“AZERSU” Open Joint Stock Company

Preliminary Consolidated Financial Statements with Independent Auditors’ Report

For the year ended 31 December 2012

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Special Purpose Independent Auditors' Report on the Preliminary Consolidated IFRS Financial Statements at 31 December 2012 to Management of "Azersu" OJSC

Building a better working world

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Special Purpose Independent Auditors' Report on the Preliminary Consolidated IFRS Financial Statements at 31 December 2012 to Management of "Azersu" OJSC

We have audited the accompanying preliminary consolidated financial statements of "Azersu" OJSC and its subsidiaries (the "Group"), which comprise the preliminary consolidated statement of financial position as at 31 December 2012, and the preliminary consolidated statement of comprehensive income, preliminary consolidated statement of changes in equity and preliminary consolidated statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information (the "preliminary consolidated financial statements"). These preliminary consolidated financial statements have been prepared as part of the Group's conversion to International Financial Reporting Standards ("IFRS").

Management's Responsibility for the Preliminary Consolidated Financial Statements

Management is responsible for the preparation of the preliminary consolidated financial statements in accordance with the basis set out in Note 2, and for such internal control relevant to the preparation of the preliminary consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the preliminary consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the preliminary consolidated financial statement, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the preliminary consolidated financial statement 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, if any, made by management, as well as evaluating the overall presentation of the preliminary consolidated financial statements.

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

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Basis for Qualified Opinion

(i) We were appointed as auditors of the Group on 18 January 2013 and thus did not observe the counting of the physical inventories at the beginning and ending of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at 1 January 2012 and 31 December 2012. Since opening and closing inventories enter into the determination of the financial performance and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the preliminary statement of comprehensive income and the net cash flows from operating activities reported in the preliminary consolidated statement of cash flows.

(ii) We were not provided with full extract of data representing balances and movements by customers of the Group from the billing system. We were unable to confirm the existence of fully provided trade receivables in the amount of AZN 24,586,897 and AZN 28,658,055 as of 1 January 2012 and 31 December 2012, respectively, and respective allowance as of each reporting date. Also we were unable to determine whether adjustments might have been necessary in respect of sales revenue for the year ended 31 December 2012 in the amount of AZN 24,586,897 and bad debt expense included in cost of sales in the amount of AZN 4,071,158.

Qualified Opinion

In our opinion, except for the possible effects of the matters described in the Basis for qualified opinion (i) and (ii) paragraphs, the preliminary consolidated financial statements as at 31 December 2012 and for the year then ended are prepared, in all material respects, in accordance with the basis set out in Note 2, which describes how IFRS have been applied under IFRS 1, including the assumptions management has made about the standards and interpretations expected to be effective, and the policies expected to be adopted, when management prepares its first complete set of IFRS consolidated financial statements as at 31 December 2013.

Emphasis of Matter

Without qualifying our opinion, we draw attention to Note 2 in the preliminary consolidated financial statements which indicates that the Group incurred a net loss of AZN 488,656,969 during the year ended 31 December 2012 and, as of that date, the Group's current liabilities exceeded its current assets by AZN 323,324,273. These conditions, along with other matters as set forth in Note 2, indicate the existence of a material uncertainty that may cast significant doubt on the Group's ability to continue as a going concern.

Basis of Accounting and Restriction on Use

Without further modifying our opinion, we draw attention to Note 2 to the preliminary consolidated financial statements, which explains why there is a possibility that the preliminary consolidated financial statements may require adjustment before constituting the final IFRS consolidated financial statements. Moreover, we draw attention to the fact that, under IFRS only a complete set of financial statements with comparative financial information and explanatory notes can provide a fair presentation of the Group's consolidated financial position, results of operations and cash flows in accordance with IFRS.

This report is intended solely for the information and use of management of the Group in connection with its conversion of the basis of the preparation of the consolidated financial statements to IFRS. It should not be used for any other purpose or provided to other parties.

Ernst & Young Holdings (CIS) B.V.

15 August 2013

"AZERSU" OJSC

PRELIMINARY CONSOLIDATED STATEMENT OF FINANCIAL POSITION

(Amounts presented are in Azerbaijani Manats)

	Notes	31 December 2012	1 January 2012
Assets			
Non-current assets			
Property, plant and equipment	6	544,197,132	235,029,795
Intangible assets		46,125	–
Prepayments	8	105,798,322	99,185,755
Deferred tax assets	22	713,911	253,857
Total non-current assets		**650,755,490**	**334,469,407**
Current assets			
Inventories	9	5,519,739	5,363,542
Taxes receivable	7	23,729,172	10,712,294
Trade and other receivables	10	22,312,237	29,197,021
Prepayments	8	2,214,647	1,045,044
Restricted cash	11	10,528,521	22,116,036
Cash and cash equivalents	11	6,991,871	3,821,820
Total current assets		**71,296,187**	**72,255,757**
Total assets		**722,051,677**	**406,725,164**
Equity and liabilities			
Equity			
Share capital	12	(400,000,000)	(400,000,000)
Subscription receivable	12	76,642,776	100,212,511
Government investments	13	(2,289,967,787)	(1,707,130,994)
Accumulated loss		2,396,407,146	1,907,750,177
Total equity		**(216,917,865)**	**(99,168,306)**
Liabilities			
Non-current liabilities			
Interest-bearing loans and borrowings	14	(103,434,325)	(97,321,901)
Deferred revenue		(31,842)	–
Provisions	15	(7,047,185)	(5,610,893)
Total non-current liabilities		**(110,513,352)**	**(102,932,794)**
Current liabilities			
Interest-bearing loans and borrowings	14	(147,407,443)	(9,458,848)
Income tax payable		(3,932,949)	(3,788,397)
Other taxes and penalties payable	16	(41,234,159)	(41,075,519)
Trade and other payables	17	(202,024,178)	(149,455,367)
Advances received		–	(670,230)
Provisions	15	(21,731)	(175,703)
Total current liabilities		**(394,620,460)**	**(204,624,064)**
Total liabilities		**(505,133,812)**	**(307,556,858)**
Total equity and liabilities		**(722,051,677)**	**(406,725,164)**

Signed and authorized for release on behalf of the Group on 15 August 2013.

AZƏRBAYCAN RESPUBLİKASI "AZƏRSU" AÇIQ SƏHMDAR CƏMİYYƏTİ

Mr. Gorkhmaz Huseynov
Chairman

Mr. Mahir Mammadov
Deputy Chairman on Economic Matters

The accompanying notes form an integral part of these preliminary consolidated financial statements.

"AZERSU" OJSC

PRELIMINARY CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(Amounts presented are in Azerbaijani Manats)

	Notes	Year ended 31 December 2012
Sales revenue	20	122,896,791
Cost of sales	21	(105,753,543)
Gross profit		**17,143,248**
Administrative expenses	21	(31,652,611)
Selling and distribution expenses	21	(91,854,266)
Other operating expenses	21	(381,701,594)
Operating loss		**(505,208,471)**
Finance cost		(309,009)
Loss before tax		**(488,374,232)**
Income tax expense	22	(282,737)
Loss for the year		**(488,656,969)**

The accompanying notes form an integral part of these preliminary consolidated financial statements.

"AZERSU" OJSC

PRELIMINARY CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

(Amounts presented are in Azerbaijani Manats)

	Notes	Share capital	Subscription receivable	Government investments	Accumulated loss	Total equity
As at 1 January 2012		**400,000,000**	**(100,212,511)**	**1,707,130,994**	**(1,907,750,177)**	**99,168,306**
Settlement of subscription receivable	12	–	23,569,735	–	–	**23,569,735**
Net increase in Government investments	13	–	–	582,836,793	–	**582,836,793**
Loss for the year		–	–	–	(488,656,969)	**(488,656,969)**
As at 31 December 2012		**400,000,000**	**(76,642,776)**	**2,289,967,787**	**(2,396,407,146)**	**216,917,865**

The accompanying notes form an integral part of these preliminary consolidated financial statements.

"AZERSU" OJSC

PRELIMINARY CONSOLIDATED STATEMENT OF CASH FLOWS

(Amounts presented are in Azerbaijani Manats)

	Notes	Year ended 31 December 2012
Operating activities		
Loss before tax		(488,374,232)
Non-cash adjustments to reconcile loss before tax to net cash flows		
Depreciation of property, plant and equipment	21	47,070,911
Impairment of trade and other receivables	10	17,044,950
Change in provision	15	1,279,850
Finance cost		309,009
Impairment of property, plant and equipment	21	381,071,773
Loss on disposal of property, plant and equipment		2,453,243
Other expenses		629,821
		(38,514,675)
Working capital adjustments		
Inventories		(7,758,810)
Taxes receivable		(13,309,866)
Trade and other receivables		(13,601,393)
Deferred revenue		(637,987)
Trade and other payables		97,804,714
		23,981,983
Interest paid		(510,330)
Income tax paid		(146,610)
Net cash flows from operating activities		**23,325,043**
Investing activities		
Purchase of property, plant and equipment		(26,908,144)
Purchase of intangible assets		(46,125)
Proceeds from disposal of property, plant and equipment		(1,243,762)
Net cash flows used in investing activities		**(28,198,031)**
Financing activities		
Proceeds from borrowings		8,793,039
Repayment of borrowings		(750,000)
Net cash flows from financing activities		**8,043,039**
Net increase in cash and cash equivalents		**3,170,051**
Cash and cash equivalents at the beginning of the year	11	**3,821,820**
Cash and cash equivalents at the end of the year	11	**6,991,871**

The accompanying notes form an integral part of these preliminary consolidated financial statements.

1. The Group's principal activity

"Azersu" Open Joint Stock Company ("Azersu" OJSC) and its subsidiaries (the "Group") was established by the Presidential Decree on 11 June 2004 in accordance with Azerbaijani legislation and is domiciled in the Republic of Azerbaijan. The Group is 100 % owned by the government of the Republic of Azerbaijan (the "Government") and is a natural monopoly in charge of the implementation of the Government policy and strategy in the field of water supply, drinking water supply and sanitation services in the Republic of Azerbaijan. The Group's main functions pertain to extraction of water from sources followed by treatment as filtering and stabilization of water specification to make available to consumers' use, distribution and sale within the Republic of Azerbaijan.

The registered address of the Group is 67 Moscow Avenue, AZ1012, Baku, the Republic of Azerbaijan.

2. Basis of preparation and significant accounting policies

Basis of preparation

These preliminary consolidated financial statements have been prepared as part of the Group`s conversion to International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). The preliminary consolidated financial statements for the year ended 31 December 2012 will be used by the Group in preparation of its first complete set of consolidated IFRS financial statements for the year ending 31 December 2013.

For all periods up to and including the year ended 31 December 2011, the Group prepared its financial statements in accordance with Azerbaijani accounting legislation and related instructions ("AAL"). These preliminary consolidated financial statements for the year ended 31 December 2012 are the first the Group has prepared using IFRS in accordance with the guidance prescribed by IFRS 1 *First-Time Adoption of International Financial Reporting Standards*. In accordance with this guidance, the Company prepared an opening balance sheet at the date of transition to IFRS (1 January 2012) based on the Group`s books and records maintained in accordance with AAL as described below, and as adjusted and reclassified in order to comply with IFRSs, using assumptions about the standards and interpretations expected to be effective, and the policies expected to be adopted, when management prepares its first complete set of consolidated financial statements as at 31 December 2013. In accordance with IFRS 1, these accounting policies shall comply with each IFRS effective at the reporting date of the Group's first consolidated financial statements (31 December 2013), with certain exceptions and exemptions as specified by IFRS 1.

As the standards and interpretations expected to be effective as at 31 December 2013 are subject to introduction or possible changes by the IASB or the International Financial Reporting Interpretations Committee ("IFRIC"), management does not rule out a possibility that the preliminary consolidated financial statements may require adjustment due to such changes before constituting the final consolidated financial statements.

Management draws attention to the fact that these preliminary consolidated financial statements do not constitute a complete set of financial statements in accordance with IFRS, as they do not contain certain comparative financial information and accordingly they do not provide a fair presentation of the Group's consolidated financial position, results of operations and cash flows in accordance with IFRS, which can be achieved only by a complete set of financial statements with comparative financial information.

The preliminary consolidated financial statements have been prepared on a historical cost basis except for certain exemptions applied as part of transition to IFRS as detailed in Note 5.

2. Basis of preparation and significant accounting policies (continued)

Basis of preparation (continued)

Going concern

The going concern basis assumes that the Group will continue its operations for the foreseeable future and will be able to realize its assets and discharge its liabilities and commitments in the normal course of business. The Group's current liabilities exceeded its current assets by AZN 323,324,273 and AZN 132,368,307 as at 31 December 2012 and 1 January 2012, respectively, caused by significant current investments in the infrastructure projects. The Group incurred a net loss of AZN 488,656,969 during the year ended 31 December 2012. The Group is part of the Government monopoly for supply of water and sewerage services and the Government keeps on investing to sustain the operations of the Group along with current investment projects.

The Group is actively involved in investing activities of construction of new water pipelines and sewerage systems in the Republic of Azerbaijan and receives subsidies from the Government on a regular basis. Historically the Group has had operating losses, negative cash flows from operations, and working capital deficit. Management has developed a Master-Plan related to construction of new infrastructure projects as well as repair of existing facilities for future generation of cash inflows, which will enable the Group to increase its subscribers, collection of receivables and reduce sales losses. Eventually this will lead to enhance the Group's financial position upon completion of the capital projects which are currently under construction. The Group continues to remain dependent on its ability to obtain sufficient funding from the Government to sustain operations and complete its current investment projects that give rise to a material uncertainty which may cast significant doubt about the Group's ability to continue as a going concern. However, management believes that appropriate measures are being taken for the Group to continue its operational existence in the foreseeable future. Accordingly, the Group continues to adopt going concern basis in preparing its preliminary consolidated financial statements.

Basis of consolidation

The preliminary consolidated financial statements of the Group comprise the financial statements of "Azersu" OJSC and its subsidiaries as at 31 December 2012. Subsidiaries are all entities (including special-purpose entities) over which the Group has control, being the power to govern the financial and operating policies so as to obtain benefits from its activities, generally accompanying a shareholding of more than one half of the voting rights.

Subsidiaries are consolidated from the date of acquisition, being the date on which the Group obtains control, and continue to be consolidated until the date when such control ceases. The financial statements of the subsidiaries are prepared for the same reporting period as the parent company, using consistent accounting policies. All intra-group balances, transactions, unrealised gains and losses resulting from intra-group transactions and dividends are eliminated in full.

Foreign currency translation

All amounts in these preliminary consolidated financial statements are presented in Azerbaijani Manats ("AZN"), unless otherwise stated.

The functional currency of "Azersu OJSC" and its subsidiaries is AZN as the majority of the Group`s revenues, costs, inventory purchased, and trade liabilities are either priced, incurred, payable or otherwise measured in AZN.

2. Basis of preparation and significant accounting policies (continued)

Foreign currency translation (continued)

The transactions executed in foreign currencies are initially recorded in AZN by applying the appropriate rates of exchanges prevailing at the date of transaction.

Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency spot rate of exchange ruling at the reporting date.

Foreign exchange gains and losses resulting from the re-measurement of monetary assets into into the functional currency are recognized in profit or loss.

Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value is determined. The gain or loss arising on translation of non-monetary items measured at fair value is treated in line with the recognition of gain or loss on change in fair value in the item (i.e., the translation differences on items whose fair value gain or loss is recognized in other comprehensive income ("OCI") or profit or loss are also recognized in OCI or profit or loss, respectively).

AZN is not a fully convertible currency outside the territory of the Republic of Azerbaijan. Within the Republic of Azerbaijan, official exchange rates are determined daily by the Central Bank of the Republic of Azerbaijan ("Central Bank"). Market rates may differ from the official rates, but the differences are, generally, within narrow parameters monitored by the Central Bank. Transactions denominated in foreign currencies are recorded at the official exchange rate on the date of the transaction.

The official rates of exchange used for translating foreign currency balances were as follow:

	15 August 2013	31 December 2012	1 January 2012
1 USD / 1 AZN	0.7845	0.7850	0.7865
1 EUR / 1 AZN	1.0426	1.0377	1.0178
1 RUR / 1 AZN	0.0237	0.0258	0.0245

Financial instruments – key measurement terms.

Depending on their classification financial instruments are carried at fair value, or amortized cost as described below.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Fair value is a current bid price for financial assets and current asking price for financial liabilities which are quoted in an active market. A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange or other institution and those prices represent actual and regularly occurring market transaction on an arm's length basis.

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition and includes transaction costs.

2. Basis of preparation and significant accounting policies (continued)

Financial instruments – key measurement terms (continued)

Amortized cost is the amount at which the financial instrument was recognized at initial recognition less any principal repayments, plus accrued interest, and for financial assets less any write-down for incurred impairment loss. Accrued interest includes amortization of transaction costs deferred at initial recognition and of any premium or discount to maturity amount using the effective interest rate method. Accrued interest income and accrued interest expense are not presented separately and are included in the carrying values of related statement of financial position items.

The effective interest rate method is a method of allocating interest income or interest expense over the relevant period so as to achieve a constant periodic rate of interest (effective interest rate) on the carrying amount. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts (excluding future credit losses) through the expected life of the financial instrument or a shorter period, if appropriate, to the net carrying amount of the financial instrument.

Financial assets

Initial recognition and measurement

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

The Group has not designated any financial assets upon initial recognition at fair value through profit or loss, held-to-maturity investments, available-for-sale financial assets, or as derivatives.

Subsequent measurement

The subsequent measurement of financial assets depends on their classification:

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. After initial measurement, such financial assets are subsequently measured at amortized cost using the effective interest rate method, less impairment. Amortized cost is calculated by taking into account any discount or premium on acquisition and fee or costs that are an integral part of the effective interest rate method. The effective interest rate method amortization is included in finance income in the statement of comprehensive income. The losses arising from impairment are recognized in the statement of comprehensive income in finance cost for loans and in cost of sales or other operating expenses for receivables.

2. Basis of preparation and significant accounting policies (continued)

Financial assets (continued)

Derecognition

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

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

When the Group has transferred its rights to receive cash flows from an asset or has entered into a pass-through arrangement, it evaluates if and to what extent it has retained the risks and rewards of ownership. When it has neither transferred nor retained substantially all of the risks and rewards of the asset, nor transferred control of the asset, the asset is recognized to the extent of the Group`s continuing involvement in the asset. In that case, the Group also recognizes an associated liability. The transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the Group has retained.

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

Impairment of financial assets

The Group assesses at each reporting date whether there is any objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that have occurred after the initial recognition of the asset (an incurred "loss event") and that loss event has an impact on the estimated future cash flows of the financial asset or the group of financial assets that can be reliably estimated. Evidence of impairment may include indications that the debtors or a group of debtors is experiencing significant financial difficulty, default or delinquency in interest or principal payments, the probability that they will enter bankruptcy or other financial reorganization and where observable data indicate that there is a measurable decrease in the estimated future cash flows, such as changes in arrears or economic conditions that correlate with defaults.

Financial assets carried at amortized cost

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

2. Basis of preparation and significant accounting policies (continued)

Financial assets (continued)

Impairment of financial assets (continued)

Financial assets carried at amortized cost (continued)

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

The carrying amount of the asset is reduced through the use of an allowance account and the loss is recognized in profit or loss. If, in a subsequent year, the amount of the estimated impairment loss increases or decreases because of an event occurring after the impairment was recognized, the previously recognized impairment loss is increased or reduced by adjusting the allowance account. If a write-off is later recovered, the recovery is credited to finance costs in the statement of comprehensive income.

Financial liabilities

Initial recognition and measurement

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

All financial liabilities are recognized initially at fair value and, in the case of loans and borrowings, carried at amortized cost. This includes directly attributable transaction costs.

The Group's financial liabilities include trade and other payables and loans and borrowings.

The Group has not designated any financial liabilities upon initial recognition as financial liabilities at fair value through profit or loss, or as derivatives designated as hedging instruments in an effective hedge.

Subsequent measurement

The measurement of financial liabilities depends on their classification as follows:

Loans and borrowings

After initial recognition, interest bearing loans and borrowings are subsequently measured at amortized cost using the effective interest rate method. Gains and losses are recognized in the statement of comprehensive income when the liabilities are derecognized as well as through the effective interest rate method amortization process.

Amortized cost is calculated by taking into account any discount or premium on acquisition and fee or costs that are an integral part of the effective interest rate method. The effective interest rate method amortization is included in finance cost in the statement of comprehensive income.

2. Basis of preparation and significant accounting policies (continued)

Financial liabilities (continued)

Derecognition

A financial liability is derecognized when the obligation under the liability is discharged or cancelled or expires. When an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability. The difference in the respective carrying amounts is recognized in the statement of comprehensive income.

Offsetting of financial instruments

Financial assets and financial liabilities are offset with the net amount reported in the preliminary consolidated statement of financial position only if there is a current enforceable legal right to offset the recognized amounts and intent to settle on a net basis, or to realize the assets and settle the liabilities simultaneously.

Cash and cash equivalents

Cash and cash equivalents include cash in hand, deposits held at call with banks, and other short-term highly liquid investments with original maturities of three months or less.

Property, plant and equipment

The Group elected to measure property, plant and equipment at the date of transition to IFRS (1 January 2012) at their fair value and use that fair value as their deemed cost at that date. Fair value was determined by reference to market-based evidence and by using the income approach. Subsequent to transition to IFRS, property, plant and equipment are stated at cost as described below, less accumulated depreciation and provision for impairment, where required.

The initial cost of an asset purchased after 1 January 2012 comprises its purchase price or construction cost, any cost directly attributable to bringing the asset into operation, the initial estimate of decommissioning obligation, if any, and for qualifying assets, borrowing costs. The assets held under finance lease are also included within property, plant and equipment.

Development of tangible assets

Expenditure on the construction, installation or completion of infrastructure facilities such as pipelines and transmission facilities is capitalized within tangible assets according to nature.

All minor repair and maintenance costs are expensed as incurred. Cost of replacing major parts components of property, plant and equipment items are capitalized and replaced part is retired.

At each reporting date management assesses whether there is any indication of impairment of property, plant and equipment. If any such indication exists, management estimates the recoverable amount, which is determined as the higher of an asset's or cash generating unit's fair value less costs to sell and its value in use. The carrying amount reduced to the recoverable amount and the impairment loss, if any, is recognized in the consolidated statement of comprehensive income. An impairment loss recognized for an asset or cash generating unit in prior years is reversed if there are indicators that impairment loss may no longer exist or may have decreased.

Gains and losses on disposals are determined by comparing proceeds with the carrying amount and are recognized in profit or loss.

2. Basis of preparation and significant accounting policies (continued)

Depreciation

Buildings, facilities, transmission devices are depreciated using straight-line method over the estimated useful lives. Machinery and equipment and vehicles are depreciated using reducing balance method. The reducing balance method of depreciation is calculated by applying the defined depreciation formula based on cost, residual value and useful life of an asset.

The estimated useful lives of the Group's property, plant and equipment are as follows:

Buildings and constructions	20 to 60 years
Facilities and transmission devices	3 to 40 years
Machinery and equipment	3 to 15 years
Vehicles	3 to 10 years
Office equipments	3 to 8 years

Land and assets under construction are not depreciated.

The expected useful lives of property, plant and equipment are reviewed on an annual basis and, if necessary, changes in useful lives are accounted for prospectively.

The residual value of an asset is the estimated amount that the Group would currently obtained from disposal of the asset less the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. The residual value of an asset is nil if the Group expects to use the asset until the end of its physical life unless scrap value is significant. The assets' residual values are reviewed, and adjusted if appropriate, at each statement of financial position date.

Inventories

Inventories are stated at the lower of cost and net realizable value. Cost is assigned by the FIFO method. Cost comprises direct purchase costs, cost of production, transportation and manufacturing expenses (based on normal operating capacity).

Operating lease

Where the Group is a lessee in a lease which does not transfer substantially all the risks and rewards incidental to ownership from the lesser to the Group, the total lease payments are charged to profit or loss on a straight-line basis over the lease term. The lease term is the non-cancellable period for which the lessee has contracted to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

When assets are leased out under an operating lease, the lease payments receivables are recognized as rental income on a straight-line basis over the lease term.

Borrowing costs

Borrowing costs directly attributable to the acquisition, construction or production of an asset that necessarily takes a substantial period of time to get ready for its intended use or sale are capitalized as part of the cost of the respective asset. All other borrowing costs are expensed in the period in which they occur. Borrowing costs consist of interest and other costs that an entity incurs in connection with the borrowing of funds.

Borrowing costs incurred on or after the date of transition (1 January 2012) for all eligible qualifying assets are capitalized.

2. Basis of preparation and significant accounting policies (continued)

Intangible assets

Intangible assets are stated at cost, less accumulated amortization and accumulated impairment losses. Intangible assets include rights, licenses and computer software.

The useful lives of intangible assets are assessed as either finite or indefinite. Intangible assets with finite lives are amortized over the useful economic life and assessed for impairment whenever there is an indication that the intangible asset may be impaired. The amortization period and the amortization method for an intangible asset with a finite useful life is reviewed at least at the end of each reporting period. Changes in the expected useful life or the expected pattern of consumption of future economic benefits embodied in the asset is accounted for by changing the amortization period or method, as appropriate, and are treated as changes in accounting estimates. The amortization expense on intangible assets with finite lives is recognized in the statement of comprehensive income in the expense category consistent with the function of the intangible assets.

Intangible assets with indefinite useful lives are not amortized, but are tested for impairment annually, either individually or at the cash-generating unit level. The assessment of indefinite life is reviewed annually to determine whether the indefinite life continues to be supportable. If not, the change in useful life from indefinite to finite is made on a prospective basis.

Impairment of non-financial assets

The Group assesses at each reporting date whether there is an indication that an asset may be impaired. If any indication exists, or when annual impairment testing for an asset is required, the Group estimates the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash-generating unit's ("CGU") fair value less costs to sell and its value in use. It is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. Where the carrying amount of an asset or CGU exceeds its recoverable amount, the asset is considered impaired and is written down to its recoverable amount. 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 assessments of the time value of money and the risks specific to the asset. In determining fair value less costs to sell, recent market transactions are taken into account, if available. If no such transactions can be identified, an appropriate valuation model is used. These calculations are corroborated by valuation multiples, quoted share prices for publicly traded subsidiaries or other available fair value indicators.

The Group bases its impairment calculation on detailed budgets and forecasts which are prepared separately for each of the Group's CGU to which the individual assets are allocated. These budgets and forecast calculations are generally covering a period of five years. For longer periods, a long-term growth rate is calculated and applied to project future cash flows after the fifth year.

Impairment losses of continuing operations, including impairment on inventories, are recognized in the income statement in those expense categories consistent with the function of the impaired asset, except for a property previously revalued where the revaluation was taken to other comprehensive income. In this case, the impairment is also recognized in other comprehensive income up to the amount of any previous revaluation.

2. Basis of preparation and significant accounting policies (continued)

Impairment of non-financial assets (continued)

For assets excluding goodwill, an assessment is made at each reporting date as to whether there is any indication that previously recognized impairment losses may no longer exist or may have decreased. If such indication exists, the Group estimates the asset's or CGU's recoverable amount. A previously recognized impairment loss is reversed only if there has been a change in the assumptions used to determine the asset's recoverable amount since the last impairment loss was recognized. The reversal is limited so that the carrying amount of the asset does not exceed its recoverable amount, nor exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognized for the asset in prior years. Such reversal is recognized in the income statement unless the asset is carried at a revalued amount, in which case the reversal is treated as a revaluation increase.

Corporate income taxes

Corporate income taxes have been provided for in the preliminary consolidated financial statements in accordance with the applicable legislation enacted by the reporting date. The income tax charge comprises current tax and deferred tax and is reflected in statement of comprehensive income.

Current tax is the amount expected to be paid to or recovered from the taxation authorities in respect of taxable profits or losses for the current and prior periods. Taxes, other than on income, are recorded within operating expenses.

Deferred income tax is provided in full, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantially enacted by the reporting date and are expected to apply when the related deferred income tax asset is realized or the deferred income tax liability is settled.

Deferred income tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities and when the deferred income taxes assets and liabilities relate to income taxes levied by the same taxation authority on either the same taxable entity or different taxable entities where there is an intention to settle the balances on a net basis.

Deferred income tax assets are recognized to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized.

Value-added tax

The tax authorities permit the settlement of sales and purchases value-added tax ("VAT") on a net basis.

VAT payable represents VAT related to sales that is payable to the tax authorities upon recognition of sales to customers, net of VAT on purchases which have been settled at the statement of financial position date. VAT related to sales which have not been settled at the statement of financial position date (VAT deferral) is also included in VAT payable. Where provision has been made for impairment of receivables, impairment loss is recorded for the gross amount of the debtor, including VAT where applicable. The related VAT deferred liability is maintained until the debtor is written off for tax purposes.

VAT recoverable relates to purchases which have not been settled at the statement of financial position date. VAT recoverable is reclaimable against VAT on sales upon payment for the purchases.

2. Basis of preparation and significant accounting policies (continued)

Provisions for liabilities and charges

Provisions for liabilities and charges are liabilities of uncertain timing or amount. They are accrued when the Group has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made. Provisions are not recognized for future operating losses.

Where there are a number of similar obligations, the likelihood that an outflow will be required in settlement is determined by considering the class of obligations as a whole. A provision is recognized even if the likelihood of an outflow with respect to any one item included in the same class of obligations may be small.

Provisions are measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation. The increase in the provision due to passage of time is recognized as interest expense.

Contributions by the Government

Contributions by the Government are made in the form of cash contributions, transfer of other state-owned entities or transfer of all or part of the Government's share in other entities. Transfer of the state-owned entities to the Group is recognized as contribution through equity statement in the amount being the fair value of the transferred entity (in case of transfer by the Government of its share in other entities – the transferred share in the fair value of the respective entity).

Government loans

The difference between fair value and carrying amount of interest free or below market rate loans provided by the Government are treated as Government grants. The grants are recognized at their fair value where there is a reasonable assurance that the grant will be received and the Group will comply with all attached conditions. Government grants relating to the purchase of property, plant and equipment are included in non-current liabilities as deferred income and are credited to profit or loss on a straight line basis over the expected lives of the related assets.

Government grants relating to income are deferred and recognized in profit or loss over the period necessary to match with the costs that they are intended to compensate.

Revenue recognition

Revenue comprises the fair value of consideration received or receivable for the sale of goods and services in the ordinary course of the Group's activities. Revenue is shown net of VAT, returns, discounts, and other sales-based taxes, if any, after eliminating sales within the Group.

Revenue from sales of water and sewerage services are recorded on the basis of regular water meter readings (monitored on a monthly basis) and estimates of customer usage from the last meter reading to the end of the reporting period. Water prices and waste water treatment tariffs to the final consumers in the Republic of Azerbaijan are regulated by the Tariff Council of the Republic of Azerbaijan.

2. Basis of preparation and significant accounting policies (continued)

Revenue recognition (continued)

Sales of services are recognized in the accounting period in which the services are rendered, by reference to stage of completion of the specific transaction assessed on the basis of the actual service provided as a proportion of the total services to be provided.

Expenses

Expenses are presented by function in the preliminary consolidated statement of comprehensive income. Categorization of the nature of expenses is based on operational functions of the Group's departments and subsidiaries.

Employee benefits

Wages, salaries, contributions to the Social Protection Fund of the Republic of Azerbaijan, paid annual leave and sick leave, bonuses, and non-monetary benefits (e.g. health services and kindergarten services) are accrued in the year in which the associated services are rendered by the employees of the Group.

Related parties

Related parties are disclosed in accordance with IAS 24, *Related Party Disclosures.*

Governmental economic and social policies affect the Group's financial position, results of operations and cash flows. The Government imposed an obligation on the Group to provide an uninterrupted supply of water to customers in the Republic of Azerbaijan at government controlled prices. Transactions with the state include taxes which are detailed in Note 22.

Related parties may enter into transactions which unrelated parties might not, and transactions between related parties may not be effected on the same terms, conditions and amounts as transactions between unrelated parties.It is the nature of transactions with related parties that they cannot be presumed to be carried out on an arms length basis.

3. Standards issued but not yet effective

The Standards and interpretations that are issued but not yet effective up to the date of issuance of the Group`s financial statements are disclosed below. The Group intends to adopt these standards, if applicable, when they become effective.

Amendments to IAS 32, Offsetting Financial Assets and Financial Liabilities (issued in December 2011 and effective for annual periods beginning on or after 1 January 2014). These amendments clarify the meaning of "currently has a legally enforceable right to set-off". The amendments also clarify the application of the IAS 32 offsetting criteria to settlement systems (such as central clearing house systems) which apply gross settlement mechanisms that are not simultaneous. These amendments are not expected to impact the Group's financial position or performance.

3. Standards issued but not yet effective (continued)

IFRS 9 Financial Instruments: Classification and Measurement (issued in December 2011 and effective for annual periods beginning on or after 1 January 2015). IFRS 9, as issued, reflects the first phase of the IASB's work on the replacement of IAS 39 and applies to classification and measurement of financial assets and financial liabilities as defined in IAS 39. The standard was initially effective for annual periods beginning on or after 1 January 2013, but Amendments to IFRS 9 *Mandatory Effective Date of IFRS 9 and Transition Disclosures*, issued in December 2011, moved the mandatory effective date to 1 January 2015. In subsequent phases, the IASB will address hedge accounting and impairment of financial assets. The adoption of the first phase of IFRS 9 will have an effect on the classification and measurement of the Group's financial assets, but will not have an impact on classification and measurements of financial liabilities. The Group will quantify the effect in conjunction with the other phases, when the final standard including all phases is issued.

4. Critical accounting estimates and judgments

The preparation of the Group's preliminary consolidated financial statements requires management to make judgments, estimates and assumptions that affect the reported amounts of revenues, expenses, assets and liabilities, and the accompanying disclosures, and the disclosure of contingent liabilities. Uncertainty about these assumption and estimates could result in outcomes that require a material adjustment to the carrying amount of the asset or liability affected in future periods.

Estimates and judgments are continually evaluated and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. The Group based its assumptions and estimates on parameters available when the preliminary consolidated financial statements were prepared. Existing circumstances and assumptions about future developments, however, may change due to market changes or circumstances arising beyond the control of the Group. Such changes are reflected in the assumptions when they occur. Management also makes certain judgments, apart from those involving estimations, in the process of applying the accounting policies.

Judgments that have the most significant effect on the amounts recognized in this consolidated financial statements and estimates that can cause a material adjustment to the carrying amount of assets and liabilities at reporting date include:

Environmental obligations

The Group records a provision in respect of estimated costs of remediation of the damage historically caused to the natural environment by the activities of the Group. The amount recognized as a provision is the best estimate of the expenditures required to settle the present obligation at the respective consolidated statement of financial position date based on requirements of the Code of Administrative Offences of the Republic of Azerbaijan in effect and is also subject to changes because of modifications and revisions. Governmental authorities continuously consider applicable regulations and their enforcement. Estimated liability for environmental remediation as of 31 December and 1 January 2012 amounted to AZN 1,307,500. Changes in any of these conditions may result in adjustments to provisions recorded by the Group.

4. Critical accounting estimates and judgments (continued)

Useful lives of property, plant and equipment and intangible assets

Management determines the estimated useful lives and related depreciation and amortization charges for its property, plant and equipment and intangible assets. This estimate is based on projected period over which the Group expects to consume economic benefits from the asset. Management will increase the depreciation charge where useful lives are less than previously estimated lives, or it will write-off or write-down technically obsolete assets that have been abandoned or sold. The useful lives are reviewed at least at each reporting date. Changes in any of the above conditions or estimates may result in adjustments to future depreciation rates.

Deferred income tax asset recognition

The net deferred tax asset represents income taxes recoverable through future deductions from taxable profits and is recorded on the consolidated statement of financial position. Deferred income tax assets are recorded to the extent that realization of the related tax benefit is probable. In determining future taxable profits and the amount of tax benefits that are probable in the future management makes judgments and applies estimation based on last three years results and expectations of future income that are believed to be reasonable under the circumstances.

Impairment of non-financial assets

Management assesses whether there are any indicators of possible impairment of all non-financial assets at each reporting date based on events or circumstances that indicate the carrying value of assets may not be recoverable. Goodwill and other indefinite life intangibles are tested for impairment annually and at other times when impairment indicators exist. Other non-financial assets are tested for impairment when there are indicators that the carrying amounts may not be recoverable.

Given the nature of the Group's activities, information on the fair value of an asset is usually difficult to obtain unless negotiations with potential purchasers are taking place. Consequently, unless indicated otherwise, the recoverable amount used in assessing the impairment charges described below is value-in-use. When value in use calculations are undertaken, management estimates the expected future cash flows from the asset or cash generating unit and chooses a suitable discount rate in order to calculate the present value of those cash flows. The Group has been considered as one CGU and impairment was determined on the level of the whole Group. The value of the CGU was calculated by discounting the future cash flows at the rate of 8.6% on pre-tax base and impairment charge of AZN 381,071,773 has been recognized in the preliminary consolidated statement of comprehensive income to write-down the book value of certain property, plant and equipment with regard to the functional use of these assets.

The discount rate calculation is based on the specific circumstances of the Group and its operating segments and derived from its weighted average cost of capital ("WACC"). In calculating WACC the cost of equity was estimated using peer group data and the cost of debt is based on interest bearing borrowings, the Group is obliged to service. Specific risks are incorporated by applying individual beta factors, market risk and size of the Group. The beta factors are evaluated annually based on publicly available market data. If the estimated WACC used in the calculation had been 1% higher / lower than management's estimate, the aggregate amount of impairment loss would have been AZN 68,603,157 higher / AZN 100,041,672 lower, respectively.

4. Critical accounting estimates and judgments (continued)

Impairment provision for trade receivables

The impairment provision for trade receivables is based on management's assessment of the probability of collection of major individual consumers' accounts receivable. Significant financial difficulties of the consumers, probability that the contract parties will suffer bankruptcy or financial reorganization, and default or delinquency in payments are considered indicators that the receivable is potentially impaired. Actual results could differ from these estimates if there is deterioration in a major customer's creditworthiness or actual defaults are higher than the estimates. Additionally, a large number of minor receivables are grouped into homogenous groups and assessed for impairment collectively. Trade receivables outstanding more than 12 months are generally written off against respective impairment provision.

When there is no expectation of recovering additional cash for an amount receivable, amount receivable is written off against associated provision.

Future cash flows of trade receivables that are evaluated for impairment are estimated on the basis of the contractual cash flows of the assets and the experience of management in respect of the extent to which amounts will become overdue as a result of past loss events and the success of recovery of overdue amounts. Past experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect past periods and to remove the effects of past conditions that do not exist currently.

Provision for unused vacation

The Group has a policy to settle total amount of payable to individual employee accrued for several years for unused vacations only when the vacation option is utilized by the employee and no reliable basis for estimation of timing of payment is available.

5. First-time adoption of IFRS

The Group has prepared preliminary consolidated financial statements which comply with IFRS applicable for periods beginning on or after 1 January 2012 as described in the accounting policies. The Group's opening balance sheet was prepared as at 1 January 2012, the Group's date of transition to IFRS. This note explains the principal adjustments made by the Group in restating its consolidated statement of financial position prepared in accordance with AAL as at 1 January 2012 and its financial statements prepared in accordance with AAL as at 31 December 2012 and for the year then ended.

The Group has not applied IFRS 3 *Business Combinations* to acquisitions of subsidiaries, which are considered businesses for IFRS, or of interests in associates and joint ventures that occurred before 1 January 2012. Use of this exemption means that the AAL carrying amounts of assets and liabilities, that are required to be recognized under IFRS, is their deemed cost at the date of the acquisition. After the date of the acquisition, measurement is in accordance with IFRS. Assets and liabilities that do not qualify for recognition under IFRS are excluded from the opening IFRS statement of financial position. The Group did not recognize or exclude any previously recognized amounts as a result of IFRS recognition requirements.

The Group has applied the transitional relief from retrospective measurement of government loans with a below-market rate of interest.

As discussed in Note 2 the Group elected to measure property, plant and equipment at fair value at the date of transition to IFRS.

5. First-time adoption of IFRS (continued)

The Group has applied the transitional provisions in IAS 23 *Borrowing Costs* and capitalizes borrowing costs relating to all qualifying assets after the date of transition. Similarly, the Group has not restated for borrowing costs capitalized under AAL on qualifying assets prior to the date of transition to IFRS.

Group reconciliation of equity as at 1 January 2012 (date of transition to IFRS)

	Notes	AAL (unaudited)	Remeasurements	IFRS as at 1 January 2012
Assets				
Non-current assets				
Property, plant and equipment	A	1,861,563,575	(1,626,533,780)	235,029,795
Intangible assets	B	11,532	(11,532)	–
Prepayments	F	105,077,351	(5,891,596)	99,185,755
Deferred tax assets	C	–	253,857	253,857
Total non-current assets		**1,966,652,458**	**(1,632,183,051)**	**334,469,407**
Current assets				
Inventories	D	6,546,106	(1,182,564)	5,363,542
Taxes receivable		10,712,294	–	10,712,294
Trade and other receivables	N	198,553,914	(169,356,893)	29,197,021
Intra-group receivable	E	255,351,214	(255,351,214)	–
Prepayments	F	943	1,044,101	1,045,044
Restricted cash	K	–	22,116,036	22,116,036
Cash and cash equivalents	K	25,937,856	(22,116,036)	3,821,820
Total current assets		**497,102,327**	**(424,846,570)**	**72,255,757**
Total assets		**2,463,754,785**	**(2,057,029,621)**	**406,725,164**
Equity and liabilities				
Equity				
Share capital	G	(319,633,734)	(80,366,266)	(400,000,000)
Subscription receivable	G	–	100,212,511	100,212,511
Government investments	H	(1,670,693,143)	(36,437,851)	(1,707,130,994)
Accumulated loss		97,107,083	1,810,643,094	1,907,750,177
Total equity		**(1,893,219,794)**	**1,794,051,488**	**(99,168,306)**
Liabilities				
Non-current liabilities				
Interest-bearing loans and borrowings	H	(143,467,400)	46,145,499	(97,321,901)
Provisions	J	–	(5,610,893)	(5,610,893)
Total non-current liabilities		**(143,467,400)**	**40,534,606**	**(102,932,794)**
Current liabilities				
Interest-bearing loans and borrowings	H	–	(9,458,848)	(9,458,848)
Income tax payable	I	–	(3,788,397)	(3,788,397)
Other taxes and penalties	I	(50,533,954)	9,458,435	(41,075,519)
Trade and other payables	I	(121,133,839)	(28,321,528)	(149,455,367)
Advances received	I	(48,584)	(621,646)	(670,230)
Intra-group payables	E	(255,351,214)	255,351,214	–
Provisions	J	–	(175,703)	(175,703)
Total current liabilities		**(427,067,591)**	**222,443,527**	**(204,624,064)**
Total liabilities		**(570,534,991)**	**262,978,133**	**(307,556,858)**
Total equity and liabilities		**(2,463,754,785)**	**2,057,029,621**	**(406,725,164)**

5. First-time adoption of IFRS (continued)

Group reconciliation of equity as at 31 December 2012

	Notes	AAL (unaudited)	Remeasurements	IFRS as at 31 December 2012
Assets				
Non-current assets				
Property, plant and equipment	A	2,575,884,453	(2,031,687,321)	544,197,132
Intangible assets	B	57,657	(11,532)	46,125
Prepayments	F	199,975,448	(94,177,126)	105,798,322
Deferred tax assets	C	–	713,911	713,911
Total non-current assets		**2,775,917,558**	**(2,125,162,068)**	**650,755,490**
Current assets				
Inventories	D	13,471,416	(7,951,677)	5,519,739
Taxes receivable		23,729,172	–	23,729,172
Trade and other receivables	N	262,272,232	(239,959,995)	22,312,237
Intra-group receivable	E	263,125,699	(263,125,699)	–
Prepayments	F	943	2,213,704	2,214,647
Restricted cash	K	–	10,528,521	10,528,521
Cash and cash equivalents	K	16,838,599	(9,846,728)	6,991,871
Total current assets		**579,438,061**	**(508,141,874)**	**71,296,187**
Total assets		**3,355,355,619**	**(2,633,303,942)**	**722,051,677**
Equity and liabilities				
Equity				
Share capital	G	(343,203,470)	(56,796,530)	(400,000,000)
Subscription receivable	G	–	76,642,776	76,642,776
Government investments	H	(2,281,708,107)	(8,259,680)	(2,289,967,787)
Accumulated loss		126,451,825	2,269,955,321	2,396,407,146
Total equity		**(2,498,459,752)**	**2,281,541,887**	**(216,917,865)**
Liabilities				
Non-current liabilities				
Interest-bearing loans and borrowings	H	(243,283,269)	139,848,944	(103,434,325)
Advances received	F	(12,422,529)	12,422,529	–
Deferred revenue		–	(31,842)	(31,842)
Provisions	J	–	(7,047,185)	(7,047,185)
Total non-current liabilities		**(255,705,798)**	**145,192,446**	**(110,513,352)**
Current liabilities				
Interest-bearing loans and borrowings	H	–	(147,407,443)	(147,407,443)
Income tax payable	I	–	(3,932,949)	(3,932,949)
Other taxes and penalties	I	(45,167,107)	3,932,948	(41,234,159)
Trade and other payables	I	(292,897,246)	90,873,068	(202,024,178)
Intra-group payables	E	(263,125,716)	263,125,716	–
Provisions	J	–	(21,731)	(21,731)
Total current liabilities		**(601,190,069)**	**206,569,609**	**(394,620,460)**
Total liabilities		**(856,895,867)**	**351,762,055**	**(505,133,812)**
Total equity and liabilities		**(3,355,355,619)**	**2,633,303,942**	**(722,051,677)**

5. First-time adoption of IFRS (continued)

Reconciliation of total comprehensive income for the year ended 31 December 2012

	Notes	AAL (unaudited)	Remeasurements	IFRS for the year ended 31 December 2012
Sales revenue	M	233,762,949	(110,866,158)	122,896,791
Cost of sales	L	(282,439,931)	176,686,388	(105,753,543)
Gross profit		**(48,676,982)**	**65,820,230**	**17,143,248**
Administrative expenses	L	–	(31,652,611)	(31,652,611)
Selling and distribution expenses	L	–	(91,854,266)	(91,854,266)
Other operating expenses	L	7,324,869	(389,026,463)	(381,701,594)
Government grant	M	5,298,800	(5,298,800)	–
Operating loss		**12,623,669**	**(517,832,140)**	**(505,208,471)**
Finance cost	L	(13,194)	(295,815)	(309,009)
Loss before tax		**(36,066,507)**	**(452,307,725)**	**(488,374,232)**
Income tax expense	C	(742,791)	460,054	(282,737)
Loss for the year		**(36,809,298)**	**(451,847,671)**	**(488,656,969)**

Notes to the reconciliation of equity as at 1 January 2012 and 31 December 2012 and total comprehensive income for the year ended 31 December 2012

A The Group's property, plant and equipment were remeasured at their fair value at the date of transition to IFRS, 1 January 2012, which subsequently is being used as a deemed cost. The excess of fair value over the net book value as a result of revaluation was charged to the accumulated loss. In addition carrying amounts as of 31 December 2012 were written down to their recoverable amount under IFRS.

B Intangible assets held by the Group at the date of transition to IFRS were written off to the accumulated loss as no benefits were expected to flow to the Group in relation with these assets.

C The various transitional adjustments lead to different timing differences. According to the Group's accounting policy it has to account for such differences. Deferred tax adjustments are recognized in correlation to the underlying transaction in accumulated loss and consolidated statement of comprehensive income as of 1January 2012 and 31 December 2012.

D At the date of transition to IFRS the Group had inventories held by the Group for the purposes of planned construction works. These inventories were reclassified to property, plant and equipment for the purpose of IFRS reporting.

E Receivables and payables of entities which are part of the Group but operate under different Tax Identification Numbers ("TIN") were eliminated for the purpose of IFRS reporting.

F The Group has made certain correcting and reclassification adjustments with respect to trade and other receivables, prepayments and advances from unidentified customers balance for the purposes of IFRS reporting.

G The amount of share capital was adjusted according to the amount shown in the share documents and a contra-equity account of subscription receivable was set up for unpaid share capital portion for the purposes of IFRS reporting.

5. First-time adoption of IFRS (continued)

Notes to the reconciliation of equity as at 1 January 2012 and 31 December 2012 and total comprehensive income for the year ended 31 December 2012 (continued)

H The Group has made a number of correcting and reclassification adjustments to reclassify Government loans financed by international financial institutions from current, non-current interest bearing loans and borrowings, to Government investments accounts for the purpose of IFRS reporting.

I The Group has made a number of correcting and reclassification adjustments with respect to income tax payable, other taxes and penalties payable, trade and other payables and advances received balances for the purpose of IFRS reporting.

J The Group has recognized provision for disability payments of employees, court cases and rehabilitation provisions for the purposes of IFRS reporting.

K The Group has made reclassification adjustment with respect to restricted cash and cash equivalents accounts.

L The Group has made certain correcting and reclassification adjustments on cost of sales, general and administrative, selling and distribution, finance, operating and other expenses for the purposes of IFRS reporting.

M The Group has made certain correcting and reclassification adjustments on sales revenue and government grant accounts for the purposes of IFRS reporting.

N Local regulation does not require the Group to create provision for receivables from supply of water to population and non-population, which is the principal activity of the Group. At the date of transition to IFRS the Group assessed doubtful and irrecoverable debts and created allowance for the IFRS reporting purposes.

6. Property, plant and equipment

Movements in the carrying amount of property, plant and equipment ("PPE") were as follows:

Cost/Valuation	Land	Buildings and constructions	Facilities	Transmission devices	Machinery and equipment	Vehicles	Office equipments	Construction in progress	Total
At 1 January 2012	**3,672,191**	**17,873,486**	**12,370,865**	**64,107,203**	**3,306,964**	**16,252,807**	**628,733**	**11,681,7546**	**235,029,795**
Additions	–	80,194	254,294	74,975,062	18,648,264	515,4305	124,2495	625,033,463	**725,388,077**
Granted assets	9,985,200	–	2,736,058	–	–	410,167	–	–	**13,131,425**
Transfers	–	–	–	14,609,535	9,888	–	–	(14,619,423)	**–**
Disposals	–	(238,671)	(763)	(307,915)	(122,126)	(133,646)	(25,333)	(381,027)	**(1,209,481)**
At 31 December 2012	**13,657,391**	**17,715,009**	**15,360,454**	**153,383,885**	**21,842,990**	**21,683,633**	**1,845,895**	**726,850,559**	**972,339,816**
Depreciation and impairment									
At 1 January 2012	–	–	–	–	–	–	–	–	–
Depreciation charge	–	(1,633,555)	(1,488,694)	(11,841,756)	(16,366,157)	(15,309,741)	(431,008)	–	**(47,070,911)**
Impairment charge	(4,672)	(4,079,125)	(5,981,528)	(29,384,483)	(82,889)	(774,947)	(465,435)	(340,298,694)	**(381,071,773)**
At 31 December 2012	**(4,672)**	**(5,712,680)**	**(7,470,222)**	**(41,226,239)**	**(16,449,046)**	**(16,084,688)**	**(896,443)**	**(340,298,694)**	**(428,142,684)**
Net book value									
At 1 January 2012	**3,672,191**	**17,873,486**	**12,370,865**	**64,107,203**	**3,306,964**	**16,252,807**	**628,733**	**116,817,546**	**235,029,795**
At 31 December 2012	**13,652,719**	**12,002,329**	**7,890,232**	**112,157,646**	**5,393,944**	**5,598,945**	**949,452**	**386,551,865**	**544,197,132**

6. Property, plant and equipment (continued)

In 2012, the Group engaged an independent appraiser, "American Appraisal" Inc., to determine the fair value of its property, plant and equipment. Fair value of property, plant and equipment was determined with the reference to income approach.

Granted assets

During the year ended 31 December 2012 certain assets (transmission pipelines and other infrastructures, vehicles etc.) were contributed to the Group by various governmental organizations in the amount of AZN 13,096,686, commercial organizations and individuals in the amount of AZN 34,739. All granted assets received during 2012 were initially measured at fair value at the date of transaction. Assets received from governmental organizations were recognized as Government investments in the preliminary consolidated financial statements (see Note 13).

Capitalization of borrowings costs

Since 2005 the Group incepted several construction projects for building of new water pipelines and reservoirs as well as waste management and sewerage system in Baku city and other regions of the Republic of Azerbaijan. The projects are financed through government investments and loans from international financial organizations. The total amount of borrowing costs capitalized during 2012, by the Group on construction property was AZN 1,524,838.

7. Taxes receivable

Taxes receivable is recoverable by means of an offset against future tax liabilities or as a direct cash refund from the tax authorities.

As at 31 December and 1 January 2012 taxes receivable mainly comprised VAT recoverable related to purchases which have not been settled at the end of the year, and thus not claimed in tax declarations and prepayment on construction works which can be claimed only after the vendor performs the associated services.

8. Prepayments

Prepayments comprised the following as at:

	31 December 2012	**1 January 2012**
Construction contracts	152,973,336	146,360,769
Less: Impairment loss provision	(47,175,014)	(47,175,014)
Other prepayments	2,214,647	1,045,044
Total prepayments	**108,012,969**	**100,230,799**

Prepayments as at 31 December and 1 January 2012 are primarily represented by prepayments made to the contractor parties for long-term construction contracts on capital projects carried out by the Group in Baku city and other regions of the Republic of Azerbaijan. The impairment loss provision on prepayments mainly relates to construction contracts and represents non-rendered portion of the construction services by contractor parties.

Other prepayments include advances to suppliers, advances paid for communication, fuel and transportation and advances to employees.

9. Inventories

Inventories comprised the following as at:

	31 December 2012	1 January 2012
Spare parts	2,649,576	2,765,136
Construction materials	767,312	1,406,354
Special clothes	729,968	466,814
Raw materials	585,150	205,846
Tools	163,737	77,675
Fuel and lubricants	135,791	59,984
Other materials	488,205	381,733
Total inventories	**5,519,739**	**5,363,542**

10. Trade and other receivables

Trade and other receivables comprised the following as at:

	31 December 2012	1 January 2012
Receivables from sale of water	89,507,955	112,349,233
Less impairment loss provision	(74,159,558)	(92,463,970)
Total trade receivables	**15,348,397**	**19,885,263**
Receivable from the Ministry of Finance	5,080,000	8,521,226
Other receivables	1,883,840	790,532
Total trade and other receivables	**22,312,237**	**29,197,021**

As at 31 December 2012 trade receivables mainly represented by receivables for sale of water to non-population and population in the amount of AZN 74,448,258 and AZN 15,059,697, respectively (1 January 2012: AZN 99,703,781 and AZN 12,645,452, respectively). General credit terms on sales of water include 30 days settlement requirement after the billing date. Tariffs on sales of water are subject to state regulations and are governed by the Tariff Council of the Republic of Azerbaijan.

Movements on the provision for impairment of trade receivables were as follows:

	2012
At 1 January	**92,463,970**
Receivables written off during the year as uncollectible net of recovery	(35,349,362)
Net change in provision	17,044,950
At 31 December	**74,159,558**

Receivable from the Ministry of Finance represents amounts due to the Group as a result of write-off of receivables from population. In accordance with the Decree #405 of the President of the Republic of Azerbaijan dated 8 April 2011 on write-off of debts of population for provision of drinkable water and utilization of sewerage services and the Decree #133 of the Cabinet of the Ministers of the Republic of Azerbaijan dated 10 August 2011, the Group was required to write-off a total amount of AZN 294 million of receivables from population as at 1 February 2011. In accordance with the Decree #133 the Group recovered losses from written-off trade receivables amounting AZN 282 million against payables to various governmental organizations and the State Budget. The remaining balance of AZN 12 million was due from Ministry of Finance of the Republic of Azerbaijan to the Group to be settled during 2011-2013.

10. Trade and other receivables (continued)

An analysis of the age of trade and other receivables which are past due but not impaired as at:

	31 December 2012	1 January 2012
1-30 days overdue	6,322,357	8,728,479
1-3 months overdue	2,799,537	4,305,817
Over 3 months overdue	–	–
Total overdue receivables	**9,121,894**	**13,034,296**

11. Cash and cash equivalents

Cash and cash equivalents comprised the following as at:

	31 December 2012	1 January 2012
Correspondent and settlement accounts	6,484,769	3,661,401
Cash in transit	484,477	156,510
Cash on hand	22,625	3,734
Other cash equivalents	–	175
Total cash and cash equivalents	**6,991,871**	**3,821,820**

Cash and cash equivalents in original currency comprised the following as at:

	31 December 2012	1 January 2012
AZN dominated bank balances	6,906,602	3,811,970
USD dominated bank balances	48,005	6,116
EUR dominated bank balances	12,452	–
Other dominated bank balances	2,187	–
Cash on hand	22,625	3,734
Total cash and cash equivalents	**6,991,871**	**3,821,820**

Restricted cash comprised the following as at:

	31 December 2012	1 January 2012
VAT deposit account	320,474	1,564,717
Account at the State Treasury	10,208,047	20,551,319
Total restricted cash	**10,528,521**	**22,116,036**

Account at the State Treasury was originated based on signed order by the Government and is held at the State Treasury of the Republic of Azerbaijan. The Group has no direct control over the account which is mainly used for financing of the Group`s construction projects and funded by the Government based on authorized requests placed at the State Treasury. Subject to the State Treasury approval appropriated funds are directly transferred to the vendor`s account. The Group treats these contributions as a Government Investment within the Group`s equity.

Effective 1 January 2008 the state tax authorities introduced VAT deposit accounts and enforced payments of input and output VAT via these accounts. In order to comply with new tax regulation, the Group has opened a VAT deposit account. In accordance with this regulation, the balance on VAT deposit account may only be withdrawn with a 45 days notice to the tax authorities.

12. Share capital

Share capital of the Group comprised of the following as at:

	31 December 2012		1 January 2012	
	Number of shares	**Share capital**	**Number of shares**	**Share capital**
"Azersu" OJSC	20,000,000	400,000,000	20,000,000	400,000,000
Subsidiaries:				
"Sutikinti" Division	100	1,423,420	100	1,423,420
Production and Technical Procurement Department	-	6,000	-	6,000
"Sukanal" Scientific Research and Design Institute	-	130,717	-	130,717
"Ganja Sukanal" OJSC	383,640	7,672,800	383,640	7,672,800
"Aghdash Sukanal" OJSC	53,568	1,071,360	53,568	1,071,360
"Goychay Sukanal" OJSC	53,568	1,071,360	53,568	1,071,360
"Sheki Sukanal" OJSC	95,663	1,913,260	95,663	1,913,260
"Birleshmish Sukanal" LLC	4,063,722	81,274,440	4,063,722	81,274,440

Parent company of the Group, "Azersu" OJSC, has a legal status of a state enterprise. The Group includes 9 separate legal entities each possessing their own share capital. As at 31 December 2012 and 1 January 2012 Azersu OJSC had authorized and issued 20,000,000 shares at par AZN 20 to the Government, which is the sole shareholder and ultimate parent of the Group. "Azersu OJSC" has ultimate control and 100% interest in all of its subsidiaries.

As at 31 December 2012 and 1 January 2012 unpaid consideration outstanding from the Government for the issued shares amounted AZN 76,642,776 and AZN 100,212,511, respectively. Accordingly, the Group recorded unpaid share capital as a subscription receivable. During 2012 in accordance with the Group's accounting policy, AZN 23,569,735 subscription receivable was settled against the Government investments based on value of the completed investment projects accepted by the Government.

13. Government investments

Government investments comprised the following as at:

	31 December 2012	1 January 2012
Non-financial asset investments	(216,716,285)	(203,619,599)
Investments financed from the State Budget	(1,990,504,643)	(1,467,071,943)
Investments financed from international financial organizations under the state guarantee	(82,746,859)	(36,439,452)
Total Government investments	**(2,289,967,787)**	**(1,707,130,994)**

During 2012, non-financial assets granted from the various budget organizations in total amount of AZN 13,096,686 were recognized as Government investments. All granted assets were measured at fair value at the date of transition.

13. Government investments (continued)

As at 1 January 2012, the balance of Government investments is comprised of fundings made both from the State Budget to finance various capital and other expenditures of the Group, the State Oil Fund of Azerbaijan Republic ("SOFAR") for financing of the Oghuz-Gabala-Baku Water Pipeline Project, Government borrowings from international financial organizations and non-financial assets granted to the Group by the Government.

14. Interest-bearing loans and borrowings

Interest-bearing loans and borrowings comprised the following as at:

	31 December 2012	1 January 2012
Government loans financed by international financial institutions	106,891,768	100,030,749
Government loan from the Ministry of Finance	137,950,000	–
Loans from local bank	6,000,000	6,750,000
Total loans	**250,841,768**	**106,780,749**

Current portion of loans of the Group were represented by the following financial institutions as at 31 December 2012 and 1 January 2012.

Financial Institution	Contractual interest rate	Original currency	Maturity date	31 December 2012	1 January 2012
World Bank (IDA)	0.75%	SDR	May 2030	1,275,814	1,226,441
World Bank (IDA)	0.75%	SDR	November 2037	324,167	14,555
KfW	0.75%	EUR	December 2032	505,360	494,651
KfW	0.75%	EUR	June 2020	–	–
Natixis	2.45%	EUR	September 2030	817,610	485,621
ADB	2.5%	SDR	November 2031	534,492	487,580
Kapital Bank	8%	AZN	September 2013	6,000,000	6,750,000
Ministry of Finance	0%	AZN	On demand	137,950,000	–
Total short-term loans and current portion of long-term loans				**147,407,443**	**9,458,848**

Non-current portion of loans of the Group were represented by the following financial institutions as at 31 December 2012 and 1 January 2012.

Financial Institution	Contractual interest rate	Original currency	Maturity date	31 December 2012	1 January 2012
World Bank (IDA)	0.75%	SDR	May 2030	36,784,597	37,952,660
World Bank (IDA)	0.75%	SDR	November 2037	11,354,579	11,643,852
KfW	0.75%	EUR	December 2032	9,502,547	5,403,772
KfW	0.75%	EUR	June 2020	4,072,417	–
Natixis	2.45%	EUR	September 2030	35,551,887	35,787,933
ADB	2.5%	SDR	November 2031	6,168,298	6,533,684
Total long-term loans				**103,434,325**	**97,321,901**

Loans from international financial institutions

Loans from international financial institutions represent lendings for the financing of projects related to development and improvement of water supply system of the Republic of Azerbaijan lended directly to the Government. The Government in its turn transferred related rights and obligations on these loans to the Group by means of re-financing agreement between the Government and the Group under the similar terms and conditions.

14. Interest bearing loans and borrowings (continued)

Loans from World Bank (IDA)

On 6 July 1995 the Government entered into loan agreement with International Development Association ("IDA") that is included in the World Bank group, for the amount of SDR 38,800,000 (AZN 46,785,040). On 30 June 2003 the Government signed another loan agreement with IDA for the amount of SDR 9,673,383 (AZN 11,664,166). The annual effective interest rate under these loan agreements is 0.75% and they are repayable until 2030 and 2037, respectively. The loans were lended for the financing of the project "Greater Baku Water Supply Rehabilitation Project". There were no drawdowns in relation to these loans during 2012.

Loans from KfW

On 25 September 2006 two loans were lended to the Government by Kreditanstalt für Wiederaufbau ("KfW") German government-owned development bank, in the amount of EUR 14,827,464 (AZN 15,386,460) and SDR 26,350,048 (AZN 27,343,445), at 0.75% and 0.71% annual effective interest rate and repayable until 2032 and 2020, respectively. The loans were lended for the financing of the project "Open Program Municipal infrastructure". As at 31 December 2012 total drawn amount under the loans amounted EUR 11,060,884 (AZN 11,477,880) and EUR 3,924,464 (AZN 4,072,417), respectively. (1 January 2012: EUR 6,511,375 (AZN 6,756,854) and nil, respectively).

Loan from Natixis

On 30 September 2006 the loan was lended to the Government by the Natixis, a French corporate and investment bank on behalf of the Government of Republic of France, in the amount of EUR 35,000,000 (AZN 36,319,500) at 2.17% annual effective interest rate and repayable until 2030. The loan was lended for the financing of the project "Reconstruction of Hovsan waste management system, Zygh pump station".

Loan from Asian Development Bank

On 29 November 2005 the loan was lended to the Government by the Asian Development Bank ("ADB"), in the amount of SDR 5,428,000 (AZN 6,545,082) at 2.54% annual effective interest rate and repayable until 2031. The loan was lended for the financing of the project "Urban Water Supply and Sanitation Project". There were no drawdowns in relation to this loan during 2012.

Loan from Kapital Bank

On 6 September 2011 the Group entered into 6-months loan agreement with Kapital Bank. The Group signed several prolongation addendums to this agreement. According to last addendum dated 6 June 2013 the loan is fully repayable in September 2013. The interest rate under the loan agreement is 8% per annum.

Loan from the Ministry of Finance of the Republic of Azerbaijan

On 27 August 2012 the Group received interest free loan from the Ministry of Finance. The facility represented on demand loan with the contractual amount of AZN 180,000,000 of which only AZN 137,950,000 was utilized by the Group as at 31 December 2012 for financing of the ongoing infrastructure projects. The loan's annual effective interest rate is 3%. The loan was settled subsequently in full on 21 January 2013 against the budgeted funds allotted to the Group from the State Budget.

15. Provisions

Provisions comprised of the following as at:

	31 December 2012	1 January 2012
Unused vacations	5,422,235	3,996,187
Provisions for environmental obligations (Note 24)	1,307,500	1,307,500
Provision for employee injuries	238,778	214,576
Provision for court cases	100,403	268,333
Total provisions	**7,068,916**	**5,786,596**

Provision for court cases

Provision for court cases represents factual and probable estimated claims against the Group which were given rise due to ongoing construction projects.

Provision for employee injuries

The Group has an obligation to compensate its employees for the damage caused to their health during their employment, as well as to compensate the families of the employees died at work.

The Group calculated the present value of the injury payments to employees using a discount rate of 6.18 %. For the purpose of calculation of the lifetime payments to injured employees, the Group estimated a life expectancy as 71 and 76 for men and women, respectively.

16. Other taxes and penalties payable

Other taxes and penalties payable comprised of the following as at:

	31 December 2012	1 January 2012
Financial penalties	19,975,729	19,657,115
Economic penalties	8,972,088	6,721,356
VAT	3,321,461	10,611,904
Income tax	4,366,936	2,393,852
Property tax	2,077,715	922,925
Land tax	491,791	202,613
Road tax	212,674	157,305
Withholding tax	11,353	14,838
Other taxes	1,804,412	393,611
Total other taxes and penalties	**41,234,159**	**41,075,519**

Financial penalties comprised of fines for delayed submission of statutory financial reports, mistakes during statutory reporting and other sanctions.

Economic penalties include pennies for delays in payments of fines and financial penalties.

17. Trade and other payables

Trade and other payables comprised of the following as at:

	31 December 2012	1 January 2012
Construction related payables	108,149,304	87,066,780
Trade payables	71,693,542	44,745,794
Other payables	986,415	806,697
Total financial payables	**180,829,261**	**132,619,271**
Payable to Social Security Fund	17,374,906	15,054,597
Payables to employees	3,820,011	1,781,499
Total trade and other payables	**202,024,178**	**149,455,367**

The Group's total payables mainly represented by payables for construction services and payables for material, transportation, water-supply, energy and utilities provided by vendors to the Group.

18. Balances and transactions with related parties

Key management compensation. Key management of the Group includes the Chairman of the Group and its six deputies. The Chairman is appointed by the President of the Republic of Azerbaijan and deputies are appointed by the Chairman. Key management individuals are entitled to salaries and benefits provided by the Group in accordance with the approved payroll matrix. During 2012 compensation of key management personnel totaled to AZN 113,193.

All transactions with the Government are disclosed in the Note 10, Note 12, Note 13 and Note 25.

The nature of the related party relationships for those related parties with whom the Group entered into significant transactions or had significant balances outstanding are detailed below.

The Group had the following outstanding balances with related parties as at 31 December and 1 January 2012, respectively:

		Government and entities under government control	
	Note	31 December 2012	1 January 2012
Gross amounts of trade receivables		16,762,013	16,158,799
Impairment provisions for trade receivables		(14,274,111)	(13,298,771)
Other receivables		5,357,369	8,658,673
Cash and cash equivalents		131,799	76,201
Restricted cash	11	10,003,793	20,302,972
Long-term borrowings		(103,434,325)	(97,321,901)
Short-term borrowings		(141,407,443)	(2,708,848)
Trade and other payables		(46,487,027)	(32,240,866)

18. Balances and Transactions with related parties (continued)

The transactions with related parties for the year ended 31 December 2012 were as follows:

	Note	Government and entities under government control
Sales revenue		(20,622,873)
Energy costs	21	32,737,148
Security costs		2,700,770
Water purchase		281,741
Other expenses		769,464
Communication		115,443

The sales to and purchases from related parties are made at terms equivalent to those that prevail in arm's length transactions except for Government loans lended at a below market rate. Outstanding balances at the yearend are unsecured and interest free except for borrowings. There have been no guarantees provided or received for any related party receivables or payables.

19. Financial risk management

Financial risk factors

In the ordinary course of business, the Group is exposed to credit, liquidity and market risks. Market risk arises from fluctuating prices on commodities purchased and sold, prices of other raw materials, currency exchange rates and interest rates. Depending on degree of price volatility, such fluctuations in market prices may create volatility in the Group's financial position. The Group's overall risk management programme focuses on the unpredictability of financial markets and seeks to minimize potential adverse effects on the Group's financial performance. To effectively manage the variety of exposures that may impact financial results, the Group's overriding strategy is to maintain a strong financial position. Although there are no structured formal management procedures, management of the Group identifies and evaluates financial risks with reference to the current market position.

Currency risk

The Group is exposed to foreign exchange risk arising from various exposures in the normal course of business. Foreign exchange risk arises primarily from future commercial transactions, recognized assets and liabilities when assets and liabilities are denominated in a currency other than the functional currency.

The following tables demonstrates the sensitivity to a reasonably possible change in the USD, EUR, SDR exchange rates, with all other variables held constant, of the Group's post-tax profit. There is no material impact on the Group's equity:

31 December 2012	Change in rates (+/–)	Effect on profit
USD/AZN	4%	(55,059) / 55,059
EUR/AZN	12%	(5,200,139) / 5,200,139
SDR/AZN	1%	(451,536) / 451,536

1 January 2012	Change in rates (+/–)	Effect on profit
USD/AZN	5%	(31,875) / 31,875
EUR/AZN	15%	(5,060,637) / 5,060,637
SDR/AZN	1%	(462,870) / 462,870

The Group's exposure to foreign currency changes for all other currencies is not material.

19. Financial risk management (continued)

Credit risk and concentration of credit risk

Credit risk refers to the risk exposure that a potential financial loss to the Group may occur if counterparty defaults on its contractual obligations.

The Group's financial instruments that are exposed to concentrations of credit risk consist primarily of cash and cash equivalents and trade and other receivables.

The Group's maximum exposure to credit risk is represented by carrying amounts of financial assets and is presented by class of assets as shown in the table below:

	31 December 2012	1 January 2012
Cash and cash equivalents	6,969,246	3,818,086
Trade and other receivables	17,232,237	20,675,795
Total maximum exposure to credit risk	**24,201,483**	**24,493,881**

The Group places its cash with reputable financial institutions in the Republic of Azerbaijan. The Group continually monitors the status of the banks where its accounts are maintained. The Group's credit risk arising from its trade receivables balance with private sector and other third-party unrelated customers is mitigated by continuous monitoring of their creditworthiness. The requirement for an impairment is analyzed at each reporting date on an individual basis for major clients. Additionally, a large number of minor receivables are grouped into homogenous groups and assessed for impairment collectively. The calculation is based on actual incurred historical data. The maximum exposure to credit risk at the reporting date is the carrying value of each class of financial assets. The Group does not hold collateral as security. Management of the Group believes that the Group is not exposed to high credit risk as the impairment provision has already been accrued in the accompanying preliminary consolidated financial statements for all debtors which are not expected to be recovered in a future.

Liquidity risk

Liquidity risk is the risk that the Group will not be able to meet its financial obligations as they fall due. The Group's approach to managing liquidity is to ensure that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Group's reputation. In managing liquidity risk, the Group should maintain adequate cash reserves and debt facilities, continuously monitors forecast and actual cash flows.

Prudent liquidity risk management includes maintaining sufficient working capital and the ability to close out market positions. As discussed in Note 2 the Group continues to remain dependent on its ability to obtain sufficient funding from the Government to sustain operations and complete its current investment projects. Refer to the respective note for management`s action points.

All of the Group's financial liabilities represent non-derivative financial instruments. The table below analyses the Group's financial liabilities into relevant maturity groupings based on the remaining period from the statement of financial position date to the contractual maturity date. The amounts disclosed in the table are the contractual undiscounted cash flows.

19. Financial risk management (continued)

Liquidity risk (continued)

The maturity analysis of financial liabilities as of 31 December 2012 and 1 January 2012 is as follows:

At 31 December 2012	Less than 3 months	3-12 months	1-5 years	More than 5 years	Total
Trade and other financial payables	180,829,261	–	–	–	**180,829,261**
Interest-bearing loans and borrowings	144,316,641	4,513,729	29,088,865	87,430,476	**265,349,711**
Total undiscounted financial liabilities	**325,145,902**	**4,513,729**	**29,088,865**	**87,430,476**	**446,178,972**

At 1 January 2012	Less than 3 months	3-12 months	1-5 years	More than 5 years	Total
Trade and other financial payables	132,619,271	–	–	–	**132,619,271**
Interest-bearing loans and borrowings	7,072,953	4,237,964	25,324,406	90,563,741	**127,199,064**
Total undiscounted financial liabilities	**139,692,224**	**4,237,964**	**25,324,406**	**90,563,741**	**259,818,335**

Capital management

The primary objective of the Group's capital management policy is to ensure a strong capital base to fund and sustain its business operations through prudent investment decisions and to maintain government, investor and creditor confidence to support its business activities.

The Group is 100% owned by the Government and periodically receives funds in the form of the Government investments for implementation of construction projects. Having considered that contributions and additions in capital depend on government decisions and there are no requirements and limits set on level of the capital, no specific capital risk management policies were developed by the Group.

Fair value of financial instruments

The fair value of the financial assets and liabilities is included at the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The estimated fair values of financial instruments have been determined by the Group using available market information, where it exists, and appropriate valuation methodologies. However, judgment is necessarily required to interpret market data to determine the estimated fair value. Management has used all available market information in estimating the fair value of the financial instruments.

19. Financial risk management (continued)

Fair value of financial instruments (continued)

Set out below is a comparison by class of the carrying amounts and fair value of the Group's financial instruments that are carried in the preliminary consolidated financial statements.

As at 31 December 2012

	Carrying value	Fair value
Cash and cash equivalents	6,969,246	6,969,246
Trade and other financial receivables	17,232,237	17,232,237
Trade and other financial payables	(180,829,261)	(180,829,261)
Long-term bank loans	(103,434,325)	(64,992,220)
Short-term bank loans	(147,407,443)	(147,407,443)

As at 1 January 2012

	Carrying value	Fair value
Cash and cash equivalents	3,818,086	3,818,086
Trade and other financial receivables	20,675,795	20,675,795
Trade and other financial payables	(132,619,271)	(132,619,271)
Long-term bank loans	(97,321,901)	(64,044,512)
Short-term bank loans	(9,458,848)	(9,458,848)

The following methods and assumptions were used to estimate the fair values:

i. Short-term financial assets and liabilities approximate their carrying amounts largely due to the short-term maturities of these instruments;

ii. Long-term borrowings are evaluated by the Group based on parameters such as interest rates, specific country risk factors, individual creditworthiness of customers and the risk characteristics of the financed project.

20. Sales revenue

Sales revenue comprised the following:

	Year ended 31 December 2012
Sales of water	112,939,128
Sewerage services	3,146,051
Other sales revenue	6,811,612
Total sales revenue	**122,896,791**

Revenue from other sales mainly comprised the sales of technical terms, water-meters and scientific research and design projects.

21. Expenses

For the year ended 31 December 2012 cost of sales, administrative expenses, selling and distribution expenses and other operating expenses comprised the following:

	Cost of sales	Administrative expenses	Selling and distribution expenses	Other operating expenses	Total
Impairment of property, plant and equipment	–	–	–	381,071,773	**381,071,773**
Wages, salaries and social security costs	19,599,945	6,962,898	37,602,452	–	**64,165,295**
Depreciation of property, plant and equipment	23,689,412	9,209,106	14,172,393	–	**47,070,911**
Energy expenses	19,789,625	60,560	12,886,963	–	**32,737,148**
Raw materials and consumables used	13,690,072	626,337	8,214,393	–	**22,530,802**
Repairs and maintenance expenses	683,320	3,444,562	12,903,565	–	**17,031,447**
Impairment of trade and other receivables	17,044,950	–	–	–	**17,044,950**
Interest expenses for tax payables	1,882,794	–	1,512,948	–	**3,395,742**
Security expenses	1,309,156	957,400	434,214	–	**2,700,770**
Fuel expenses	1,752,669	–	460,281	–	**2,212,950**
Taxes other than on income	535,908	64,320	1,070,908	–	**1,671,136**
Economic sanctions and other penalties	396,494	492,751	–	–	**889,245**
Change in other provisions and liabilities	–	1,279,850	–	–	**1,279,850**
Bank expenses	147,589	325,178	298,194	–	**770,961**
Business trip expenses	291,983	244,899	187,011	–	**723,893**
Rent expenses	67,746	125,896	450,109	–	**643,751**
Communication expenses	64,620	258,694	276,833	–	**600,147**
Insurance expenses	183,133	33,631	179,017	–	**395,781**
Loss on disposal of property, plant and equipment	1,713,049	–	740,194	–	**2,453,243**
Water purchases	281,741	–	–	–	**281,741**
Other expenses	2,629,337	7,566,529	464,791	629,821	**11,290,478**
	105,753,543	**31,652,611**	**91,854,266**	**381,701,594**	**610,962,014**

22. Income tax

Income tax expense for the year ended 31 December 2012 comprised the following:

	Year ended 31 December 2012
Current income tax expense	742,791
Change in the deferred tax	(460,054)
Income tax expense	**282,737**

22. Income tax (continued)

Differences between IFRS and applicable domestic tax regulations give rise to the temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and their tax bases. The tax effect of these temporary differences is detailed below:

	31 December 2012	1 January 2012
Deductable temporary differences:		
Property, plant and equipment	351,078	132,497
Losses carried forward	–	19,093
Provisions	44,072	29,201
Other	318,761	73,066
Net deferred income tax asset	**713,911**	**253,857**

At 31 December and 1 January 2012 cumulative balance of unrecognized deferred tax asset from carry forward losses and other temporary differences amounted AZN 425,671,389 and AZN 328,452,886, respectively.

A reconciliation between tax expense and the product of accounting profit multiplied by the Group's domestic tax rate for the year ended 31 December 2012 is as follows:

	2012
Loss before tax	**(488,374,232)**
Theoretical tax charge at statutory rate of 20 per cent	(97,674,846)
Non-deductible expenses	739,080
Increase in unrecognized deferred tax asset	97,218,503
Income tax expense for the year	**282,737**

The Group does not file a consolidated tax return. In the context of the Group's current structure, tax losses and current tax assets of different Group companies may not be offset against current tax liabilities and taxable profits of other Group companies and, accordingly, taxes may accrue even where there is a consolidated tax loss. Therefore, deferred tax assets and liabilities are offset only when they relate to the same taxable entity.

The Group`s several subsidiaries have tax losses, which in accordance with Azerbaijani tax legislation, can be carried forward for five years. However, as these losses relate to subsidiaries that have a history of losses, deferred tax assets have not been recognized as these losses may not be used to offset taxable profits elsewhere in the Group. The Group evaluated and concluded that it is not probable that deferred tax assets on balances of loss-making subsidiaries will be recovered in foreseeable future and recognized full allowance for deferred tax asset on these entities.

23. Significant non-cash investing and financing activities

Investing and financing transactions that did not require the use of cash and cash equivalents and were excluded from the consolidated cash flows statement are as follows:

Construction works financed by the Government	568,446,121
Loan received from the Ministry of Finance of the Republic of Azerbaijan	137,950,000
Property, plant and equipment granted to the Group by the Government (Note 6)	13,096,686
Repayment of Group`s loans by the Ministry of Finance of the Republic of Azerbaijan	3,441,226

23. Significant non-cash investing and financing activities (continued)

As discussed in Note 11 the Group's account at the State Treasury is restricted by financing of the Group's construction activities by the Government. The total amount of funds appropriated by the Government for the payment of the Group's construction activities during the year ended 31 December 2012 amounted AZN 706,396,121.

As discussed in Note 14, during 2012 the Group utilized loan facility provided by the Ministry of Finance of the Republic of Azerbaijan for financing of ongoing construction activities. All respective transactions have been processed through the Group's account at the State Treasury.

During 2012, the borrowings from the international financial institutions in the amount of AZN 3,441,226 were settled against the receivable from the Ministry of Finance of the Republic of Azerbaijan as detailed in Note 10 in accordance with the Decree #133 of the Cabinet of the Ministers of the Republic of Azerbaijan.

24. Contingences, commitments and operating risks

Operating environment.

The Group's operations are conducted in the Republic of Azerbaijan. As an emerging market, at the present time the Republic of Azerbaijan is developing business and regulatory infrastructure that would generally exist in a more mature market economy.

Whilst there have been improvements in economic trends in the Republic of Azerbaijan, the country continues to display certain characteristics of an emerging market. These characteristics include, but are not limited to, the existence of a currency that is not freely convertible in most countries outside of the Republic of Azerbaijan. The tax, currency and customs legislation within the Republic of Azerbaijan is subject to varying interpretations and changes.

The future economic direction of the Republic of Azerbaijan is largely dependent upon the effectiveness of economic, financial and monetary measures undertaken by the Government, together with tax, legal, regulatory, and political developments. Management is unable to predict all developments in the economic environment which would have an impact on the Group's operations and consequently what effect, if any, they could have on the financial position of the Group.

The Azerbaijani economy is vulnerable to market downturns and economic slowdowns elsewhere in the world. While the Government has introduced a range of stabilization measures, there continues to be uncertainty regarding the access to capital and cost of capital for the Group and its counterparties, which could affect the Group's financial position, results of operations and business prospects. While Management believes it is taking appropriate measures to support the sustainability of the Group's business in the current circumstances, unexpected further deterioration in the areas described above could negatively affect the Group's results and financial position in a manner not currently determinable.

These preliminary consolidated financial statements do not include any adjustments that may result from the future clarification of these uncertainties. Such adjustments, if any, will be reported in the period when they become known and estimable.

24. Contingences, commitments and operating risks (continued)

Legal proceedings

From time to time and in the normal course of business, claims against the Group are received. On the basis of its own estimates internal professional advice management is of the opinion that no material losses will be incurred in respect of claims in excess of provisions that have been made in these preliminary consolidated financial statements.

Tax legislation

Azerbaijani tax, currency and customs legislation is subject to varying interpretations, and changes, which may occur frequently. Management's interpretation of such legislation as applied to the transactions and activity of the Group may be challenged by the relevant authorities. Fiscal periods remain open to review by the tax authorities in respect of taxes for three calendar years preceding the year of review. Under certain circumstances such reviews may cover longer periods.

The Group's management believes that its interpretation of the relevant legislation is appropriate and the Group's tax, currency legislation and customs positions will be sustained and potential tax liabilities of the Group will not exceed the amounts recorded in these preliminary consolidated financial statements.

Environmental matters

The enforcement of environmental regulation in the Azerbaijan Republic is evolving and the enforcement posture of government authorities is continually being reconsidered. The Group periodically evaluates its obligations under environmental regulations. As obligations are determined, they are recognized immediately. Potential liabilities, which might arise as a result of changes in existing regulations, civil litigation or legislation, cannot be estimated but could be material. In the current enforcement climate under existing legislation, management believes that there are no significant liabilities for environmental damage above environmental obligation provision currently made by the Group.

25. Events after the reporting date

Following significant events took place after the reporting date:

- According to the Order of the Cabinet of Ministers of the Republic of Azerbaijan dated 30 December 2012, subsidies of AZN 734 million were allotted to the Group for construction of the ongoing infrastructure projects and maintenance purposes. Respective financing has started from January 2013.
- As discussed in Note 14 the loan received from the Ministry of Finance of the Republic of Azerbaijan in August 2013 in the amount of AZN 137,950,000 was fully settled by the Group against 2013 subsidies from the State Budget as stated above on 21 January 2013.