bulgarian lev (BGN), which is accepted as being its presentation currency. The data in the financial statements and the notes thereto are presented in thousands of Bulgarian levs (BGN'000).

The presentation of the financial statements in accordance with IFRS requires the management to make best estimates, accruals and reasonable assumptions that affect the reported values of assets and liabilities and the disclosure of contingent receivables and payables as at the date of the financial statements, and respectively, on the reported amounts of income and expenses for the reporting year. These estimates, accruals and assumptions are based on the information, which is available at the date of the financial statements, and therefore, the future actual results might be different from them (the uncertainties being more significant in the conditions of financial crises).

2.2. Comparatives

The Fund has accepted to present comparative information for one prior period in its financial statements. Additionally, when for the purposes of achieving a more reliable presentation of the reporting items and transactions, changes would be necessary in their classification and presentation as individual components of the financial statements, prior year comparatives are reclassified to ensure the required comparability with the current reporting period.

The comparative data in the balance sheet, the cash flow statement and the statement of changes in equity of these financial statements cover the period from 4 July 2007 to 31 December 2007 because FLAG was established on 4 July 2007 (Note 1). The income statement does not include comparative data because the Fund did not perform any activities in 2007 and respectively, it did not gain income and incur expenses in that period.

2.3. Reporting currency

The functional and presentation currency of FLAG is the Bulgarian lev. Starting from 1 July 1997 the Bulgarian Lev was pegged to the German Mark at the ratio of BGN 1 : DEM 1. With the introduction of the Euro as an official currency of the European Union, starting from 1 January 1999, the fixed ratio between both currencies is BGN 1.95583 : EUR 1.

Upon its initial recognition, a foreign currency transaction is recorded in the functional currency whereas the exchange rate to BGN at the date of the transaction or operation is applied to the foreign currency amount. Cash and cash equivalents, loans and receivables, investments in securities, liabilities under placements, loans and other payables, as monetary reporting items, denominated in foreign currency, are recorded in the functional currency by applying the daily exchange rate as quoted by the Bulgarian National Bank (BNB). At the end of each working month, all monetary reporting items are revalued at the official rate quoted by BNB.

The non-monetary items in the balance sheet, which are initially denominated in a foreign currency, are accounted for in the functional currency by applying the historical exchange rate at the date of the transaction and are not subsequently re-valued at the closing exchange rate.

2.4. Interest income and expenses

Interest income and expenses are recognised in the income statement on accrual basis for all interest-bearing instruments using the effective yield method based on the actual purchase price or the applicable floating rate. Interest income and expenses include the amortisation of any discount or premium or other differences between the initial carrying amount of an interest-bearing instrument and its amount at maturity calculated on an effective interest rate basis.

Interest income includes interest gained on deposits with banks, interest on granted loans, fees and commissions on granted loans and advances to counterparts (municipalities), which represent an

integral part of the effective income from the financial instrument.

Interest expense is recognised on accrual basis and includes the interest on received loans and other borrowed funds, fees and commissions under loans received, which represent an integral part of the effective interest expense.

2.5. Financial instruments

2.5.1. Financial assets

The Fund classifies its financial assets in the category 'loans (loans granted) and receivables'. The classification depends on the nature and purpose (designation) of the financial assets at the date of their acquisition. The management determines the classification of the financial assets of FLAG at the time of their initial recognition on the balance sheet.

The Fund usually recognises its financial assets on the balance sheet on the trade date, being the date on which the Company commits (undertakes an ultimate engagement) to acquire the respective financial assets. All financial assets are initially measured at their fair value plus the directly attributable transaction costs.

Financial assets are derecognised from the balance sheet of the Fund when the rights to receive cash (flows) from these assets have expired or have been transferred, and the Fund has transferred substantially all the risks and rewards of ownership of the asset to another entity (person). If the Fund retains substantially all risks and rewards associated with the ownership of a particular transferred financial asset, it continues to recognise the transferred asset on its balance sheet but also recognises a secured liability (a loan) for the consideration received.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They are presented and measured in the balance sheet at their amortised cost using the effective interest method less any allowance for impairment. This group of financial assets of the Fund includes: deposits with banks, cash at current bank accounts, receivables under loans granted, trade and other receivables from counterparts and third parties. Interest income on loans and receivables is recognised on effective interest basis. It is presented in the income statement under 'interest income'.

Impairment of financial assets

All financial assets of the Fund are subject to review for impairment. At each balance sheet date the Fund makes a judgment on whether objective evidence is available that particular financial assets, classified as 'loans and receivables', have indications for impairment. The criteria used by the Fund to

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determine that there are objective indicators for impairment losses include: default in contractual payments of principal and interest; difficulties of the debtor with regard to cash flows; deterioration of financial, market and competitive position of the debtor and other similar indicators. Impairment is recognised provided that the present value of the respective financial asset of this group, determined by discounting of the actually expected future cash flows at the effective interest rate, exceeds its carrying amount at the date of valuation.

Impairment losses of loans and other receivables are accounted for in a special allowance account and are presented separately in the income statement.

2.5.2. Financial liabilities and equity instruments

The Fund classifies its liabilities and equity instruments either as financial liabilities or as equity in accordance with the substance and the conditions of the contractual arrangements with the respective counterparty regarding these instruments. Financial liabilities are classified at the time of their origination. All financial liabilities of the Fund are classified as 'other financial liabilities' and are carried at amortised cost.

The financial liabilities of the Fund, are initially recognised on the balance sheet at fair value net of the directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method. Interest expense is carried to the income statement on current basis.

Financial liabilities are derecognised when the obligation under the liability is discharged or cancelled, or the counterpart loses its entitlement.

2.6. Equipment and other fixed assets

Equipment and other fixed assets (tangible fixed assets) of the Fund include: computers and other office equipment, motor vehicles and furniture and fixtures. They are presented in the financial statements at historical cost of acquisition (cost) less the accumulated depreciation and any impairment losses in value.

Initial measurement

Upon their initial acquisition, tangible fixed assets are valued at cost of acquisition (cost), which comprises the purchase price, including customs duties and any directly attributable costs of bringing the asset to working condition for its intended use.

FLAG has set a value threshold of BGN 700, below which the acquired assets, regardless of having the features of property, plant and equipment, are treated as current expense at the time of their acquisition.

Subsequent measurement

The approach chosen by FLAG for subsequent measurement of tangible fixed assets, is the cost model under IAS 16, i.e. cost of acquisition (cost) less any accumulated depreciation and any accumulated impairment losses in value.

Depreciation methods

The Fund applies the straight-line depreciation method for tangible fixed assets. The useful life per group of assets has been determined considering: physical wear, the characteristic features of the equipment, the intentions for future use and the expected obsolescence, and is as follows:

- computers - 2 years;
- motor vehicles – 4 years;
- furniture and fixtures - 5 years.

The set useful life is reviewed at each year-end and is adjusted prospectively in case that any material deviations from future expectations concerning the terms of use are determined.

Subsequent costs

Repair and maintenance costs are recognised as current expenses as incurred. Subsequent costs having the nature of replacement of certain components and significant parts or improvements and restructuring, are capitalised in the carrying amount of the respective asset whereas the residual useful life is reviewed at the capitalisation date. At the same time, the non-depreciated part of the replaced components is derecognised from the carrying amount of the assets and is recognised in the current expenses for the period of restructure.

Impairment of assets

The carrying amounts of equipment and other fixed assets are reviewed for impairment when events or changes in circumstances indicate that they might significantly differ from their recoverable amount. If any indications exist that the estimated recoverable amount of an asset is lower than its carrying amount, the latter is adjusted to the recoverable amount of the asset. The recoverable amount of tangible fixed assets is the higher of the fair value less costs to sell or the value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market conditions and assessments of the time value of money and the risks, specific to the particular asset. Impairment losses are recognised in the income statement under

'depreciation and amortisation expenses'.

Gains and losses on disposal (sale)

Tangible fixed assets are derecognised from the balance sheet when they are permanently disposed of and no future economic benefits are expected therefrom or on sale. The gains or losses arising from the sale of individual assets are determined as the difference between the consideration received and the carrying amount of the asset at the date of sale. They are stated net under 'other operating income' on the face of the income statement.

2.7. Interest-bearing loans and other borrowings

All loans and other borrowings are initially recognised and measured at cost (nominal amount), which is accepted to be the fair value of the consideration received on the transaction, netted of the direct costs related to these loans and borrowings. After the initial recognition, the interest-bearing loans and other borrowings are subsequently measured at amortised cost by applying the effective interest method. The amortised cost is calculated by taking into consideration all types of charges, commissions and other costs, including any discount or premium on settlement associated with these loans. Gains and losses are recognised in the income statement over the depreciation period or when the liabilities are written-off or reduced and are presented under the item 'interest expense'.

2.8. Payables to personnel under the social security and labour legislation

In accordance with the Bulgarian legislation, FLAG is obliged to pay contributions to social security and health insurance funds. The amount of the contributions is defined by the Social Security Code and the Health Insurance Act based on the income for the period. The employment relations of the employees with the Fund, in its capacity of an employer, are based on the provisions of the Labour Code (LC) and the effective social security legislation.

The employer's major duty is to make the mandatory social security contributions for the hired employees to the Pensions Fund, the Supplementary Mandatory Pension Security Fund, to the General Diseases and Maternity Fund, the Unemployment Fund, the Labour Accident and Professional Diseases Fund, the Guaranteed Receivables of Workers and Employees Fund and for health insurance.

Social security and health insurance contributions are defined under the Law on the Budget of State Social Security and the Law on the Budget of National Health Insurance Fund for the respective year. The contributions are apportioned between the employer and the employee at a ratio, which is changed annually and is provided for in the Social Security Code. The total contribution amount for Pensions Fund; Supplementary Mandatory Pensions Security Fund, General Diseases and Maternity Fund; Unemployment Fund, and health insurance for 2008 is as follows:

For the period 1 January 2008 – 31 December 2008: 32.5% for those employed under the third category

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terms (employer:employee ration being 60:40).

In addition, entirely at its own account, the employer pays a contribution to the Guaranteed Receivables of Workers and Employees Fund at the amount of 0.5% as well as a contribution to the Labour Accident and Professional Diseases Fund, which is differentiated for the various entities from 0.4% to 1.1% depending on the business activities of the entity (in accordance with Appendix 2 to the Law on the Budget of State Social Security for 2007) and is 0.5% for the Fund.

The social security plans, applied by FLAG in its capacity of an employer, are based on the Bulgarian legislation and are defined contributions plans. Under these plans, the employer pays monthly contributions to the government funds as follows: “Pensions Fund”, “General Disease and Maternity Fund”, “Unemployment Fund”, “Labour Accident and Professional Diseases Fund”, “Guaranteed Receivables of Workers and Employees Fund” as well as for supplementary mandatory pension security (universal and professional pension funds) – on the basis of rates fixed by law (as stated above), and has no other legal or constructive obligation to pay any additional amounts to the funds in the future. The obligations referring to health insurance are analogous.

There is no established and functioning private voluntary social security scheme at FLAG.

Short-term benefits

Short-term benefits of Fund’s employee in the form of remunerations, bonuses and social payments and benefits (payable within 12 months after the end of the period when the employees have rendered the service or has met the required terms and requirements) are recognised as an expense in the income statement in the period when the service thereon has been rendered or the requirements for their receipt have been met and as a current liability (less any amounts already paid and deductions due) at their undiscounted amount. The Fund payables for social security and health insurance are recognised as a current expense and liability at their undiscounted amount together with the respective benefits they relate to and within the period of their accrual.

At each balance sheet date the Fund measures the expected costs on the accumulating compensated absences, which amount is expected to be paid as a result of the unused entitlement. The measurement includes the estimated expenses on the employee’s remunerations and the statutory social security and health insurance contributions due by the employer thereon.

Long-term retirement benefits

In accordance with the requirements of the Labour Code, the employer is obliged to pay to its personnel upon retirement an indemnity, which depending on the length of service with an entity varies between two and six gross monthly salaries as at the termination date of the employment. In their nature these are defined benefit schemes.

The calculation of the amount of these liabilities necessitates the participation of qualified actuaries in

order to determine their present value at the date of the financial statements, at which they are included in the balance sheet, adjusted with the amount of the unrecognised actuarial gains and losses, and respectively, the change in their value including the recognised actuarial gains and losses is included in the income statement.

Termination benefits

In accordance with the provisions of the Labour Code, the employer is obliged, upon termination of the employment contracts prior to retirement, to pay indemnities as follows:

- for non-observed preliminary notice: one gross monthly salary;
- due to closing down of the enterprise or part of it, staff cuts, reduction of the volume of work and work stoppage for more than 15 days, etc.: at the amount of one gross monthly salary;
- upon termination of the employment contract due to illness: at the amount of two gross monthly salaries;
- for unused annual paid leave: for the respective years of the time recognised as service period.

The Fund recognises employee benefit obligations on employment termination before the normal retirement date when it is demonstrably committed, based on announced plan, to terminating the employment contract with the respective individuals without possibility of withdrawal or in case of formal issuance of documents for voluntary redundancy. Termination benefits due more than 12 months are discounted and presented in the balance sheet at their present value.

2.9. Income taxes

Current income taxes

Current income taxes are determined in accordance with the requirements of the Bulgarian tax legislation – the Corporate Income Taxation Act (CITA). The nominal income tax rate for year 2008 is 10%.

Deferred income taxes

Deferred income taxes are determined using the liability method on all temporary differences, existing at the balance sheet date, between the carrying amounts of the assets and liabilities and their tax bases.

Deferred tax liabilities are recognised for all taxable temporary differences.

Deferred tax assets are recognised for all deductible temporary differences and the carry-forward of unused tax losses, to the extent that it is probable they will reverse and a taxable profit will be available or taxable temporary differences might occur, against which these deductible temporary differences can

be utilised, with the exception of the differences arising from the initial recognition of an asset or liability, which has affected neither the accounting nor taxable profit (loss) as at the date of the transaction.

The carrying amount of all deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is probable that they will reverse and sufficient taxable profit will be generated or taxable temporary differences will occur in the same period, from which they can be deducted.

Deferred taxes, related to items directly credited or charged to equity or other balance sheet items, are also reported directly in the respective equity component or balance sheet item.

Deferred tax assets and liabilities are measured at the tax rates that are expected to be applied in the period when the asset will be realised or the liability will be settled (paid), based on the tax laws that are enacted or to a great degree of probability will be enacted. As at 31 December 2008, the deferred income taxes are computed at a tax rate of 10%.

2.10. Payables to suppliers and other counterparts

Payables to suppliers and other counterparts are accounted for and presented in the financial statements at original invoice amount (cost of acquisition), being the fair value of the consideration to be paid in the future for goods and services received. In case of payments deferred over a period exceeding the common credit terms, where no additional interest payment has been envisaged or the interest considerably defers from the common market interest rates, the payables are initially valued at their fair value and subsequently – at amortised cost, after deducting the interest incorporated in their nominal value and determined following the effective interest rate method.

2.11. Cash and cash equivalents

Cash and cash equivalents are presented at amortised cost and include: cash in hand, cash in current bank accounts and deposits placed with banks – at sight and/or with original maturity if up to three months.

For the purposes of the cash flow statement, the composition of cash is analogous (except for blocked cash) and it is presented at the same value.

2.12. Share capital and reserves

The Fund is a joint-stock company and is obliged to register with the Commercial Register a specified *share capital*, which should serve as a security for the creditors of the Fund for execution of their receivables. The shareholders are liable for the obligations of the Fund up to the amount of the share of the capital held by each of them and may claim refunding of this share only in case of liquidation or bankruptcy proceedings.

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The share capital represents the non-distributable capital of the Fund and is presented at the nominal value of the issued shares.

FLAG is obliged to set aside a *Reserve Fund* in accordance with the requirements of the Commercial Act. The following may be sources for the fund:

- a portion of profit, determined by the sole owner of the capital, but not less than 1/10 to be allocated until the amount of the fund reaches 1/10 of the capital;
- any premium received in excess of the nominal value of shares upon their issue;
- other sources as provided for by a decision of the General Meeting.

The amounts in the Reserve Fund can only be used to cover annual loss or losses from previous years. When the amount of the fund reaches the minimum value specified in the Articles of Incorporation, the excess may be used for increasing share capital.

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3. INTEREST INCOME

The *interest income* of FLAG for year 2008 amount to BGN 1,067 thousand. They have been generated from term deposits placed at accounts with commercial banks in Bulgaria whereby the amounts of the received joint-stock capital contributions are invested.

4. PERSONNEL COSTS

Personnel costs for year 2008 include:

	For the period 01.01 - 31.12.2008 BGN '000
Remunerations to members of the Board of Directors and the Executive Director	69
Remunerations to personnel and for social security	23
	<u>92</u>

5. OTHER OPERATING EXPENSES

The *other operation expenses* of the Fund for year 2008 include:

	For the period 01.01 - 31.12.2008 BGN '000
Consulting services	226
Office rent	29
Accounting services	9
Repair services	6
Public procurement fees and public advertisements	5
Stationery	5
Registration fees for establishment	3
Translation services	3
Office furnishing	3
Brokers' commissions	3
Other	14
	<u>306</u>

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6. INCOME TAX EXPENSE

The main components of *income tax expense* for year 2008 include:

	For the period 01.01 - 31.12.2008 BGN '000
Tax profit under tax return	693
Current tax expense	69
Deferred income taxes related to:	
- occurrence of temporary differences	(2)
Income tax expense carried to the income statement	67
Reconciliation of income tax expense applicable to the accounting profit or loss	
Accounting profit for the year	669
Tax calculated at nominal tax rate of 10%	67
Tax effects of non-deductible amounts	-
Income tax expense carried to the income statement	67

7. CASH AND CASH EQUIVALENTS

Cash and cash equivalents of the Fund include:

	31.12.008 BGN '000	31.12.2007 BGN '000
Short-term deposits with banks denominated in BGN and with original maturity of up to 3 months	30,299	-
Current accounts with banks in BGN	321	-
Start-up capital accounts with banks in BGN	-	30,000
	30,620	30,000

The cash available as at 31 December 2008 is current and deposit accounts of the Fund with the following banks: DSK Bank AD, Raiffeisenbank AD, Eurobank EFG Bulgaria AD, UniCredit Bulbank AD.

The start-up capital account for the establishment of FLAG was opened with BNB. As at 31 December 2007 the cash amount at that account remained blocked through the budget of MRDW.

Cash placed in term deposits with banks as at 31 December 2008 is denominated in BGN only. It is of original maturity from one to three months and with an option for possible re-negotiation on expiry.

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The interest rates of deposits range between 7% and 8.20% depending on deposit amount and the market terms for the particular bank while these for current amounts vary around 0.02%.

8. RECEIVABLES AND PREPAYMENTS

The *receivables and prepayments* of the Fund as at 31 December 2008 include:

	31.12.2008 BGN '000
VAT receivables	45
Prepaid deferred expenses	3
Deposit provided	3
Advances for services	1
	<u>52</u>

As at 31 December 2007, the Fund had receivables and prepayments to counterparts.

The amount of the receivable VAT was refunded by the tax authorities in February 2009 after a tax audit performed.

The provided deposit is to the lessor of Fund's office.

The deferred expenses represent insurance costs and subscriptions paid by instalments.

9. EQUIPMENT AND OTHER FIXED ASSETS

	<i>Motor vehicles</i>	<i>Office equipment and computer hardware</i>	<i>Furniture and fixtures</i>	<i>Total</i>
	31.12.2008 BGN'000	31.12.2008 BGN'000	31.12.2008 BGN'000	31.12.2008 BGN'000
Book value				
Balance at 1 January 2008				
Additions in 2008	36	16	7	59
Balance at 31 December 2008	<u>36</u>	<u>16</u>	<u>7</u>	<u>59</u>
Accumulated depreciation				
Balance at 1 January 2008				
Depreciation charge for the period - 2008	-	2	-	2
Balance at 31 December 2008	<u>-</u>	<u>2</u>	<u>-</u>	<u>2</u>
Carrying amount at 31 December 2008	<u>36</u>	<u>14</u>	<u>7</u>	<u>57</u>

The Fund had no tangible fixed assets in 2007.

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10. DEFERRED TAX ASSETS

The *deferred tax assets* as at 31 December 2008 are related to the following balance sheet items:

	temporary difference	tax
	31.12.2008	31.12.2008
	BGN '000	BGN '000
Benefits to members of BD and to Executive Director not paid	23	2
Accruals for unused paid leaves	1	-
Total deferred tax assets	<u>24</u>	<u>2</u>

The Fund had no recognised deferred tax assets as at 31 December 2007.

The movement of deferred tax assets in 2008 is presented below:

<i>Deferred tax assets</i>	<i>Recognised in the income statement</i>	<i>Balance at 31 December 2008</i>
	BGN '000	BGN '000
Benefits to members of BD and to Executive Director not paid	2	2
Accruals for unused paid leaves	-	-
Total deferred income tax assets	<u>2</u>	<u>2</u>

On recognising deferred tax assets, the probability of a reversal of the individual differences and the abilities of the Company to generate sufficient taxable profit in the future, have been taken into account.

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11. PAYABLES TO PERSONNEL AND FOR SOCIAL SECURITY

The *payables to personnel and for social security* as at 31 December 2008 are related to current remunerations for December and are as follows:

	31.12.2008
	BGN '000
Payables to personnel for remunerations not paid	34
Payables for social security	3
Payables to personnel under accrued amounts for unused leaves	1
	<u>38</u>

As at 31 December 2007, the Fund had no payables to personnel and for social security.

12. TAXES PAYABLES

The *tax payables* as at 31 December 2008 are regular and include:

	31.12.2008
	BGN '000
Income tax	69
Personal income tax	3
	<u>72</u>

As at 31 December 2007, the Fund has no tax payables.

No tax audits and inspections of FLAG have been performed as at 31 December 2008.

A tax audit is performed within a 5-year period after the end of the year in which the tax return for the respective liability has been submitted. The audit confirms finally the tax liability of the respective company – tax liable entity, except for cases explicitly provided by law.

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13. OTHER LIABILITIES

The *other liabilities* as at 31 December 2008 include:

	31.12.2008 BGN '000
Payables under guarantees	15
Deposit received	3
Payables to suppliers	1
	<u>19</u>

As at 31 December 2007, the Fund had no other liabilities to counterparts and third parties.

The payables under guarantees are related to the execution of a consultancy agreement for Fund's activity administration procedures. They are determined as 5% (performance guarantee) of the total amount under the consultancy agreement and are withheld for payment to the assignee until 13 March 2009.

The deposit is received from a bank which participates in the organised by the Fund public procurement for a Managing Bank.

14. EQUITY

Share capital

As at 31 December 2008, the registered share capital of the Fund for Local Authorities and Governments in Bulgaria – FLAG JSC amounts to BGN 30,000 thousand and is distributed into 30,000 shares at BGN 1,000 (one thousand) par value each. (31 December 2007: the same amount and structure).

15. RELATED PARTIES AND RELATED PARTY TRANSACTIONS

Related parties

Shareholder – sole owner

The state through the Ministry of Regional Development and Public Works is the sole holder of FLAG shares.

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC

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for the period ended 31 December 2008

Key managing personnel

The members of the Company's key personnel are disclosed in Note 1.2.

Related party transactions

No related party transactions were concluded and/or performed in 2007 and 2008.

Remunerations of key managing personnel

<i>Expenses on remunerations of key managing personnel</i>	For the period 01.01 - 31.12.2008 BGN '000
Salaries and other short-term benefits	<u>69</u>

In the period from 4 July 2007 to 31 December 2007 there are no accrued and/or paid amounts to key managing personnel.

<i>Payables to key managing personnel</i>	31.12.2008 BGN '000
Salaries and other short-term benefits	<u>23</u>

Tantiemes to members of the Board of Directors and the Executive Director or bonuses were not voted and paid in the period from 4 July 2007 to 31 December 2008.

16. CONTINGENT LIABILITIES AND COMMITMENTS

On 22 December 2008 a loan agreement was signed between the Fund and the European Bank for Reconstruction and Development (EBRD). The loan amount, which EBRD will grant to FLAG, has an upper limit of EUR 35,000 thousand (BGN 68,454 thousand) and this amount will be drawn in two portions:

1. Loan 'a' will be at an amount not exceeding EUR 18,000 thousand (BGN 35,205 thousand)
2. Loan 'b' will be at an amount not exceeding EUR 17,000 thousand (BGN 33,249 thousand).

The purpose of the loan is that FLAG shall provide loans to municipalities having a particular level of creditworthiness, which is not sufficient for independent use of credit resources from Bulgarian market. The term of the loan is 15 years with a 3-year grace period. The agreed interest rate is based on 6-month EURIBOR plus a margin ranging between 2.25% and 2.75% depending on the presence of bad credits. Additionally, there are fees and charges as follows: (a) annual commitment charge; (b) one-off fee for initial expenses (Front-End Fee); (c) annual loan administration fee.

The future income and receivables from debtors of the Fund as well as cash with current bank accounts will serve as loan collaterals.

On 8 January 2009 the amount of BGN 176 thousand (EUR 90 thousand) was paid, which represents an one-off fee for initial expenses on concluding the loan agreement with EBRD (Front-End Fee).

17. FINANCIAL RISK MANAGEMENT

In the ordinary course of business, the Fund is exposed to a variety of financial risks. These risks are identified, measured and monitored by the management through various control mechanisms in order to be managed and to prevent undue risk concentration. The major risks to which the Fund is exposed include: credit, market and liquidity risk as well as operational risk.

Risk management structure

The main units, which are directly responsible for risk management in 2008 are as follows:

Board of Directors – defines the main directions of policy and mechanisms for the management of Fund's assets and liabilities as well as the risks related thereto and performs periodically a review of these policies with a view of their possible necessity in changes and further development in response to changes occurring in the business environment, the activities and the balance sheet structure of the Fund.

Executive Director – organises and governs the process of development and implementation of internal rules, methods and procedures related to the current monitoring and management of each type of financial risk.

There are two departments in the structure of the Fund with functions and responsibilities directly related to the management of the different types of financial risk:

- *Finance and Risk Management Department* – its functions cover: research and analysis of financial markets in relation to funds lending and preparation of proposals to the Executive Director to conclude contracts in this area; forecasts and analysis of the necessity in resources for the realisation of the specific objectives of Fund activities; current management of Fund's cash flows and liquidity; development of policies and methods for credit portfolio and risk

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC

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for the period ended 31 December 2008

limits management, as well as for current control over the implementation of the strategy and policies approved by the Board of Directors in this area; current control on the execution of activities assigned to the Managing Bank and the other partner banks;

- *Projects Department* – its functions include all activities on the current monitoring, analyses and inspections of the execution of projects financed by FLAG.

In December 2008, UniCredit Bulbank was chosen by a competition as a Managing Bank, which will play an important role in the future credit activities of the Fund and will assist the Fund including in financial risk management. It is envisaged that the bank shall provide its position on received loan applications from municipalities, which will be prepared by the Project and Monitoring Department, Lending Department and Finance and Risk Management Department of the Managing Bank. The functions of the Managing Bank will include:

- Interaction with FLAG following an approved procedure for performing the activities for providing loans to municipalities;
- Review of loan applications from municipalities and assessment of their creditworthiness in relation to the risk of the respective project;
- Preparation of grounded proposals to FLAG to approval of loan applications;
- Administration of the process for repayment of liabilities by municipalities-borrowers;
- Assistance in the monitoring process of the projects financed by the Fund.

The activities of the Managing Bank started on 22 December 2008 with the signing of its agreement with the Fund.

Credit risk

Credit risk is the risk that the customers/counterparts will fail to discharge their contractual obligations to the Fund in full and on time. In 2008, the credit risk of the Fund was relatively limited as far as its financial assets represent bank deposits.

Credit risk management in 2008 was performed by the experts of the Finance and Risk Management Department (in year 2009 it will be performed by the Lending Department) and was monitored jointly by the Executive Director and the Board of Directors. The credit risk management function ensures that appropriate investment policies are applied with regard to the owned funds and respectively, the compliance of these policies with the related credit monitoring procedures and controls for current monitoring of the respective loan, deposit or receivable.

The risk credit exposure is managed through current analysis of the ability of counterparts/servicing banks to meet interest and principal repayment obligations and by establishing appropriate lending

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

for the period ended 31 December 2008

limits and ranges. Cash deposits are placed to first-class banks with a good reputation in the Bulgarian market. Additionally, the presence of concentration of receivables in a particular counterparty is currently monitored and in case that such concentration is found the respective counterparty becomes subject to a specific current supervision.

As at 31 December 2008, the Fund has distributed its bank deposits to three large commercial banks.

Market risk

Market risk is the risk of adverse movements in the level of interest rates, in the rate of exchange between currencies and the market price of securities and other financial instruments.

Interest risk

Interest risk arises from the possibility that changes in total market interest levels may potentially impact net interest income or net interest margin (being the difference between gross interest income and gross interest expense) and the market value of equity.

The interest rates for the assets of the Fund are usually determined on the basis of the basic interest rate as quoted by the Central Bank (BNB) as far as they are all denominated in Bulgarian levs.

In 2008, the Fund was not exposed to interest risk resulting from short-term fluctuations of market interest rates because the interest-bearing assets of the Fund were short-term ones and had fixed interest rate to maturity. At the same time it had not assumed interest-bearing liabilities. The interest risk was currently followed by the Executive Director in order to ensure measures in compliance with market risk limitations. In addition, the Executive Director follows the interest risk and develops measures to cover and maintain the risk within admissible limits.

The table below summarises the interest structure and the risk exposure of the Fund. It includes its financial assets and liabilities at their net book values in accordance with interest-related clauses, set in the contracts, their maturity structure and their sensitivity to interest rate changes.

<i>31 December 2008</i>	<i>With fixed interest %</i>	<i>Interest-free</i>	<i>Total</i>
	BGN'000	BGN'000	BGN'000
Financial assets			
Cash and cash equivalents	30,620	-	30,620
Receivables from counterparties	-	3	3
Total financial assets	30,620	3	30,623
Financial liabilities			
Payables to counterparties	-	19	19
Total financial liabilities	-	19	19

This is a translation from Bulgarian of the financial statements of FLAG JSC for year 2008.

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

for the period ended 31 December 2008

In 2007, the amount of the paid-in share capital was held in interest-free start-up capital account with BNB.

Analysis of interest sensitivity and risk

The table below includes the financial assets and liabilities of the Fund at net book value, categorised by the earlier of contractual interest change or maturity dates.

<i>31 December 2008</i>	<i>Up to 1 month</i>	<i>Interest-free</i>	<i>Total</i>
	<i>BGN'000</i>	<i>BGN'000</i>	<i>BGN'000</i>
Financial assets			
Cash and cash equivalents	30,620	-	30,620
Receivables from counterparts	-	3	3
Total financial assets	30,620	3	30,623
Financial liabilities			
Payables to counterparts	-	19	19
Total financial liabilities	-	19	19

Currency risk

Currency risk is the risk of adverse impact of fluctuations in the prevailing foreign currency exchange rates on the financial position and cash flows of the Fund as a result of open currency positions. Its policy is that the financial assets and liabilities shall be entirely denominated in EUR or BGN. Since the BGN is fixed to the EUR, there was no a significant outstanding exchange rate risk for the Group related thereto in 2008.

Liquidity risk

Liquidity risk is the risk that the Fund is unable to meet its current and potential payment obligations as and when they fall due without unacceptable losses.

The matching and controlled mismatching of the maturities and interest rates of financial assets and liabilities is fundamental to the management of the Fund's liquidity. An unmatched position potentially enhances profitability, but also increases the risk of losses. The maturities of assets and liabilities and the ability to replace, at an acceptable cost, interest-bearing liabilities as they mature are important factors in assessing the liquidity of the Fund and its exposure to changes in interest rates. In 2008, the control and monitoring of total liquidity of the Fund was performed by the Executive Director.

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

for the period ended 31 December 2008

The following table analyses the gross undiscounted cash flows related to the financial assets and liabilities of the Fund grouped by remaining term to maturity.

<i>At 31 December 2008</i>	Up to 1 month	1-3 months	4-12 months	Over 1 year	Total
Financial assets					
Cash and cash equivalents	30,727	-	-	-	30,727
Receivables from counterparts	-	-	-	3	3
Total financial assets	<u>30,727</u>	<u>-</u>	<u>-</u>	<u>3</u>	<u>30,730</u>
Financial liabilities					
Payables to counterparts	-	19	-	-	19
Total financial liabilities	<u>-</u>	<u>19</u>	<u>-</u>	<u>-</u>	<u>19</u>

In 2007, the amount of the paid-in share capital was held in interest-free start-up capital account with BNB.

Capital management

The main objectives of Fund's equity management are directed to maintaining its level to an amount sufficient to achieving the objectives set with its establishment – support of the efforts of Bulgarian municipalities to prepare and successfully execute projects co-funded by the programs of the European Union for modernisation and expanding municipal infrastructure and for creating stable economic and social structures.

In the period from its establishment to 31 December 2008, FLAG had been financing its activities entirely from its equity.

In its future activities the Fund will have to observe certain financial ratios as a result of the obligations undertaken on the basis of the loan agreement with EBRD. These include: (a) debt service coverage ratio; (b) operational ratio; (c) loans in arrears ratio; and (d) debt to equity ratio.

As at 31 December 2008, the Fund has not maintained such financial ratios because no loan has been received from EBRD and it has not started its basic credit activities under the objectives of its establishment.

Fair value of financial assets and liabilities

Fair value is generally the amount for which an asset could be exchanged, or a liability settled in an arm's length transaction between independent and knowledgeable parties.

The policy of the Fund is to disclose in its financial statements the fair value of these financial assets and liabilities for which market quotations are available. The fair value concept presumes realization of the financial instruments through sales. However, in most cases the Fund expects to realize the assets through their full repayment over time. The financial assets and liabilities, held thereby at the balance sheet date, are non-current, contracted at market interest rates and measured at amortised cost. Therefore, the management believes that their fair value is approximately equal to their carrying amount. It is also of the opinion that the estimates of the financial assets and liabilities presented in the balance sheet are in line with them and are as reliable, adequate and trustworthy as possible for financial reporting purposes under the existing circumstances.

18. POST BALANCE SHEET DATE EVENTS

On 9 March 2009, the Minister of Regional Development and Public Works, in his capacity of a representative of the State as a sole owner of the capital of FLAG JSC, took a decision for increase of the capital of FLAG to BGN 80,000 thousand through the issue of 50,000 new shares of BGN 1,000 each.

On 12 March 2009, the Minister of Regional Development and Public Works, in his capacity of a representative of the State as a sole owner of the capital of FLAG JSC, took a decision to dismiss Henry Russell from being a member of the Board of Directors of FLAG JSC and to assign Michael Neumayr as a member of the Board of Directors of FLAG JSC.

On 27 April 2009, steps were undertaken by FLAG JSC for concluding a second loan agreement with EBRD for the amount of EUR 35,000 thousand (BGN 68,454 thousand).

On 14 May 2009, steps were undertaken by FLAG JSC to receive the first tranche from EBRD under the concluded loan agreement (Note 16) amounting to EUR 6,469 thousand (BGN 12,652 thousand) in relation to ten municipal projects approved for financing by FLAG JSC.

Our Ref. A973 /29 May 2009

To
Mr Emil Savov
Executive Director

Mrs Kalina Todorova
Chief Accountant though
Fiscalia EOOD

Fund for Local Authorities and Governments
in Bulgaria FLAG JSC
Sofia

Re: Audit of the annual financial statements of the Fund for Local Authorities and Governments
in Bulgaria – FLAG JSC for the year ended 31 December 2008

Dear Mr Savov,

Dear Mrs Todorova,

In pursuit of our engagement to audit the annual financial statements of FLAG JSC ('the Fund') for the year ended 31 December 2008, we would like to kindly inform you that our audit work has been completed.

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By means of this letter we are presenting to you our main findings and recommendations, resultant from the audit procedures we have performed, which we hope to be of benefit for your future work.

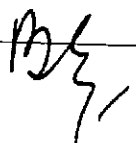
In relation to the audit as a part of the usual audit procedures, we have also performed a review of the Fund's systems of internal controls and accounting but only to the extent necessary to provide us with grounds for expressing our audit opinion on the financial statements as a whole. Our work has not been directly focused on finding weaknesses and establishing fraud or other irregularities in the functioning of both systems (other than those that might affect our audit opinion) and for this reason it should not be relied on for ascertaining that no other weaknesses exist. Therefore, the comments included in this letter, refer to only those issues that have drawn our attention in the normal course of our audit and do not represent an engagement for a thorough assessment of both systems showing all possibilities for improvement thereto as would be the result of a special purpose audit.

The findings and recommendations, which we have discussed with you in the course of our audit and respectively, which have been reflected in the annual financial statements of the Fund as at 31 December 2008, are not included in this letter. Herein we would like to draw your attention to those issues, which are valid also at the time of completion of our audit of the annual financial statements for 2008:

1. Accounting function and system

Findings

1. The primary accounting documentation and accounting ledgers are prepared and kept in accordance with the provisions of the Bulgarian accounting and tax legislation.
2. The Fund has implemented and uses two standardized software for the accounting reporting:
 - Business Navigator for reporting of all transactions. The ledgers, which this software produces and keeps, generate the necessary information base for the preparation of the financial statements and tax declarations of the Company in accordance with the statutory requirements of the Bulgarian accounting and tax legislation;



For that reason, the current control over the authorisation and performance of cash and expense operation was performed by the Executive Director.

BD took a decision the free cash of the Fund to be placed in deposit accounts with banks of Group A as per the classification of BNB by taking into account also the provided bank offers for interest rate on deposits.

The most significant expense, recognised in year 2008, was incurred in line with the conducted public procurement procedure under the requirements of the Bulgarian Public Procurement Act and was intended to choose consultants for supporting the administration of Fund's activities. The competition was carried out based on a decision and with the approval of the BD. A commission, especially assigned for the purpose, reviewed, assessed and ranked the tender documents presented by participants and the final decision on the consultant was approved also by BD. We performed a detailed examination of the documentation on the performance of a tender under public procurement procedure and did not identify material omissions and/or errors.

The remaining expenses, recognised for year 2008, were approved by the Executive Director and a significant portion of the payments to counterparts were made through banks.

The observance of the accounting, tax, labour and social security legislation was monitored by the Executive Director assisted by the accountant of the Fund. No cases of material omissions, deviations and/or errors in application of the stated regulatory fields or lack of knowledge thereof have come to our attention in the course of the audit (see p. 3 of the letter).

Recommendations

Our recommendations are related mainly to the expected start-up of the actual activities of the Fund in 2009 in accordance with the objectives of its establishment, namely:

- (a) to supplement, develop further and formalize the internal rules and controls, including the financial control of the Fund;
- (b) to consider the establishing of an authorised department / group of individuals that shall exercise internal control on the observance of the internal procedures and controls in the execution of the different types of activities and operations of the Fund; and
- (c) to consider and implement optimal segregation of duties and responsibilities on achieving of a defined growth in the volume of activities and respectively, of the staff of the Fund.

MS

Management response

FLAG operates as a public entity and following the provisions of the Internal Audit in the Public Sector Act an internal auditor has been hired in October 2008. Most of the internal audit procedures were adopted and fully implemented in early 2009. In addition to that, following the agreement with EBRD, FLAG will exercise a monitoring over the public procurement procedures of the borrowers.

Two staff members responsible for the credit activity were hired in January 2009 thus the real borrowing process started in mid January 2009.

3. VAT receivable for refund. The VAT status of FLAG*Finding*

As at 31 December 2008, FLAG JSC recognised in its balance sheet a VAT receivable for refund at the amount of BGN 45 thousand – the input tax was mainly used for consulting services in assisting the administration of the Fund and for purchased tangible fixed assets intended for Fund's own use.

In the course of our audit it has been clarified that the Fund has the status of a financial institution (within the meaning of the Bulgarian legislation) and is envisaged to perform only lending activities to municipalities and municipal companies, i.e. it will not perform taxable activities as per the VAT Act. In this sense, the Fund would not be usually in the position to be eligible for VAT refund and respectively, for inputs tax (the coefficient would approximate zero), and in substance this circumstance means that VAT will usually turn to be non-refundable tax and should be capitalised to the value of fixed (non-current) assets or recognised under operating expenses for the respective period (as per the practice of the banks in Bulgaria).

At the same time, as a result of an inspection performed in the first quarter of 2009 by National Revenue Agency authorities on the period September – December 2008, the amount of the above-mentioned receivable under VAT has been refunded to the Fund.

BE

Implication

Since the main activities of the Fund (providing loans to municipalities) represent a financial service, which is exempted from VAT, in substance the Fund has no right of input tax. Therefore, our position is that the amount of BGN 45 thousand VAT (purchases), which has been refunded to the Fund, is not in compliance with the requirements of the VAT Act since there are no legal grounds for the use of input tax (which has been used by the Fund in the period September – December 2008).

Therefore, our position (which has been consulted with the experts of our tax department) is that there is a tax risk that in a future tax audit the tax administration may revise its opinion and may claim the amount of BGN 45 thousand as unjustifiably refunded in the inspection and shall be returned to the state budget along with the interest for the past period.

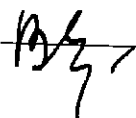
Recommendation

Our recommendations could be summarised as follows:

- (a) Since the Fund has used input tax under VAT at the amount of BGN 45 thousand without having the formal grounds for that under VATA, and respectively, it should recover the said amount to the state budget, it would be good to consider earlier reversal and payment of the amount to the state budget, which would lead to a smaller amount of the due penalty interest under law. The adjustment of the already refunded tax will affect in increase the current expenses (possibly on particular fixed assets). As a result of this, it may become necessary to adjust also the accounting depreciation plan and the tax depreciation plan as well as the tax financial result for year 2008;
- (b) It would be good if the accountants of the Fund consider the policy and respectively, the more precise treatment and accounting for VAT amounts, which becomes a necessity as a result of the specific status and type of operations of the Fund leading in most cases to non-refundable VAT. Practically, this means that VAT shall be capitalised to the value of fixed assets at the purchase date while with regard to other operations – it shall be recognised currently within operating expenses.

Management response

The management accepts the recommendations and will act accordingly.



4. Accounting policy for defining the useful life of tangible fixed assets

Finding

For financial reporting purposes the Fund applies the depreciation rates as determined in the Bulgarian tax legislation.

Implication

The adoption of such depreciation policy creates a risk the period of actual use of certain assets to differ significantly from that used for the purposes of the financial statements and this would result in some mismatch between the period of recognition of depreciation expense and the period of the actual use of the asset.

Recommendation

We would recommend that in year 2009 the depreciation policy of the Fund shall be revised for financial reporting purposes by rendering the useful life and the depreciation rates in line with the judgment and intents of the management for the use of any type of asset.

Management response

The management accepts the recommendations and will act accordingly.

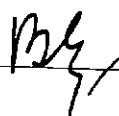
5. Completion of documentation

Finding

In the course of our examination of the primary documents on the conducted public procurements under the Public Procurement Act it has been found that certain documents of the tender are kept in the Ministry of Regional Development and Public Works and not in the Fund (lists and envelopes from financial proposals of participants in the tender, notification of the Public Procurement Agency).

Implication

There is a definite risk that these documents may be not properly filed and subsequently, difficult to find for the completion of the documentation on the Fund itself.



Recommendation

We would recommend to Fund's management to undertake actions and request these documents from the Ministry of Regional Development and Public Works in order to be kept with the Fund thus ensuring the completion of its documentation.

Management response

The management started the process of receiving this documentation. Notifications of the Public Procurement Agency are done electronically via e-signature so no documents on paper are available.

The findings contained in this letter have been offered to your attention in order to assist the accounting department, and respectively the management of the Fund in their future work on the development, completion and implementation of internal control procedures and accountancy.

If you have further questions or need additional information, please, do not hesitate to contact us at: 38, Oborishte Str., Sofia 1504, tel. 9433700, fax 9433707.

Sincerely yours,

Valia Iordanova

Dimitar Popov

29 May 2009

Sofia

This report contains confidential information and is designated to be used solely by the management of FLAG JSC. It may not be copied or shared with other persons without the express written consent of the auditor - AFA OOD. This report may be translated solely with the consent of the auditor while AFA OOD has the right to request changes and amendments in the translated text.



AUDIT
FINANCE
ACCOUNTING
TAX
LAW

**TO
EUROPEAN BANK FOR RECONSTRUCTION
AND DEVELOPMENT**

Copy:

**THE MANAGEMENT OF
FUND FOR LOCAL AUTHORITIES
AND GOVERNMENTS IN BULGARIA**

**REPORT ON THE FINANCIAL COVENANTS
of
FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC**

In accordance with the Loan Agreement signed between EBRD and the FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC, dated 22 December 2008, we as auditors have to certify as to whether the FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC has complied with the financial covenants contained in Section 5.12 of the said Agreement.

We certify hereby that the FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC neither has performed any lending operations as per its core activities, nor has received any amounts under the said Agreement as at 31 December 2008 and therefore, the Report on Financial Ratios is inapplicable at this date.

30 May 2009
38, Oborishte Street
1504-Sofia, Bulgaria

AFA OOD

AFA OOD

Valia Iordanova

Engagement Partner

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