

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

FINANCIAL STATEMENTS

31.12.2009

GENERAL INFORMATION	2
ACTIVITIES REPORT	3
REPORT OF THE INDEPENDENT AUDITOR TO THE SHAREHOLDERS OF FLAG JSC	10
INCOME STATEMENT	12
BALANCE-SHEET	13
CASHFLOW STATEMENT	14
CHANGES IN EQUITY STATEMENT	15
NOTES	
1. CORPORATE INFORMATION	16
2. BASIS FOR PREPARATION AND ESSENTIAL ACCOUNTING POLICIES	17
3. INCOME FROM INTEREST	28
4. FINANCIAL EXPENSES	28
5. EXPENSES ON LABOUR	29
6. OTHER OPERATIONAL EXPENSES	29
7. EXPENSES ON TAXES	30
8. CASH	30
9. ACCOUNTS RECEIVABLE AND PREPAID COSTS	31
10. EQUIPMENT AND LONG-TERM ASSETS	31
11. EXTENDED LOANS	32
12. LIABILITIES UNDER EBRD LOAN	32
13. LIABILITIES TO STAFF AND SOCIAL INSURANCE	33
14. TAX LIABILITIES	33
15. OTHER LIABILITIES	33
16. OWNERS' EQUITY	34
17. RELATED PERSONS AND TRANSACTIONS WITH RELATED PERSONS	34
18. CONTINGENT LIABILITIES AND COMMITMENTS	35
19. MANAGEMENT OF THE FINANCIAL RISK	36
20. EVENTS AFTER THE BALANCE-SHEET DATE	39
21. APPROVAL OF THE FINANCIAL STATEMENTS	39

GENERAL INFORMATION

Board of Directors:

Ekaterina Spasova Gecheva - Zaharieva
Ivelina Vesselinova Vassileva
Emil Rumenov Savov
James Hislop
Lilyana Pavlova Nikolova
Vessela Danailova Daneva
Preslav Plamenov Borisov

Executive Director:

Emil Rumenov Savov

Accountants:

Fiscala EOOD

Management address:

Sofia, 17-19 Sv.Sv. Kiril i Metodi St.

Legal experts:

Dessislava Ivanova-Atanassova

Servicing banks:

IniCredit Bulbank
Reiffaisenbank
Bank DSK
United Bulgarian Bank
Eurobank EFG Bulgaria
Union Bank

Auditor:

BDO Bulgaria Ltd.

ACTIVITY REPORT

For the year ending on 31 December 2009

The management presents its annual report and annual financial statements as at 31 December 2009, drawn up in compliance with the International Financial Reporting Standards, adopted by the European Union.

OVERVIEW OF THE ACTIVITY

A. Business Programme

The Fund has started accepting loan applications of the municipalities on 15 January 2009 and 96 loan applications have been submitted by the end of December, amounting to a total of BGN 120.7 million, to support projects in the amount of BGN 390 million.

- Equity

The share capital of the company was increased by BGN 30 million in 2009, paid in two installments BGN 15 million each, thus bringing the total share capital to BGN 60 million. This, together with the borrowed long-term credit resource, allows FLAG to lend BGN 200 million to the local governments, with equity/borrowed resource ratio of 30/70.

- Management

The fund is managed by the Board of Directors, consisting of seven members. The Board of Directors organizes and manages the operational activity of the Fund in performing all its functions. The Board has held 25 meetings in 2009, most of which devoted to making decisions on approval of loans and annexes thereto.

The following changes took place in the membership of the BD upon decisions made by the sole proprietor in the reporting period:

- ✓ James Hislop replaced Henry Russel as a representative of the European Bank for Reconstruction and Development (EBRD) on 17 June 2009.
- ✓ Penka Yordanova and Krassimira Georgieva replaced Dimcho Mihalevsky and Iskra Mihailova as representatives of the Ministry of Regional Development and Public Works (MRDPW) on 23 July 2009.
- ✓ The Board of Directors elected Krassimira Georgieva to the post Chairperson of the Board on 28 July 2009.
- ✓ Ekaterina Zaharieva and Lilyana Pavlova replaced Penka Yordanova and Krassimira Georgieva as representatives of MRDPW; Vessela Daneva replaced Lyubomir Datsov as representative of the Ministry of Finance; Ivelina Vassileva replaced Atanas Kostadinov as representative of the Ministry of Environment and Water (MEW) and Preslav Borissov replaced Dimitar Peichev as representative of the Ministry of Agriculture and Food on 8 September.
- ✓ On 18 September 2009 the Board elected Ekaterina Zaharieva as chairperson and Ivelina Vassileva – Deputy Chairperson of the Board.

By the end of 2009 the members of the Board of Directors were the following: Ekaterina Zaharieva (MRDPW) – Chairperson, Ivelina Vassileva (MEW) – Deputy Chairperson; Vessela Daneva – MoF – member; Preslav Borissov (MAF) – member; James Hislop (EBRD) – member and Emil Savov (National Association of Municipalities in the Republic of Bulgaria) – member and Executive Director.

- Administrative Activities

- Human Resources

The key personnel of the Fund consisting of experts with appropriate qualification were already available by the beginning of 2009 so that the Fund could commence its lending activities. The status and changes in the number of staff are presented in the table below.

Position	Beginning of 2009	Hired	Dismissed	Reappointed	At the end of 2009
Experts at Projects and Monitoring Directorate	2				2
Experts at Finance and Risk Management Directorate				+1	1
Experts at Lending Directorate	2	2		-1	3
Director of Projects and Monitoring Directorate	1				1
Director of Finance and Risk Management Directorate	1				1
Director of Lending Directorate				+1	1
Internal auditor	1	1	1		1
Office manager	1	1		-1	1
Total	8	4	1	-	11

Several training events were organized for the staff during the year, focusing on municipal budgets, assessment of municipal credit bearing capacity, calculating the net operational surplus and public procurement.

- **External auditor for 2009**

At a meeting held on 14 October 2009 the Board of Directors approved the results of the public procurement procedure conducted for the appointment of an external auditor for 2009, pursuant to art. 2, paragraph 1, item 2 of the Ordinance on Awarding Small Public Procurement, by approving BDO Bulgaria as contractor. This decision was later approved by the proprietor of the company.

- **Loan Agreement with EBRD**

In February 2008 the Fund initiated steps for concluding a second loan agreement with EBRD for the purpose of securing additional resources at the expense of increasing its equity. The Board of Directors adopted a Letter of Mandate on the 23 April on the second loan and the Minister of Regional Development and Public Works gave his consent on concluding an agreement and after the Government made a decision to authorize the Minister of RDPW to sign a support letter, loan agreement 2 was signed on 3 July.

By virtue of the Agreement FLAG is entitled to receiving EURO 35 million for a period of 12 years with a grace period of two years. The funds from the loan shall be used to lend to municipalities which show a definite level of creditworthiness, which is insufficient however for the purposes of borrowing on the market.

- **Main results of the lending activity in 2009**

The year 2009 saw the approval of 70 loans extended to 57 municipalities in the amount of BGN 72 776 thousand, intended to support the implementation of projects in the amount of BGN 242 million, whereby the average percent of the loan in the overall budget of the supported project is 30%. The typical loan extended to the municipalities is for bridge financing in the amount of BGN 1.1 million with maturity of 11 months. This characteristics is due to the following reasons:

- ✓ Type of projects for which the municipalities sought credit resource (mainly roads and educational infrastructure under OPRD);
- ✓ Stage of the projects for which loans were requested from FLAG – as a rule for the second half of the project period;
- ✓ Character of the grant assistance –100% of projects costs were to be reimbursed, which fact determined the short-term nature of the requested loans.

The tables below show the extended loans by types of loans, by operational programmes and by sources for repayment of principals.

By type of loans	Number of loans	Total amount in BGN	Amount in BGN			Maturity in months		
			Minimum	Maximum	Average	Min.	Max.	Average
Investment	58	70,351,378	250,000	4,401,319	1,212,955	4	85	11
Preparation	1	150,791				11	11	11
Preparation with TA	11	2,273,508	32,962	350,228	206,683	8	16	11
Total	70	72,775,677						

By OPs

Regional Development	53	58,851,378	250,000	4,401,319	1,110,403	4	85	10
Environment	16	13,773,508	32,962	3,500,000	860,844	8	19	13
Total	69	72,624,886						

By repayment source

Operational programmes	68	71,846,286	32,962	4,401,319	1,056,563	4	23	10
Own funds	2	929,391	150,791	778,600	464,696	11	85	48
Total	70	72,775,677						

The funds disbursed in 2009 under loan contracts amount to BGN 65.7 million and the repayment under the loan contracts amounted to BGN 17.3 million.

62 annexes to 31 loan contracts (mainly the part concerning the repayment schedules) were considered in 2009.

10 Loan requests are being considered now in the total amount of BGN 9 million.

The municipalities of Glavinitsa, Kirkovo, Krumovgrad, Madan, Valchedrum and Mezdra (road infrastructure), Kaolinovo, Sozopol, Lovech (road infrastructure), Venets and Gabrovoby by the end of 2009 have fully repaid their loans to the Fund amounting to a total of BGN 13.7 million.

The municipality of Strambolovo was the only one in arrears of 37 days for the principal of BGN 210 thousand as at 31 December 2009. In implementing article 57 of the Municipal Debt Act FLAG notified the National Audit Office and the Municipal council about the status of the loan.

16 of the filed loan applications were not approved for the reasons summarized in the table below.

Status	Total number	Incl. OPRD	Incl. OPE	Incl. for project preparation	Total amount
Declined by the BD	3	2	1	0	5,488,703
Put off for later by the BD	2	0	2	0	5,905,215
Withdrawn by the municipality	1	0	0	1	900,000
FLAG waiting for clarifications on a case	3	0	3	0	3,527,540
Submitted at a too early stage	3	2	1	0	3,600,000

Waiting for documents to be presented	3	0	0	3	1,415,558
The project is not within the scope of financing by FLAG	1				445,000
Total	16	4	7	4	21,282,016

• **Information and publicity**

With a view to assisting the access of municipalities to FLAG financing, the Fund has developed a separate section of the Consultative Paper on the 2010 Municipal Budgets, which is traditionally developed by the National Association of Municipalities. This section of the paper contains specific recommendations and examples of good practices in using debt financing from the Fund.

B. Financial Condition

1. Report and Structure of Income and Expenses

Statement of Income and Expenses

№	Name	Amount in BGN thous.	Amount in BGN
	EXPENSE ITEMS	1 600	1 600 261.96
1	Remun. BD, Ex.Director,social insurance	111	111 433.00
2	Consult. services-Consortium (SCG and CE 2000)	54	53,760.00
3	Process representation under the agreement with EBRD	3	3,103.69
4	Legal services	11	10,750.00
5	Media, announcements, brochures	4	3,876.00
6	Rental - office	105	105,062.92
7	Accounting services	18	18,000.00
8	Auditor services	8	7,790.10
9	Notary fees, courier services, cleaning, subscriptions, insurance, translations	15	14,990.23
10	Communications – telephones and cards	5	5,101.37
11	Maintenance of IT network	7	6,800.00
12	Furnishing	4	3,621.88
13	Assets – 2 computers and a telephone exchange	4	3,863.75
14	Stationery	10	10,193.34
15	Other materials	2	2,087.00
16	Fuel and automobile materials	2	2,221.33
17	Depreciation	19	18 804.85
18	Salaries and social insurance contributions	205	205 341.18
19	Business trips	1	900.10
20	Training	3	3 287.63
21	EBRD costs – non-financial	108	108 093.83

22	Bank fees, including:	246	245 522.89
	- <i>Commitment fee EBRD</i>	156	155 572.36
	- <i>Front-end commission EBRD</i>	55	54 514.63
	- <i>Loan administration fee EBRD</i>	24	24 461.75
	- <i>Commission as per contract UniCredit</i>	4	3 907.52
	- <i>Bank fees for transfers, monthly fees, etc.</i>	7	7 066.63
23	Expenses on interest charged on EBRD loan	553	553 352.64
24	Expenses on interest deducted on EBRD loan	102	102 304.23

INCOME ITEMS		4 813	4 813 286.04
1	Income from interest on loans	1 200	1 200 068.29
2	Income from default interest on loans	15	15 034.56
3	Income from fees on loans	28	28 482.22
4	Income from interest on deposits – due	766	765 729.38
5	Income from interest - deposits	2 804	2 803 971.59

DEPOSITS		64 145	64 145 377.63
1	Raiffeisenbank	46 246	46 245 826.00
2	UniCredit	17 899	17 899 551.63

Structure of Expenses

Groups of expenses	Amount	Share of total expenses
Operational costs	147,719.92	9.23%
Hired services	97,100.10	6.07%
Acquisition of LTTA and depreciation	26,290.48	1.64%
Remuneration – staff, BD	316,774.18	19.80%
UniCredit management fee, other fees	10,974.15	0.69%
On EBRD loans – interest	655,656.87	40.97%
On EBRD loans – fees	234 548.74	14.66%
On EBRD loans – other expenses	111,197.52	6.95%
	1 600 261.96	

The expenses on fees and other expenses to EBRD, as well as the payment of BGN 53.8 thousand under a consultancy contract of 2008, being hired services are one-off expenses. If they are deducted, the operational expenses of the Company will be in the amount of BGN 599 thousand.

2. Yield

1. From extended loans – at average interest rate of 5.94% the yield, including interest rate and commitment fee, stands at BGN 1,244 thousand.
2. From management of temporarily unemployed funds – FLAG has concluded contracts with banks for open-end deposits, the annual yield of which ranges from 7.90 to 10.50%. The overall yield from them is BGN 3.57 million, distributed among the different sources in the following way:

Source	Paid in 2009	Due as at 31.12.2009
UniCredit Bulbank	775	711 776

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

Raiffeisenbank	2 290 712	53 953
DSK	10 754	
Union bank	318 812	
Eurobank EFG	179 729	
Total:	2 803 972	765 729

3. Cash Available

As at the end of 2009 the Fund had BGN 65,145 thous. on deposit accounts and BGN 50 thous. on its payments account.

COMPREHENSIVE INCOME STATEMENT
For the year ending 31 December 2009

	Notes	2009 BGN'000	2008 BGN'000
FINANCIAL INCOME AND EXPENSES			
Interest income	3	4,785	1,067
Other operational income, net		28	2
Financial costs on interest and fees	4	(979)	0
NET FINANCIAL INCOME		3,834	1,069
OTHER INCOME/ EXPENSES			
Labour cost	5	(319)	(92)
Depreciation costs	10	(19)	(2)
Other operational costs	6	(361)	(306)
PROFIT FROM OPERATIONS		3,135	669
Expenses on profit tax	7	313	67
NET PROFIT FOR THE YEAR		2,822	602
OTHER COMPREHENSIVE INCOME		0	0
TOTAL COMPREHENSIVE INCOME, NET OF TAXES		2,822	602

Executive Director:

Prepared by

(Fiscala EOOD)

Audited by:

(BDO Bulgaria Ltd.)

Stoyanka Apostolova, Manager
CPA, Registered auditor

BALANCE SHEET
As of 31 December 2009

	Notes	31 December 2009 BGN'000	31 December 2008 BGN'000
ASSETS			
Receivables on subscribed shares		0	0
Cash and cash equivalents	8	66,489	30,620
Receivables and prepaid expenses	9	5	52
Equipment and other long-term assets	10	42	57
Deferred tax assets		1	2
Extended loans	11	48,508	0
TOTAL ASSETS		115,045	30,731
LIABILITIES			
Liabilities under EBRD loan	12	51,574	0
Liabilities to staff and social insurance liabilities	13	57	38
Tax liabilities	14	258	72
Other liabilities	15	3	19
TOTAL LIABILITIES		51,892	129
EQUITY			
Authorized capital	16	60,000	30,000
Statutory reserves	16	60	0
Retained earnings	16	3,093	602
TOTAL EQUITY		63,153	30,602
TOTAL LIABILITIES AND EQUITY		115,045	30,371

Executive Director:

Prepared by:
(Fiscala EOOD)

Audited:
(BDO Bulgaria Ltd.)

Stoyanka Apostolova, Manager
CPA, Registered auditor



STATEMENT OF CASH FLOWS
For the year ending 31 December 2009

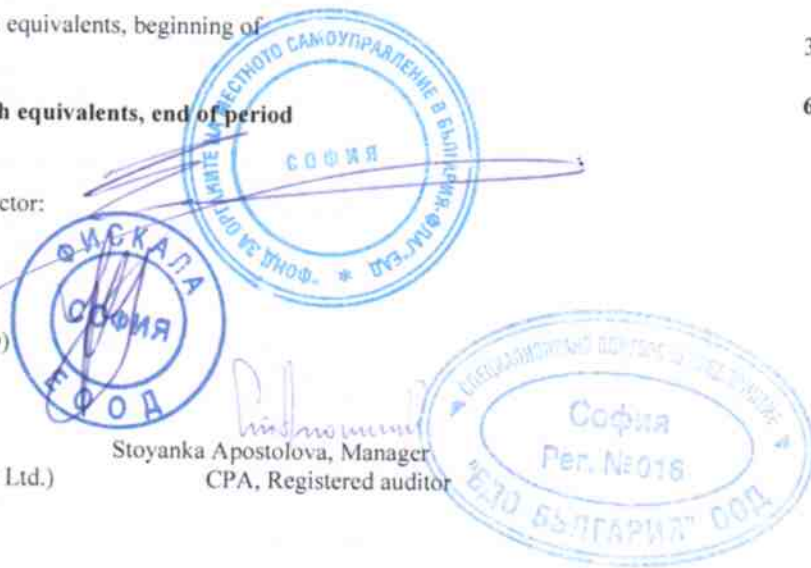
	Notes	2009	2008
		BGN'000	BGN'000
Operational activities cash flow			
Interest received on bank deposits		3,026	845
Payments to suppliers		(342)	(345)
Payments to staff and for social insurance		(286)	(60)
Other proceeds / (payments), net		(404)	17
Net cash flow from operational activities		1,994	457
Cash flow from investment activities			
Purchase of equipment and other long-term assets		(4)	(59)
Net cash flow used in investment activity		(4)	(59)
Cash flow from financial activity			
EBRD loan		51,984	
Contributions to authorized capital		30,000	
Loans extended to municipalities		(65,744)	
Loans repaid by municipalities		17,283	
Gains from interest and fees		1,197	
Financial expenses		(1,385)	
Net cash flow from financial activity		33,335	
Net increase of cash and cash equivalents		35,325	398
Cash and cash equivalents, beginning of period		30,398	30,000
Cash and cash equivalents, end of period		65,723	30,398

Executive Director:

Prepared by:
(Fiscala EOOD)

Audited:
(BDO Bulgaria Ltd.)

Stoyanka Apostolova, Manager
CPA, Registered auditor



STATEMENT OF CHANGES IN EQUITY
For the year ending 31 December 2009

	<i>Authorized capital</i>	<i>Retained earnings</i>	<i>Reserves</i>	<i>Total equity</i>
Note	BGN'000	BGN'000	BGN'000	BGN'000
Balance as of 31.12.2008	30,000	602		30,602
1. Authorized capital subject to registration	30,000	-	-	30,000
2. Distributed profit for 2008		(331)	60	(271)
3. Profit from operational activities		2,822		2,822
Balance as at 31 December 2009	60,000	3,093	60	63,153

Executive Director:

Prepared by:
(Fiscalia EOOD)

Audited:
(BDO Bulgaria Ltd.)

Stoyanka Apostolova, Manager
CPA, Registered auditor



EXPLANATORY NOTES

About the year ending 31 December 2009

1. Corporate Information

1.1. Establishment

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC (FLAG OR THE FUND) was established on the grounds of Decree No 4 of the Council of Ministers of 07.03.2007. The Fund was registered by decision № 1 dated 04.07.2007 under CF 10151/2007 with Sofia City Court.

The management address of the Fund is 17-19 Sv.Sv.Kiril i Metodi St., Sofia, Bulgaria.

1.2. Ownership and Management

The Republic of Bulgaria, represented by the Ministry of Regional Development and Public Works, is the sole proprietor of the Fund. FLAG is represented by the executive member of the Board of Directors Emil Savov.

FLAG has a one-tire management system with a Board of Directors, consisting of 7 members with term of office of 3 years. As at 31.12.2009 the following persons were members of the BD:

Board of Directors:

Ekaterina Spasova Gecheva - Zaharieva
Ivelina Vesselinova Vassileva
Emil Rumenov Savov
James Hislop
Lilyana Pavlova Nikolova
Vessela Danailova Daneva
Preslav Plamenov Borisov

1.3. Object of Activity

FLAG was established for a special purpose – to finance for consideration municipal infrastructure and other projects and co-finance the preparation and implementation of projects of the European Union.

As at 31.12.2009 FLAG has 11 employees (31.12.2008: 6).

1.4. Main Indicators of the Economic Environment

The main indicators of the economic environment which influenced the activity of the Fund in 2009 are presented in the table below:

Indicator	2008	2009
GDP in BGN million ¹	66,728	66,256
GDP growth	6.0%	1.0%
Inflation at year end	7.8%	2.5%
Average exchange rate of US dollar for the year	1.33682	1.40532
Exchange rate of US dollar at year end	1.38731	1.36409
Base interest rate at year end	5.77%	0.39%
Unemployment (year end)	6.3%	12.0%

2. SUMMARY OF ACCOUNTING POLICIES

2.1. Basis for the Preparation of the Financial Statements

The financial statements of FLAG JSC were prepared in conformity with all International Financial Reporting Standards (IFRS), which comprise: financial reporting standards and interpretations by the IFRIC, approved by the International Accounting Standards Board (IASB), and the International Accounting Standards and interpretations given by the International Accounting Standards Committee (IASC), which are effective as of 1 January 2009 and which were adopted by the Commission of the European Union.

The Fund has adopted for the current financial year all new and/or revised standards and interpretations, issued by the International Accounting Standards Board (IASB) and respectively by the International Financial Reporting Interpretations Committee (IFRIC), which are relevant to its activity.

Several standards and interpretations, which were not adopted by FLAG before, have been issued, but have not yet come into force as at the date of issuing these financial statements for approval. The management is of the opinion that the following among them might have a potential effect on the future accounting policy and financial statements of the Fund:

- *IFRS 7, Financial instruments: disclosure and additional amendment to IAS 1, Presentation of financial statements – disclosure of equity* (in effect for reporting periods starting on or after 1 January 2007, amendment in force from 1 January 2009). IFRS 7 introduced new requirements aimed at improving the disclosure of the information about the financial instruments. It requires qualitative and quantitative information to be disclosed about risks that have arisen as a result of the financial instruments, including the minimum specific disclosures of credit risks, liquid risks and market risks. Where such risks are viewed as essentially important for the Bank, the disclosure must be performed on the basis of the information used by the key management. It replaces the requirements for disclosure contained in IAS 32 – Financial

¹ New, denominated les
Source: NSI, BNB

Instruments: Disclosure and Presentation. It is applied to all entities which apply IFRS. Amendments were made to IFRS 7, announced in March 2009, in effect for periods beginning on or after 1 January 2009. The amendments require disclosure of financial instruments valued at fair value according to the level in the hierarchy of valuation at fair value. The amendments to IFRS 7 have an impact on the notes to the statements and do not affect the financial position or comprehensive income of FLAG JSC. The amendment to IAS 1 introduced the requirement to disclose the level and equity management of an entity. The bank has applied IFRS 7 and the amendment to IAS 1 to the statements for the period commencing on 1 January 2007 and the amendments to IFRS 7 to the period beginning on 1 January 2009.

(ii) *Standards, amendments to and explanations of published standards in force in 2009, which are not relevant to FLAG's activity.*

- *IAS 23, Borrowing Costs (revised)* (in effect for reporting periods beginning on or after 1 January 2009). The main change as compared to the previous version is the elimination of the option of recognition of borrowing costs immediately as expense where relating to qualified assets, which in the broad sense are assets that take a significant period of time to become ready for use or sale. This will have no effect on the assets of FLAG JSC, since this option is not used by it.

- *IFRIC 12, Service Concession Arrangements* (in effect for reporting periods beginning on or after 1 January 2008). IFRIC 12 provides guidance on accounting by stock exchange brokers in connection with service concession arrangements, by virtue of which the entity is deregistered from the stock exchange and goes private. IFRS 12 does not refer to the activity of FLAG.

- *Revised IFRS 3, Business combinations and additional amendments to IAS 27 Consolidated and individual financial statements* (both in effect for reporting periods beginning on or after 1 July 2009). The revised IFRS 3 and the amendments to IAS 27 are the outcome of a joint project of the IASB and the issuing of the US standards, as a result of which IFRS coincide to a great extent with the respective US requirements issued recently. There are definitely very significant changes in the requirements of IFRS and the existing options, if the business combinations are considered.

- *IFRIC 13, Customer Loyalty Programmes* (in effect for reporting periods beginning on or after 1 July 2008). IFRIC 13 refers to transactions-sales whereby the entities grant their customers loyalty award credits which should account for their obligation to provide free or discounted goods or services if and when the customers repay the credits. IFRIC 13 is not relevant to the activity of FLAG.

- *Amendment to IFRS 2, Share-based payment: statutory conditions and canceling* (in effect for reporting periods beginning on or after 1 January 2009). The amendment to IFRS 2 refers more specifically to entities which work on programmes in which share options are granted to employees. This is due to the fact that it leads to sudden acceleration of expenses according to IFRS 2, which would be otherwise

recognized for future periods, if the employee decides to stop making payments to the programme, as well as in case of a potential revision of the fair value of granted options, and going as far as the possibility of the employees stepping out of this plan. The amendments to IFRS 2 are not relevant to the activity of FLAG due to the lack of such agreements.

- *IFRS 8, Operating segments* (in effect for reporting periods beginning on or after 1 January 2009). This standard replaced IAS 14, Accounting of segments, with the requirement to define primary and secondary accounting segments. According to IFRS 8 the external reports of the Bank on segments are based on internal information as presented to the chief decision makers for the purposes of allocation of the Bank's resources. IFRS 8 will have no effect on the financial statements of FLAG JSC.

The management has defined that the above mentioned amended/new standards and/or interpretations could not exert any influence on FLAG's accounting policy, insofar as its activity is not in those economic sectors, neither does it involve such transactions, operations and policies, or such accounting segments.

The financial statements of FLAG are prepared on the basis of the historic price, except for the financial instruments, which according to their classification under IFRS must be valued and presented at depreciable value as at the balance sheet date.

The Fund maintains its accounting ledgers in Bulgarian lev (BGN), which is its accounting currency for the purposes of presentation. Data in the financial statements and notes thereto are presented in BGN thousand.

The presentation of the financial statements according to the International Financial Reporting Standards requires from the management to make the best estimates, charges and reasonable assumptions that exert an influence on the value of assets and liabilities accounted for, on income and expenses and on the disclosures of contingent receivables and liabilities as at the date of the statement. These estimates, charges and assumptions are based on the information available as at the date of the financial statements, due to which any future actual results might be different (in the conditions of a financial crisis the uncertainty is even more significant).

2.2. Comparative Data

The Fund has accepted to present comparative information about a preceding period in its annual financial statements. In addition, where for the purposes of more truthful presentation of the accounting segments and operations it would be necessary to make changes in their classification and present them as separate components of the financial statements, the comparative data about the preceding year are reclassified to make them comparable to the current reporting period.

2.3. Accounting Currency

The functional currency and the currency of presentation in the financial statements of FLAG is the Bulgarian lev. Since 1 July 1997 the lev was fixed to the German mark by the Law on BNB in a ratio BGN 1:DEM 1, and with the introduction of the EURO as an official currency of the EU on 1 January 1999, the fixed ratio of the two currencies has become BGN 1.95583:EUR 1.

At initial recognition, a transaction in a foreign currency is accounted for in the functional currency, by applying the exchange rate applicable at the moment of the transaction or operation. Any cash and equivalents, loans and accounts receivable, investment in securities, liabilities on deposits, loans and other liabilities, such as monetary accounting segments, denominated in foreign currency are accounted for in the functional currency by applying the exchange rate, published daily by BNB. A revaluation of all monetary accounting segments is made at the end of each working month based on the official exchange rate announced by BNB.

The non-monetary accounting segments in the balance sheet, initially denominated in a foreign currency, are accounted for in the functional currency, whereby applying the historic exchange rate as at the date of the operation and are not revaluated subsequently on the basis of the closing rate.

2.4. Interest Income and Expenses

The interest income and expenses are recognized in the income statement on the basis of the principle of charging for all interest-bearing instruments while applying the method of effective income on the basis of the acquisition price or the applicable non-fixed interest rate. Interest income and expenses include depreciation of each deduction or premium or any other differences between the initial carrying value of interest-bearing instruments and their value at maturity, calculated on the basis of the effective interest rate.

The interest income includes realized interest gains from bank deposits, interest on extended loans, fees and commissions on extended loans and advance payments to counterparties (municipalities), which form an inseparable part of the effective income from the financial instrument.

The interest expenses are recognized on the principle of charging and include the interest on received loans and other borrowed funds, fees and commissions on received loans, which form an inseparable part of the effective expense on interest.

2.5. Financial Instruments

2.5.1. Financial Assets

The Fund classifies its financial assets in the category "loans (granted credits) and accounts receivable". The classification depends on the character and objectives (purpose) of the financial assets as at the date of their acquisition. The management defines the classification of the financial assets of FLAG as at the date of their initial recognition in the balance sheet.

Normally the Fund recognizes the financial assets in its balance sheet as at the date of trading – the date on which it has made a final commitment to acquire the financial assets in question. All financial assets are

initially valued at their fair value plus the direct transaction costs.

Financial assets are written off the balance sheet of the Fund when the rights to receiving cash (flows) from these assets expire or are transferred and the Fund has transferred an essential portion of the risks and benefits associated with the ownership of the asset to another entity (person). If the Fund still continues holding an essential part of risks and benefits associated with the ownership of a transferred financial asset, it continues recognizing the asset in its balance sheet, while also recognizing a secured liability (loan) for the obtained funds.

Loans and Accounts Receivable

Loans and accounts receivable are non-derivative financial instruments with fixed and identifiable payments, which are not quoted on an active market. They are presented and valued in the balance sheet at depreciable value where the method of effective interest, minus impairment is applied. This group of financial assets of the Fund includes: bank deposits, cash on current bank accounts, receivables under granted loans, trade and other accounts receivable from counterparties and third persons. The interest gains from loans and accounts receivable is recognized 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 impairment review. The management of the Fund assesses as at the date of each balance sheet the presence of objective evidence that certain financial assets, classified in the group "loans and accounts receivable" show signs of impairment. The criteria used by the Fund in determining whether the objective indicators of losses or impairment are present are: violations in agreed repayment of principal and interest; cash flow difficulties, suffered by the debtor; deterioration of the financial, market and competitive position of the debtor, etc. Impairment is recognized in case that the present value of the financial asset of this group, determined by discounting the expected future cash flows by the effective interest rate, exceeds its carrying value as at the date of valuation.

The impairment loss associated with loans and other receivables is accounted for on a special corrective account and is 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 owner's equity depending on the nature and conditions in the contract with the respective counterparty on these instruments. It determines the classification of financial liabilities in the moment of their occurring. All financial liabilities of the Fund are classified in the group "Other financial liabilities" and are accounted for at their depreciable value.

The financial liabilities of the Fund are initially recognized in the balance sheet according to their fair value, net the direct costs on the transaction, and subsequently – on depreciable value applying the method of effective interest. The expenses on interest are accounted for currently, in the income statement.

The financial liabilities are written off after the obligation thereto is settled, cancelled or the

counterparty loses the right to realize them.

2.6. Equipment and other Long-Term Assets

Equipment and other long-term assets (long-term tangible assets) include: computers and other office equipment, automobiles, etc. They are presented in the financial statements on their historic acquisition price (cost), minus the accumulated depreciation and impairment loss.

Initial Valuation

At their initial acquisition the long-term tangible assets are valued at their acquisition price (cost), comprising the purchase price, including any customs duties and direct costs necessary to make the asset fully operational. FLAG has determined a threshold of BGN 700, below which an acquired asset regardless of whether it has characteristics of a long-term asset, is treated as a current expense at the moment of acquisition.

Subsequent Valuation

The approach of subsequent balance sheet valuation of LTTAs, chosen by FLAG, is the cost model as per IAS 16 – the acquisition price (cost) less any accumulated depreciation and any accumulated impairment losses.

Depreciation Methods

The Fund applies the straight-line method of depreciation of LTTAs. The useful life by groups of assets is determined according to: the physical wearing out, the specificity of the equipment; any future intentions to use it, the presumed moral wearing out, and it is as follows:

- Computers – 2 years
- Transport vehicles – 4 years
- Implements – 5 years

The determined useful life is reviewed at the end of each year and should a significant divergence from the expectations about the future period of use of the assets be established, it is adjusted accordingly.

Subsequent Expenses

The costs on repair and maintenance are recognized as current expenses in the period when they were incurred. Subsequent expenses, which have the character of replacement of certain key parts or of a reconstruction or overhaul, are capitalized to the carrying value of the asset and its residual useful life as at the date of capitalization is reviewed. The non-depreciated part of the replaced components is written off the carrying value of the asset and is recognized in the current expenses for the period of reconstruction.

Impairment of Assets

The carrying amounts of equipment and other LTTAs are subject to test for impairment whenever events or changes in circumstances indicate that they might vary durably from their recoverable value. Where indications that the estimated recoverable value is lower than their carrying amount are present, the latter is written off to the level of the recoverable value of the assets. The recoverable value of LTTAs is the higher of the two: the fair value with sales costs excluded, or the cost in use. To determine the cost in use of assets the future cash flows are discounted to their present value by applying a discount rate before taxation, which reflects the current market conditions and assessment of the time value of money as well as of the risks specific for the respective asset. Impairment loss is recognized in the income statement under "Depreciation expenses".

Profit and Loss from Sales

LTTAs are written off the balance sheet when they are permanently decommissioned and no more future economic benefits are expected to flow from them, or else – when they are sold. The profit or loss from sales of individual assets are defined by comparing the revenue from sale and the carrying amount of the asset as at the date of the sale. They are presented net, under "other operational revenues", net, on the front page of the income statement.

2.7. Interest-bearing Loans and other Borrowed Financial Resources

All loans and other borrowed financial resources are recognized initially and evaluated at their cost (nominal amount), which is taken for fair value of what is received under the transaction, net the direct costs associated with these loans and borrowed funds. After the initial recognition the interest-bearing loans and other borrowed funds are subsequently assessed at depreciable value, determined by applying the effective interest method. The depreciable value is calculated by taking account of all kinds of fees, commissions and other costs, including a discount or premium, associated with these loans. The profits and losses are recognized in the income statements during the depreciation period or when the liabilities are written off or reduced and are presented under "Interest expenses".

2.8. Liabilities to Staff pursuant to the Social Insurance and Labour Legislation

Under the Bulgarian law FLAG is obliged to make contributions to the social and health insurance funds. The size of the contributions is determined by the Social Insurance Code and the Health Insurance Act – on the basis of the income for the period. Labour relations with the personnel of the Fund, in its capacity of employer, are based on the provisions of the Labour Code and of the existing social insurance legislation.

The employer's main obligation is to ensure the compulsory social insurance of the hired persons with fund Pensions, the additional compulsory pension insurance, to make contributions to fund General Disease and Motherhood, fund Labour Accidents and Vocational Diseases, fund Unemployment, fund Guaranteed Receivables of Workers and Employees and Fund Health Insurance.

The size of insurance contributions is determined in the Budget of Public Social Insurance Act (BPSIA) and the Budget of the Health Insurance Fund Act for each year. The contributions are split among the employer and the insured person in proportion which changes annually and is determined in the Social Insurance Code. The total amount of the contribution to Fund Pensions, additional compulsory pension insurance; Fund General Disease and Motherhood, Fund Unemployment and health insurance for 2009 is as follows:

For the period 01.01.2009 – 31.12.2009: for persons employed for 3rd category of work – 33.5% (split among employer and employee in proportion 60:40).

In addition, only at its own expense the employer makes insurance contributions to Fund Guaranteed Receivables of Workers and Employees to the amount of 0.5%, as well as contributions to Fund Labour Accidents and Vocational Diseases, which vary from enterprise to enterprise in the range of 0.4% to 1.1% depending on the line of business of the entity (as per Note 2 to BPSIA for 2007), which is 0.5 % for the Fund.

The insurance schemes applied by FLAG in its capacity of employer, are based on the Bulgarian legislation and contain defined contributions. According to these schemes the employer pays monthly contributions to the public funds Pensions, fund General Disease and Motherhood, fund Labour Accidents and Vocational Diseases, fund Unemployment, fund Guaranteed Receivables of Workers and Employees, as well as the additional compulsory pension insurance funds (universal and professional pension funds) in percentage as determined by the law (indicated above) and has no other legal or constructive obligation to make additional payments to funds in the future. Similar is the situation with the health insurance.

FLAG has no private voluntary pension insurance scheme.

Short-term Income

The short-term income of the staff of the Fund in the form of remuneration, bonuses and social benefits (payable within 12 months after the end of the period in which the staff has earned them or has satisfied the required conditions) are recognized as expense in the income statement for the period in which the staff has expended labour for them or the requirements for their granting have been met, and as a current liability (after deducting any amounts already paid and due) in their undiscounted amount. The contributions due for social and health insurance are recognized as current costs and liability as an undiscounted amount, together and in the period of recognition of the respective incomes they are associated with.

As at the date of each financial statement the Fund makes an assessment of the amount of expected expenses on accumulated unused leaves, subject to compensation, which is expected to be paid. The assessment includes an estimate of the costs on remunerations and on contributions to the compulsory public social and health insurance funds, which the employer owes over these amounts.

Long-term Income at Retirement

According to the Labour Code the employer is obliged to pay to the employees upon entering retirement age a compensation which, depending on the duration of employment relations with the enterprise may vary between 2 and 6 gross working salaries as at the date of termination of the employment contract relations. In their characteristics these schemes are plans with defined incomes.

The calculation of the magnitude of such liabilities requires the involvement of qualified actuaries, in order to define their present value as at the date of the financial statement, with which they will be presented

in the balance sheet, adjusted by the size of non-recognized actuarial profit and loss; and respectively – the changes in their value, including the recognized actuarial profit and loss – in the income statement.

Income at Leaving

According to the provisions of the Labour Code the employer is obliged in case of terminating the labour contract before retirement age to pay compensation for the following:

- failure to observe the notification period – the gross labour remuneration due for one month;
- in case of closing the enterprise or part thereof, laying off staff, reducing the volume of work, suspending the operations for more than 15 days, etc. – the gross labour remuneration due for one month;
- in case of terminating the labour contract because of sickness– compensation in the amount of 2 gross monthly salaries;
- for unused paid annual leave – for the respective years during the period recognized as service for the purposes of retirement.

The Fund recognizes liabilities to the staff in case an employee leaves before retirement age; when there is a binding commitment on the basis of an announced plan to terminate the labor contract with the person in question without repealing the termination; or in case where documents are formally issued for voluntary resigning. Incomes at leaving, payable for more than 12 months, are discounted and presented in the balance sheet at their present value.

2.9. Profit Taxes

Current Profit Taxes

The current profit taxes are determined in conformity with the requirements of the Bulgarian tax laws – The Corporate Profit Tax Act. The nominal tax rate for 2009 is 10%.

Deferred Profit Taxes

The deferred taxes are determined by applying the balance sheet passive method to all temporary differences as at the date of the financial statement, existing between the carrying amounts and the tax bases of the individual assets and liabilities.

Deferred tax liabilities are recognized for all taxable temporary differences.

Deferred tax assets are recognized for all deductible temporary differences and for the unutilized tax losses to the extent to which they are likely to occur again and to have sufficient taxable profit generated in the future, or to have taxable temporary differences occur, from which such deductible differences could be deducted, except for differences caused by the initial recognition of an asset or a liability which has not affected the balance-sheet or tax profit (loss) as at the date of the operation.

The carrying amount of all deferred tax assets is reviewed on each date of the financial statements and reduced to the extent to which they are likely to occur again and to generate a sufficient taxable profit or to

have taxable temporary differences occurring in the same period from which they could be deducted .

Deferred taxes relating to segments which are directly accounted for as equity or another balance sheet item, are also accounted for directly under the respective equity component or balance sheet item.

Deferred tax assets and liabilities are assessed on the basis of tax rates which are expected to apply in the period in which the assets will be realized and the liabilities will be settled (repaid), on the basis of the tax laws in effect or expected with significant certainty to be in effect. As at 31.12.2009 the deferred profit taxes were assessed with a rate of 10%.

2.10. Liabilities to Suppliers and other Counterparties

The liabilities to suppliers and other counterparties are accounted for and presented in the financial statements at their invoice value (acquisition price), which is taken for fair value of the deal and will be paid in the future against received goods and services. In the cases of deferred payments that exceed the normal credit period, where no additional interest payment is foreseen, or the interest differs significantly from the normal market interest rate, the liabilities are valued initially at fair value, and subsequently – at depreciable value, after deducting the interest incorporated in their nominal value, determined on the basis of the effective interest method.

2.11. Cash and Cash Equivalents

The cash and cash equivalents are presented at depreciable value and comprise: cash in hand, on current payment accounts with banks and on bank deposits – demand deposits and/or ones with original maturity up to three months.

The composition of the cash and cash equivalents for the purposes of the cash flow statement is similar (except for blocked funds), and they are presented with the same valuation.

2.12. Equity and Reserves

The Fund is a sole proprietor joint stock company and is obliged to register with the Commercial register a specified amount of **share capital**, to be used as a security for the receivables of the creditors of the Fund. The share holders are responsible for the liabilities of the Fund to the amount of their interest in the equity and may claim this back only in liquidation or insolvency proceedings.

The share capital is the capital of the Fund which is not subject to distribution and is presented at the par value of issued shares.

FLAG is obliged to set a **Reserve Fund**, in conformity with the requirements of the Commerce Act. Sources for such a fund could be:

- a portion of the profit determined by the sole proprietor, but no less than 1/10 until the funds in the fund reach 1/10 of the equity;

- the funds obtained in excess of the par value of the shares at their issuing;
- other sources as determined by the General meeting.

The funds from the Reserve fund may be used only to cover annual losses and previous year losses. When the funds reach the minimum determined in the Charter, any amounts in excess of this minimum may be used for increasing the share capital of the Fund.

3. INTEREST REVENUE

The interest revenues include:

	2009 BGN'000	2008 BGN'000
Interest revenue from loans extended by FLAG to municipalities	1,215	0
Revenue from interest on deposits	3,570	1,067
Total interest revenue	4,785	1,067

FLAG's interest revenues for 2009 amount to BGN 4,785 thous. where BGN 3,570 thousand were generated by time deposits opened with commercial banks in Bulgaria in 2008 and 2009, through which part of the paid-in share capital contributions were invested. BGN 1,215 thous. were generated from credits extended to municipalities in the Republic of Bulgaria.

4. FINANCIAL EXPENSES

The financial expenses comprise:

	2009 BGN'000	2008 BGN'000
Expenses on interest	656	0
Expenses on foreign currency operations	77	0
Expenses on fees and commissions	246	0
Total financial expenses	979	0

The financial expenses of FLAG for 2009 amount to BGN 979 thousand. BGN 246 thousand were related to fees and commissions to financial institutions, servicing FLAG's operations. BGN 656 thousand were related to interest on loans extended to FLAG by EBRD.

5. LABOUR COSTS

The labour costs for 2009 comprise:

	2009	2008
	BGN'000	BGN'000
Remuneration of members of the Board of Directors and the Executive Director	108	69
Remuneration of staff and social insurance contributions	211	23
Total labour costs	319	92

6. OTHER OPERATIONAL EXPENSES

The other operational expenses of the Fund for 2009 comprise:

	2009	2008
	BGN'000	BGN'000
Legal services- EBBP	109	
Rentals	99	29
Consultancy services	58	226
Accounting and auditor services	26	9
Materials	16	
Computer maintenance	7	
Communications	5	
Media	3	
Translations	3	3
Social insurance	2	
Insurance	2	
Others	31	39
Total other operational expenses	361	306

7. EXPENSES ON PROFIT TAXES

The main components of the expenses on profit taxes in 2009 are the following:

	2009	2008
	BGN'000	BGN'000
Taxable profit according to tax return	3,116	693
Current tax expenses	311	69
Deferred profit taxes relating to:		
- occurrence of temporary differences	2	(2)

Expense on profit tax accounted for in the income statement	<u>313</u>	<u>67</u>
Reconciliation of the expense on profit taxes determined against the balance sheet result		
Balance sheet profit for the year	3,135	669
Tax calculated at the nominal tax rate of 10%	315	67
Tax effects of unrecognized amounts	(2)	0
Expense on profit taxes accounted for in the income statement	<u>313</u>	<u>67</u>

8. CASH AND CASH EQUIVALENTS

The cash and cash equivalents of the Fund comprise:

	2009	2008
	BGN'000	BGN'000
Short-term deposits with banks, in BGN and with original maturity up to 3 months	64,911	30,299
Payment accounts with banks in Bulgarian lev	1,578	321
Total cash	<u>66,489</u>	<u>30,620</u>

The cash available as at 31.12.2009 is on current accounts and deposits with the following banks: Reiffaisenbank JSC and UniCredit Bulbank JSC.

The cash placed on time deposits as at 31.12.2009 is only in Bulgarian lev. The short-term deposits with Reiffaisenbank JSC are with an original maturity of three months and possibility for eventual renegotiation upon maturity. The short-term deposits with UniCredit Bulbank are with original maturity of 12 months and are payable at any time.

The interest levels for the deposits are within the range of 7 % to 10.5 % depending on the amount and the market conditions of the respective bank, and for the current accounts - around 0.02%.

For the purposes of the cash flows any charged but not received interest on deposit accounts of FLAG is not accounted for as cash.

9. ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	2009	2008
	BGN'000	BGN'000
Receivables from VAT	0	45
Non-financial deferred expenses	3	3
Others	2	4
Total receivables and prepaid expenses	5	52

The deferred expenses are ones on insurance and subscriptions.

10. EQUIPMENT AND OTHER LONG-TERM ASSETS

	Automobiles	Office and computer equipment	Implements	Total
	BGN'000	BGN'000	BGN'000	BGN'000
Carrying value				
As at 1 January 2008	-	-	-	-
Acquired	36	16	7	59
Transfers	-	-	-	-
Written off	-	-	-	-
As at 31 December 2008	36	16	7	59
Acquired	-	4	-	4
Transfers	-	-	-	-
Written off	-	-	-	-
As at 31 December 2009	36	20	7	63
Depreciation				
On 1 January 2008	-	-	-	-
Charged depreciation	-	2	-	2
Written off	-	-	-	-
As at 31 December 2008	-	2	-	2
Charged depreciation	9	9	1	19
Written off	-	-	-	-
As at 31 December 2009	9	11	1	21
Balance sheet value				
As at 1 January 2008	-	-	-	-
As at 31 December 2008	36	14	7	57
As at 31 December 2009	27	9	6	42

Based on performed impairment test of long-term tangible assets, the management of the Fund has not established any indications that the balance-sheet value of the assets exceeds their recoverable value.

11. EXTENDED LOANS

	Non-impaired assets	Impaired assets	Provisions	Total balance- sheet value
31.12.2009				
Loans to municipalities	48,508	-	-	48,508
31.12.2008				
Loans to municipalities	-	-	-	-

12. LIABILITIES UNDER EBRD LOAN

	2009 BGN'000	2008 BGN'000
Liabilities under EBRD loan	51,574	-
Total	51,574	-

The liabilities of FLAG to the European Bank for Reconstruction and Development were undertaken as a result of a loan agreement, by virtue of which EBRD will extend to FLAG a loan with a limit of EURO 35,000 thousand (BGN 68,454 thousand), which will be disbursed in two parts:

1. Loan "a" in an amount which will not exceed EURO 18,000 thousand (BGN 35,205 thousand)
2. Loan "b" in an amount which will not exceed EURO 17,000 thousand (BGN 33,249 thousand)

The loans shall be extended for a period of 15 years, with a 3-year grace period. The agreed interest rate is based on the six-month EURIBOR plus a margin ranging from 2.25% to 2.75% depending on the presence of bad loans. Fees are foreseen in addition, such as: (a) annual commitment fee; (b) one-off front - end fee; (c) annual administration fee.

As at 31.12.2009, FLAG has absorbed EURO 26,619 thousand (BGN 52,061 thousand) of the committed resources. The difference between the absorbed funds and the balance-sheet value as at 31.12.2009 is due to charged interest and rescheduled fees under the agreement.

13. LIABILITIES TO THE STAFF AND FOR SOCIAL INSURANCE

The liabilities to the staff and social insurance funds as at 31.12.2009 relate to current remuneration for December and are as follows:

	2009	2008
	BGN'000	BGN'000
Liabilities to staff	47	35
Liabilities for social insurance	10	3
Total liabilities to staff and for social insurance	57	38

14. TAX LIABILITIES

The tax liabilities as at 31.12.2008 are current ones and comprise:

	2009	2008
	BGN'000	BGN'000
Profit tax	253	69
Personal income tax	5	3
Total tax liabilities	258	72

No tax audits and checks of FLAG have been performed by 31.12.2009.

A tax audit is performed within five years after the expiring of the year for which a tax return on the respective liability has been filed. The audit gives a final confirmation of the tax liability of the entity – taxable person, except for the cases explicitly provided for otherwise by the law.

15. OTHER LIABILITIES

The other liabilities comprise as at 31.12.2009:

	2009	2008
	BGN'000	BGN'000
Liabilities under guarantees	-	15
Received deposit	-	3
Liabilities to suppliers	3	1
Total other liabilities	3	19

16. EQUITY

Authorized Capital

As at 31.12.2009 the authorized capital of Fund for Local Authorities and Governments in Bulgaria

– FLAG JSC stands at BGN 60,000 thousand, divided into 60 thousand shares BGN 1,000 (one thousand) each.

Reserve Fund

FLAG is obliged to create a *Reserve Fund*, in conformity with the requirements of the Commerce Act, art. 246, paragraph 2, item 1 in the amount of 10 per cent of the net annual income. As at 31.12.2009 the funds in the Reserve Fund amount to BGN 60 thousand.

Retained Earnings from Previous Years

As at 31.12.2009 the retained earnings were in the amount of BGN 3,093 thousand, comprising net income for 2009 of BGN 2,822 thousand and retained earnings for 2008 in the amount of BGN 271 thousand.

17. RELATED PERSONS AND TRANSACTIONS WITH RELATED PERSONS

Composition of related persons

Share holder – sole proprietor

The State, through the Ministry of Regional Development and Public Works is the single holder of the shares of FLAG.

Key management personnel

The key management personnel is presented in Note 1.2.

Transactions with related persons

No transactions with related persons were executed in 2007, 2008 and 2009.

Remuneration of the key management personnel

	2009	2008
	BGN'000	BGN'000
Costs on remuneration of the key management personnel	108	69
Total remuneration of key management personnel	108	69

Liabilities to key management personnel

2009 2008

	BGN'000	BGN'000
Salaries and other short-term incomes	34	23
Total liabilities to key management personnel	34	23

18. CONTINGENT LIABILITIES AND COMMITMENTS

As at 31.12.2009 FLAG has not absorbed BGN 16,393 thousand under the loan agreement with EBRD.

A second loan agreement of the Fund with EBRD was signed on 03.07.2009. The size of the loan to be extended by EBRD to FLAG has a limit of EURO 35,000 thousand (BGN 68,454 thousand), which amount will be disbursed in two portions:

3. Loan "a" will be in an amount that will not exceed EURO 30,000 thousand (BGN 58,675 thousand)
4. Loan "b" will be in an amount that will not exceed EURO 5,000 thousand (BGN 9,792 thousand)

The objective of the loan is to allow FLAG to lend to municipalities which have a definite level of credit bearing capacity, which however is not sufficient to allow the municipality to borrow on the market in Bulgaria.

The period of the loan is 12 years, with a two-years grace period. The agreed interest rate is based on the six-month EURIBOR plus a margin ranging from 2.25% to 2.75% depending on the presence of bad loans. Additionally fees are to be paid: (a) annual commitment fee; (b) one-off front - end fee; (c) annual administration fee.

The loan is secured with the future revenues and accounts receivable of the Fund from borrowers, as well as cash on bank accounts.

As at 31.12.2009 the unabsorbed portion of the loans extended by FLAG JSC to municipalities amount to BGN 2,400 thousand. The biggest non-disbursed amount is the one forming part of the loan extended to Gotse Delchev municipality – BGN 1,040 thousand, for a project for rehabilitation of 25 streets and green areas in the town of Gotse Delchev.

19. MANAGEMENT OF THE FINANCIAL RISK

In its activity the Fund is exposed to different types of risks. They are identified, measured and monitored by the management with the help of various controls, with a view to managing the risk and avoiding the concentration of unwarranted risk. The main risks that the Fund is exposed to are: credit, market and liquidity, as well as operational risks.

Risk management structure

The main responsibility for risk management in 2009 was borne by:

The Board of Directors – it defines the main policy directions and mechanisms for management of the assets and liabilities of the Fund and accordingly – the risk associated with them, which includes inter alia periodical reviews of the policies to identify possible need for changes and further policy development in response to changes occurring in the economic environment, in the activity and structure of the balance sheet of the Fund.

The Executive Director – he organizes and directs the process of development and implementation of internal rules, methodologies and procedures, relating to the on-going management and monitoring of each type of financial risk.

The structure of the Fund includes two directorates, the functions and responsibilities of which are directly related to the management of the different types of financial risks:

- *Finance and Risk Management Directorate* – its functions encompass: studying and analyzing the financial markets with a view to drafting proposals to the Executive Director for concluding contracts in this area; making projections and analyses of the need for resources for attainment of the specific objectives of the Fund; on-going management of the cash flows and liquidity of the Fund; developing policies and methodologies for management of the loan portfolio, and setting risk limits, as well as exercising on-going control on the implementation of the strategy and policies, adopted by the Board of Directors in this area; on-going control of the execution of the activities assigned to the Managing bank and the other banks partners.
- *Lending Directorate* – it receives project proposals for funding, makes evaluation on the basis of set limits, drafts proposals for the price parameters of the loans and prepares reasoned reports on requested funding, conducts market studies and analyses for the purposes of FLAG's lending activity, drafts methodologies and guidelines relating to the lending activity of the Fund and draws up plans and monitoring reports about the activity of the Managing bank in implementing the commitments made in connection with the project financing by the Fund.
- *Projects Directorate* – its functions cover all activities associated with the on-going monitoring, analyses and checks of the implementation of the projects financed by FLAG.
- *Internal auditor* – the functions of the auditor include control of the management procedures and their adequacy with a view of the character of the activity; evaluation of the processes of identifying, assessing and managing the risks, put in place in the Fund and audit of the procedures applied in the lending process and in the interrelations with the Managing bank.

In 2009 the administration of the lending process was assisted by UniCredit Bulbank, selected as a Managing bank through a competitive process conducted in 2008. Among the main responsibilities of the Bank was to assist the Fund in managing the financial risks. During the year the Bank has presented opinions on loan applications submitted by municipalities, drawn up by its Directorates Projects and Monitoring, Lending and Finance and Risk Management. The functions of the Bank include mainly:

- Interacting with FLAG in lending to municipalities in conformity with an approved procedure;
- Considering loan applications submitted by municipalities and assessing their credit bearing capacity relating to the risk inherent in the respective project proposal;
- Developing reasoned proposals to FLAG for approval of loan applications;
- Administering the process of repayment of the debt by borrowers;
- Assisting the process of monitoring the projects financed by FLAG.

October 2009 saw the development and adoption by the Board of Directors of a first draft of an internal procedure for measurement and management of the risk of the activity aimed at optimizing the return of the loan portfolio of FLAG by introducing a realistic risk surcharge. This policy is being further developed now by an external consultant of the European Bank for Reconstruction and Development.

Credit Risk

Credit risk is the risk that the clients/counterparties will not be in a position to repay the full amount due to the Fund within the agreed/foreseen time limit. As at the end of 2009 the outstanding amount of debt of the municipalities to FLAG was BGN 45,1 million .

The credit risk management was performed by Lending Directorate in 2009 while being also overseen by the Executive Director and the Board of Directors. The function for management of the credit risk is to ensure the implementation of an appropriate investment policy with respect to the financial resources and respectively – the conformity of this policy with the related procedures and controls for on-going monitoring of the respective loan, deposit or account receivable.

The credit risk exposure is managed by conducting on-going analyses of the capacity of the counterparties/servicing banks to observe their contractual obligations for payment of principal and interest, and also by setting appropriate credit limits. The cash deposits are placed only with first class banks with good reputation on the Bulgarian market. In addition, the possible concentration of receivables of a counterparty is monitored on an on-going basis and where such concentration is established – the respective counterparty is subjected to special on-going supervision.

The banks deposits of the Fund have been distributed among three first class banks as at 31.12.2009.

Market Risk

The market risk is the risk of possible negative fluctuations in the interest rates, exchange rates of different foreign currencies and of the market price of securities and other financial instruments.

Interest Risk

The interest risk is the possibility for a potential change in the net income from interest or net interest margin (the difference between the gross interest income and gross interest costs) and the market value of the equity due to changes in the overall market interest levels.

In 2009 the Fund was not exposed to significant interest risks due to the low values of the six-month EURIBOR, which is basic both for the servicing of the financial liabilities of the Fund and for its price policy. The interest risk was monitored on an on-going basis by the Executive Director with a view to ensuring measures in conformity with the market risk limits. The Executive Director also oversees on permanently the interest risk and develops measures to have it covered and maintained within acceptable limits.

The table below summarizes the interest structure and risk exposure of the Fund. It includes its financial assets and liabilities at balance sheet value in accordance with the interest clauses, laid down in the contracts, their maturity structure and sensitivity to any changes in the interest rates:

	With fixed interest %	With floating interest %	Interest-free	Total
As at 31 December 2009				
Financial assets				
Cash	66,489			66,489
Extended loans		48,508		48,508
	66,489	48,508		114,997
Financial liabilities				
Liabilities under EBRD loan		51,574		51,574
		51,574		51,574
As at 31 December 2008				
Financial assets				
Cash	30,620			30,620
Receivables from counterparties			3	3
	30,620		3	30,623
Financial liabilities				
Liabilities to counterparties			19	19
			19	19

Currency Risk

The currency risk is the risk of possible negative impact of the fluctuations in the prevailing exchange rates on the financial condition and cash flows of the Fund due to open foreign currency exposure. The Fund's policy is to have its financial assets and liabilities fully denominated in Euro and Bulgarian lev. Since the Bulgarian lev is fixed to the Euro, the operations of the Fund do not contain a foreign currency risk.

Liquidity risk

The liquidity risk is the risk that the Fund might not be in a position, to without suffering unacceptable loss, meet its current and potential liabilities, associated with payments that have become due and payable.

The matching and controlled mismatch of the maturity terms and interest rates of the financial assets and liabilities is the main issue pertaining to the liquidity management of the Fund. The mismatch in the maturity structure raises potentially the profitability, but it also increases the risk of incurring losses. The maturity terms of assets and liabilities, as well as the capability for replacement of the interest liabilities at the moment of their maturity at an acceptable price, are important factors when assessing the liquidity of the Fund and the impact of the changes in the interest rates. The control and overseeing of the overall liquidity in 2009 were performed by the Executive Director.

The table below presents an analysis of the gross undiscounted cash flows, associated with the financial assets and liabilities of the Fund, grouped by residual term to maturity:

	1-3 months	4-12 months	Over 1 year	Total
As at 31.12.2009				
Financial assets				
Cash and cash equivalents	66,489	-	-	66,489
Receivables and prepaid expenses	5	-	-	5
Extended loans	14,991	26,138	7,379	48,507
<i>Total financial assets</i>	81,485	26,138	7,379	115,002
Financial liabilities				
Liabilities under EBRD loan	-	-	52,615	52,615
<i>Total financial liabilities</i>	-	-	52,615	52,615
As at 31.12.2008				
Financial assets				
Cash and cash equivalents	30,727			30,727
Receivables from counterparties	-	-	3	3
<i>Total financial assets</i>	30,727	-	3	30,730
Financial liabilities				
Liabilities to counterparties		19		19
<i>Total financial liabilities</i>	-	19	-	19

Equity Management

The Fund's main objectives in equity management are aimed at maintaining its size at a level that is sufficient for the development of its activities and attainment of the goals underlying its establishment – supporting the efforts of the Bulgarian municipalities in preparing and successfully implementing projects co-financed from the programmes of the European Union for upgrading and extending the municipal infrastructure and creating sustainable economic and social structures.

Fair Value of the Financial Assets and Liabilities

The fair value most generally defined is the amount for which an asset can be exchanged or a liability can be paid when a normal transaction is executed between independent and informed counterparties.

The Fund's policy is to disclose in its financial statements the fair value of its assets and liabilities for which market prices are quoted. The fair value concept presumes realizing the financial instruments through sale. In most cases however the Fund expects to realize its assets through their full repayment (clearing off) in the course of time. The financial assets and liabilities owned by the Fund as at the date of the balance sheet are short-term ones, negotiated at market interest rates and valued at depreciable value. The management therefore is of the opinion that their fair value is approximately equal to their balance sheet value. It is also of the opinion that the valuations of the financial assets and liabilities presented in the balance sheet reflect the existing circumstances and are as reliable, adequate and truthful for the purposes of financial reporting as possible.

20. EVENTS THAT HAVE OCCURRED AFTER THE DATE OF THE BALANCE SHEET

No significant events that could change the financial statements as at 31.12.2009 have occurred in the period between the reporting date and the date of this report.

21. APPROVAL OF THE FINANCIAL STATEMENTS

The financial statements were approved by the Management of the Company and signed on its behalf

by:

Emil Savov

Executive Director



TO
THE SHAREHOLDERS
OF Fund for Local Authorities and Governments in Bulgaria EAD
SOFIA

INDEPENDENT AUDITOR'S REPORT

We have audited the accompanying financial statements of Fund for Local Authorities and Governments in Bulgaria EAD, which comprise the balance sheet as at December 31, 2009, and the statement of comprehensive income, 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. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the International Standards on Auditing. These 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 opinion.

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of Fund for Local Authorities and Governments in Bulgaria EAD as of December 31, 2009, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Report on other Legal and Regulatory Requirements

We conducted verification of the Annual Management Report with regard to the correspondence between the annual management report and the annual financial statements for the same reporting period in accordance with the requirements of the Accountancy Act.

In our opinion, as a result of this verification the Annual Management Report corresponds to the annual financial statements as of December 31, 2009 with regard to the financial information.

Sofia, 24.03.2010

BDO Bulgaria Ltd.


Stoyanka Apostolova, Partner
CPA, Registered Auditor

