

“AZERSU” Open Joint Stock Company

Consolidated Financial Statements

*Year ended 31 December 2014
together with Independent Auditors' Report*

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Independent Auditors' Report to Management of "Azersu" OJSC

We have audited the accompanying consolidated financial statements of "Azersu" OJSC and its subsidiaries (the "Group"), which comprise the consolidated statement of financial position as at 31 December 2014, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

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

Auditors' Responsibility

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

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

Basis for Qualified Opinion

Because we were appointed auditors of the Group during 2013, we were not able to observe the counting of the physical inventories at the beginning of that year or satisfy ourselves concerning those inventory quantities by alternative means. Since opening inventories affect the determination of the financial performance and cash flows, we were unable to determine whether adjustments might have been necessary in respect of profit for the year ended 31 December 2013 reported in the consolidated statement of comprehensive income and net cash flows from operating activities reported in the consolidated statement of cash flows. Our audit opinion on the consolidated financial statements for the year ended 31 December 2013 was qualified accordingly. Our opinion on the current year's consolidated financial statements is also qualified because of the possible effect of this matter on the comparability of the current year's figures and the comparative information.

Qualified Opinion

In our opinion, except for the possible effects on the comparative information of the matter described in the Basis for qualified opinion paragraph, the consolidated financial statements present fairly, in all material respects, the financial position of the Group as at 31 December 2014 and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Emphasis of Matter

Without qualifying our opinion, we draw attention to Note 2 in the consolidated financial statements which indicates that the Group incurred a net loss of AZN 886,032 thousand during the year ended 31 December 2014 and, as of that date, the Group's current liabilities exceeded its current assets by AZN 647,599 thousand. 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.

Ernst & Young Holdings (CIS) B.V.

24 June 2015

“AZERSU” OJSC

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

(Amounts presented are in thousands of Azerbaijani manats)

	Notes	31 December 2014	31 December 2013 (restated)
Assets			
Non-current assets			
Property, plant and equipment	5	384,163	483,086
Intangible assets		407	11
Deferred tax assets	21	1,199	985
Total non-current assets		385,769	484,082
Current assets			
Inventories	7	6,958	13,104
Taxes receivable	6	45,563	35,877
Trade and other receivables	8	10,388	14,921
Prepayments		1,148	666
Restricted cash	9	5,707	3,131
Cash and cash equivalents	9	1,964	3,064
Total current assets		71,728	70,763
Total assets		457,497	554,845
Equity and liabilities			
Equity			
Share capital	10	400,000	400,000
Subscription receivable	10	—	(16,838)
Additional paid-in capital	10	24,546	—
Government investments	11	3,656,940	3,156,031
Accumulated loss		(4,436,898)	(3,550,866)
Total equity		(355,412)	(11,673)
Liabilities			
Non-current liabilities			
Interest-bearing loans and borrowings	12	82,437	96,414
Deferred revenue		—	32
Provisions	13	11,145	10,679
Total non-current liabilities		93,582	107,125
Current liabilities			
Interest-bearing loans and borrowings	12	213,245	109,688
Income tax payable		5,514	3,696
Other taxes and penalties payable	14	59,804	39,262
Trade and other payables	15	438,656	304,385
Advances received		2,085	2,342
Provisions	13	23	20
Total current liabilities		719,327	459,393
Total liabilities		812,909	566,518
Total equity and liabilities		457,497	554,845

Signed and authorized for release on behalf of the Group on 24 June 2015.

Mr. Gorkhmaz Huseynov
Chairman



Mr. Mahir Mammadov
Deputy Chairman on Economic Matters

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

“AZERSU” OJSC

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(Amounts presented are in thousands of Azerbaijani manats)

	Notes	Year ended 31 December 2014	Year ended 31 December 2013 (restated)
Sales revenue	18	140,979	134,857
Cost of sales	19	(87,991)	(93,254)
Gross profit		52,988	41,603
Administrative expenses	19	(29,875)	(30,656)
Selling and distribution expenses	19	(94,912)	(86,516)
Other operating expenses	19	(837,190)	(987,521)
Other income	20	23,338	15,093
Operating loss		(885,651)	(1,047,997)
Finance cost		(370)	(726)
Loss before tax		(886,021)	(1,048,723)
Income tax (expense)/benefit	21	(11)	62
Loss for the year		(886,032)	(1,048,661)

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

“AZERSU” OJSC

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

(Amounts presented are in thousands of Azerbaijani manats)

	Notes	Share capital	Subscription receivable	Additional paid-in capital	Government investments	Accumulated loss	Total equity
As at 1 January 2013		400,000	(76,643)	–	2,289,968	(2,502,205)	111,120
Settlement of subscription receivable	10	–	59,805	–	–	–	59,805
Net increase in Government investments	11	–	–	–	866,063	–	866,063
Loss for the year (restated)		–	–	–	–	(1,048,661)	(1,048,661)
As at 31 December 2013 (restated)		400,000	(16,838)	–	3,156,031	(3,550,866)	(11,673)

	Notes	Share capital	Subscription receivable	Additional paid-in capital	Government investments	Accumulated loss	Total equity
As at 31 December 2013 (restated)		400,000	(16,838)	–	3,156,031	(3,550,866)	(11,673)
Settlement of subscription receivable	10	–	16,838	–	–	–	16,838
Net increase in Government investments	10, 11	–	–	24,546	500,909	–	525,455
Loss for the year		–	–	–	–	(886,032)	(886,032)
As at 31 December 2014		400,000	–	24,546	3,656,940	(4,436,898)	(355,412)

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

“AZERSU” OJSC

CONSOLIDATED STATEMENT OF CASH FLOWS

(Amounts presented are in thousands of Azerbaijani manats)

	Notes	Year ended 31 December 2014	Year ended 31 December 2013 (restated)
Operating activities			
Loss before tax		(886,021)	(1,048,723)
Non-cash adjustments to reconcile loss before tax to net cash flows			
Depreciation of property, plant and equipment and amortization cost	19	12,194	29,506
Change in impairment of trade and other receivables	8	20,459	11,969
Change in provision	13	469	3,630
Finance cost		370	726
Impairment of property, plant and equipment and intangible assets	19	837,190	987,521
Loss on disposal of property, plant and equipment		753	1,683
		(14,586)	(13,688)
Working capital adjustments			
Inventories		6,146	(7,584)
Taxes receivable		(9,686)	(13,780)
Trade and other receivables		(15,926)	(9,657)
Advances received		(289)	2,342
Other taxes and penalties		23,041	–
Prepayment		(482)	–
Trade and other payables		134,271	97,941
		122,489	55,574
Interest paid		(339)	(444)
Income tax paid		(906)	(786)
Net cash flows from operating activities		121,244	54,344
Investing activities			
Purchase of property, plant and equipment		(119,024)	(57,247)
Purchase of intangible assets		(1,580)	–
Proceeds from disposal of property, plant and equipment		–	65
Net cash flows used in investing activities		(120,604)	(57,182)
Financing activities			
Repayment of borrowings		(1,740)	(1,090)
Net cash flows used in financing activities		(1,740)	(1,090)
Net decrease in cash and cash equivalents		(1,100)	(3,928)
Cash and cash equivalents at the beginning of the year	9	3,064	6,992
Cash and cash equivalents at the end of the year	9	1,964	3,064

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

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

1. The Group’s principal activity

“Azersu” Open Joint Stock Company (“Azersu” OJSC) and its subsidiaries (the “Group”) were established by the Presidential Decree on 11 June 2004 in accordance with Azerbaijani legislation and are 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

The consolidated financial statements of the Group have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB). The principal accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all the periods presented.

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 647,599 and AZN 388,630 as at 31 December 2014 and 2013, respectively, due to significant current investments in the infrastructure projects. The Group incurred a net loss of AZN 886,032 during the year ended 31 December 2014 (2013: AZN 1,048,661). 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.

These conditions 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 applied going concern basis in preparing its consolidated financial statements.

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

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

Basis of consolidation

The consolidated financial statements of the Group comprise the financial statements of “Azersu” OJSC and its subsidiaries as at 31 December 2014. 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, unrealized gains and losses resulting from intra-group transactions and dividends are eliminated in full.

Foreign currency translation

All amounts in these consolidated financial statements are presented in thousands of 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.

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 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:

	31 December 2014	31 December 2013
1 USD / 1 AZN	0.7844	0.7845
1 EUR / 1 AZN	0.9522	1.0780
1 SDR / 1 AZN	1.1364	1.2122

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

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

Fair value measurement

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

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value measurement is based on the presumption that the transaction to sell the asset or transfer the liability takes place either:

- ▶ In the principal market for the asset or liability; or
- ▶ In the absence of a principal market, in the most advantageous market for the asset or liability.

The principal or the most advantageous market must be accessible by the Group. The fair value of an asset or a liability is measured using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest. A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

The Group uses valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximizing the use of relevant observable inputs and minimizing the use of unobservable inputs.

All assets and liabilities for which fair value is measured or disclosed in the consolidated financial statements are categorized within the fair value hierarchy, described as follows, based on the lowest level input that is significant to the fair value measurement as a whole:

- ▶ Level 1 – Quoted (unadjusted) market prices in active markets for identical assets or liabilities;
- ▶ Level 2 – Valuation techniques for which the lowest level input that is significant to the fair value measurement is directly or indirectly observable;
- ▶ Level 3 – Valuation techniques for which the lowest level input that is significant to the fair value measurement is unobservable.

For assets and liabilities that are recognized in the consolidated financial statements on a recurring basis, the Group determines whether transfers have occurred between Levels in the hierarchy by re-assessing categorization (based on the lowest level input that is significant to the fair value measurement as a whole) at the end of each reporting period.

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.

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 consolidated 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.

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

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

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.

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.

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

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

Financial assets (continued)

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.

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 consolidated 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.

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

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

Financial liabilities (continued)

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.

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 consolidated statement of comprehensive income.

Offsetting of financial instruments

Financial assets and financial liabilities are offset with the net amount reported in 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

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 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.

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

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

Property, plant and equipment (continued)

Development of tangible assets (continued)

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.

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 equipment	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 consolidated 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).

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

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

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 for all eligible qualifying assets are capitalized.

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.

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

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

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.

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 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 the consolidated statement of comprehensive income.

Current tax is the amount expected to be paid to or recovered from the state budget through 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.

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

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

Corporate income taxes (continued)

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 legislation allows 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 state budget through tax authorities upon recognition of sales to customers under timing methods envisaged in the legislation, 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 deferred liability related VAT 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.

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).

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

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

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.

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 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) 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.

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.

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

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

Correction of error

In 2013 due to clerical errors impairment loss provision recognized by the Group was understated by AZN 14,199, related bad debt expenses were understated by AZN 11,969 and reversal of bad debt expenses was overstated by AZN 2,230. These errors resulted in overstatement of Trade and other receivables as at 31 December 2013 by AZN 14,199, understatement of Selling and distribution expenses by AZN 11,969 and overstatement of Other income by AZN 2,230 for the year then ended. To correct these errors the Group restated comparative information as of and for the year ended 31 December 2013 as follows:

	As previously reported	Correction of errors	As restated
Consolidated statement of financial position as at 31 December 2013			
Trade and other receivables	29,120	(14,199)	14,921
Accumulated loss	(3,536,667)	(14,199)	(3,550,866)
Consolidated statement of comprehensive income for the year ended 31 December 2013			
Selling and distribution expenses	(74,547)	(11,969)	(86,516)
Other income	17,323	(2,230)	15,093

3. Adoption of new or revised standards and interpretations

The Group applied for the first time certain standards and amendments, which are effective for annual periods beginning on or after 1 January 2014.

The nature and the impact of each new standard and amendment is described below:

Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27)

These amendments provide an exception to the consolidation requirement for entities that meet the definition of an investment entity under IFRS 10 *Consolidated Financial Statements* and must be applied retrospectively, subject to certain transition relief. The exception to consolidation requires investment entities to account for subsidiaries at fair value through profit or loss. These amendments have no impact on the Group, since neither the Company nor its subsidiary qualifies to be an investment entity under IFRS 10.

Offsetting Financial Assets and Financial Liabilities – Amendments to IAS 32

These amendments clarify the meaning of ‘currently has a legally enforceable right to set-off’ and the criteria for non-simultaneous settlement mechanisms of clearing houses to qualify for offsetting and are applied retrospectively. These amendments have no impact on the Group, since none of the entities in the Group has any offsetting arrangements.

Annual Improvements 2010-2012 Cycle

In the 2010-2012 annual improvements cycle, the IASB issued seven amendments to six standards, which included an amendment to IFRS 13 *Fair Value Measurement*. The amendment to IFRS 13 is effective immediately and, thus, for periods beginning at 1 January 2014, and it clarifies in the Basis for Conclusions that short-term receivables and payables with no stated interest rates can be measured at invoice amounts when the effect of discounting is immaterial. This amendment to IFRS 13 has no impact on the Group.

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

3. Adoption of new or revised standards and interpretations (continued)

Standards issued but not yet effective

Standards issued but not yet effective up to the date of issuance of the Group's consolidated financial statements are listed below. This listing is of standards and interpretations issued, which the Group reasonably expects to be applicable at a future date. The Group will adopt those standards when they become effective.

IFRS 9 Financial Instruments

In July 2014, the IASB issued the final version of IFRS 9 *Financial Instruments* which reflects all phases of the financial instruments project and replaces IAS 39 *Financial Instruments: Recognition and Measurement* and all previous versions of IFRS 9. The standard introduces new requirements for classification and measurement, impairment, and hedge accounting. IFRS 9 is effective for annual periods beginning on or after 1 January 2018, with early application permitted. Retrospective application is required, but comparative information is not compulsory. Early application of previous versions of IFRS 9 (2009, 2010 and 2013) is permitted if the date of initial application is before 1 February 2015. The Group is assessing the impact from adopting IFRS 9 on the classification and measurement of the Group's financial assets and financial liabilities.

Annual improvements 2010-2012 Cycle

These improvements are effective from 1 July 2014 and are not expected to have a material impact on the Group. They include:

IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets

The amendment is applied retrospectively and clarifies in IAS 16 and IAS 38 that the asset may be revalued by reference to observable data on either the gross or the net carrying amount. In addition, the accumulated depreciation or amortisation is the difference between the gross and carrying amounts of the asset.

IAS 24 Related Party Disclosures

The amendment is applied retrospectively and clarifies that a management entity (an entity that provides key management personnel services) is a related party subject to the related party disclosures. In addition, an entity that uses a management entity is required to disclose the expenses incurred for management services.

Annual improvements 2011-2013 Cycle

These improvements are effective from 1 July 2014 and are not expected to have a material impact on the Group. They include:

IFRS 13 Fair Value Measurement

The amendment is applied prospectively and clarifies that the portfolio exception in IFRS 13 can be applied not only to financial assets and financial liabilities, but also to other contracts within the scope of IFRS 9 (or IAS 39, as applicable).

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

3. Adoption of new or revised standards and interpretations (continued)

Standards issued but not yet effective (continued)

Annual improvements 2011-2013 Cycle (continued)

IFRS 15 Revenue from Contracts with Customers

IFRS 15 was issued in May 2014 and establishes a new five-step model that will apply to revenue arising from contracts with customers. Under IFRS 15 revenue is recognised at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer. The principles in IFRS 15 provide a more structured approach to measuring and recognising revenue. The new revenue standard is applicable to all entities and will supersede all current revenue recognition requirements under IFRS. Either a full or modified retrospective application is required for annual periods beginning on or after 1 January 2017 with early adoption permitted. The Group is currently assessing the impact of IFRS 15 and plans to adopt the new standard on the required effective date.

4. Critical accounting estimates and judgments

The preparation of the Group's 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 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 2014 amounted nil (31 December 2013: AZN 1,308). Changes in any of these conditions may result in adjustments to provisions recorded by the Group.

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

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.

Current taxes

Azerbaijani tax, currency and customs legislation is subject to varying interpretations and changes occurring frequently. Further, the interpretation of tax legislation by tax authorities as applied to the transactions and activity of the Group may not coincide with that of management. As a result, tax authorities may challenge transactions and the Group may be assessed additional taxes, penalties and interest, which can be significant. The periods remain open to review by the tax and customs authorities with respect to tax liabilities for three calendar years preceding the year of review. Under certain circumstances reviews may cover longer periods.

As at 31 December 2014 management believes that its interpretation of the relevant legislation is appropriate and that it is probable that the Group's tax, currency and customs positions will be sustained.

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 8.9% (2013: 9.7%) on pre-tax base and impairment charge of AZN 837,190 (2013: AZN 987,521) has been recognized in 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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

4. Critical accounting estimates and judgments (continued)

Impairment of non-financial assets (continued)

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 50,641 higher/AZN 68,126 lower (2013: AZN 58,169/AZN 75,952, respectively).

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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

5. Property, plant and equipment

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

Cost	Land	Buildings and constructions	Facilities	Transmission devices	Machinery and equipment	Vehicles	Stationary and office equipment	Construction in progress	Total
At 1 January 2013	13,657	18,463	11,611	124,039	19,786	22,421	2,059	766,916	978,952
Additions	–	5	75	128	13,914	7,854	1,665	929,393	953,034
Granted assets	–	413	1,812	2,357	42	–	6	–	4,630
Transfers	–	12	11,896	11,063	525	64	–	(23,560)	–
Disposals	(131)	(38)	(133)	(880)	(365)	(21)	(67)	(113)	(1,748)
At 31 December 2013	13,526	18,855	25,261	136,707	33,902	30,318	3,663	1,672,636	1,934,868
Additions	–	–	26	104	4,342	1,075	329	741,642	747,518
Granted assets	–	158	485	1,168	481	220	–	–	2,512
Transfers	–	308	832	6,306	92	–	–	(7,538)	–
Disposals	–	(9)	(14)	(37)	(31)	(2)	(2)	(658)	(753)
At 31 December 2014	13,526	19,312	26,590	144,248	38,786	31,611	3,990	2,406,082	2,684,145
Depreciation and impairment									
At 1 January 2013	(5)	(6,671)	(8,882)	(48,271)	(17,407)	(16,268)	(998)	(336,253)	(434,755)
Depreciation charge	–	(1,145)	(1,153)	(6,699)	(9,940)	(10,022)	(547)	–	(29,506)
Impairment charge	–	(3,785)	(11,043)	(62,288)	(4,333)	(408)	(1,037)	(904,627)	(987,521)
At 31 December 2013	(5)	(11,601)	(21,078)	(117,258)	(31,680)	(26,698)	(2,582)	(1,240,880)	(1,451,782)
Depreciation charge	–	(922)	(454)	(2,399)	(4,649)	(3,299)	(306)	–	(12,029)
Impairment charge	(3,162)	(1,849)	(3,583)	(17,418)	(1,685)	(433)	(469)	(807,572)	(836,171)
At 31 December 2014	(3,167)	(14,372)	(25,115)	(137,075)	(38,014)	(30,430)	(3,357)	(2,048,452)	(2,299,982)
Net book value									
At 31 December 2013	13,521	7,254	4,183	19,449	2,222	3,620	1,081	431,756	483,086
At 31 December 2014	10,359	4,940	1,475	7,173	772	1,181	633	357,630	384,163

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

5. Property, plant and equipment (continued)

Granted assets

During the years ended 31 December 2014 and 2013 certain assets (transmission pipelines and other infrastructures, vehicles etc.) were contributed to the Group by various governmental and commercial organizations. The Group engaged an independent appraiser to determine the fair value of granted assets as of 31 December 2014 and 2013. Fair value of granted assets was determined as AZN 2,512 comprising assets granted by governmental organizations (2013: AZN 4,505). There were no assets granted by commercial organizations during 2014 (2013: AZN 124). Assets received from governmental organizations were recognized as Government investments in the consolidated financial statements (see Note 11).

Prepayments

Included in construction in progress are prepayments made for construction activities and services that have not been provided yet. The net amounts of such prepayments are AZN 6,258 and AZN 35,119 as at 31 December 2014 and 31 December 2013, respectively.

Capitalization of borrowings costs

Since 2005, the Group inceptioned 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 2014, by the Group on construction property was AZN 952 (2013: AZN 1,336).

6. Taxes receivable

As at 31 December 2014 and 31 December 2013 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.

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

7. Inventories

Inventories comprised the following as at:

	31 December 2014	31 December 2013
Materials	3,709	5,876
Goods	1,560	1,957
Goods for sale	727	832
Spare parts	607	685
Raw materials	313	273
Fuel and lubricants	42	71
Goods in transit	—	3,410
Total inventories	6,958	13,104

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

8. Trade and other receivables

Trade and other receivables comprised the following as at:

	31 December 2014	31 December 2013 (restated)
Receivables from sale of water	69,173	58,262
Less impairment loss provision	(59,519)	(44,899)
Total trade receivables	9,654	13,363
Other receivables	734	1,558
Total trade and other receivables	10,388	14,921

As of 31 December 2014 trade receivables are mainly represented by receivables for sale of water to non-population and population in the amount of AZN 52,765 and AZN 16,408, respectively (31 December 2013: AZN 45,234 and AZN 13,028, 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:

	2014	2013 (restated)
At 1 January	44,899	74,159
Receivables written off during the year as uncollectible net of recovery	(5,839)	(41,229)
Net change in provision (Note 19)	20,459	11,969
At 31 December	59,519	44,899

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

	31 December 2014	31 December 2013 (restated)
1-30 days overdue	2,217	6,400
1-3 months overdue	–	–
Over 3 months overdue	–	–
Total overdue receivables	2,217	6,400

9. Cash and cash equivalents

Cash and cash equivalents comprised the following as at:

	31 December 2014	31 December 2013
Cash in transit	997	620
Correspondent and settlement accounts	940	2,428
Cash on hand	23	13
Other cash equivalents	4	3
Total cash and cash equivalents	1,964	3,064

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

9. Cash and cash equivalents (continued)

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

	31 December 2014	31 December 2013
AZN dominated bank balances	1,884	2,994
USD dominated bank balances	45	44
EUR dominated bank balances	12	13
Cash on hand	23	13
Total cash and cash equivalents	1,964	3,064

Restricted cash comprised the following as at:

	31 December 2014	31 December 2013
VAT deposit account	151	–
Account at the State Treasury	5,556	3,131
Total restricted cash	5,707	3,131

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 day notice to the tax authorities.

10. Share capital

Share capital of the Group comprised the following as at:

	31 December 2014		31 December 2013	
	Number of shares	Share capital	Number of shares	Share capital
“Azersu” OJSC	20,000,000	400,000	20,000,000	400,000
Subsidiaries:				
“Sutikinti” Division	100	1,423	100	1,423
Production and Technical Procurement Department	–	6	–	6
“Sukanal” Scientific Research and Design Institute	–	131	–	131
“Ganja Sukanal” OJSC	383,640	7,673	383,640	7,673
“Aghdash Sukanal” OJSC	53,568	1,071	53,568	1,071
“Goychay Sukanal” OJSC	53,568	1,071	53,568	1,071
“Sheki Sukanal” OJSC	95,663	1,914	95,663	1,914
“Birleshmish Sukanal” LLC	4,063,722	81,274	4,063,722	81,274

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

10. Share capital (continued)

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 2014 and 31 December 2013 “Azersu” OJSC had authorized and issued 20,000,000 shares at par AZN 20. “Azersu” OJSC has ultimate control and 100% interest in all of its subsidiaries.

During 2014 the Group recorded additional paid-in capital in the amount of AZN 24,546 (2013: nil) based on value of the completed investment projects accepted by the Government.

During 2014 in accordance with the Group’s accounting policy, AZN 16,838 (2013: AZN 59,805) subscription receivable was settled against the Government investments based on value of the completed investment projects accepted by the Government.

11. Government investments

Government investments comprised the following as at:

	31 December 2014	31 December 2013
Non-financial asset investments	223,643	221,346
Investments financed from the State Budget	3,150,731	2,771,066
Investments financed from international financial organizations under the state guarantee	282,566	163,619
Total Government investments	3,656,940	3,156,031

The balance of Government investments comprised funding made from the State Budget to finance various capital and other expenditures of the Group, Government borrowings from international financial institutions and non-financial assets granted to the Group by the Government.

During 2014, fair value of non-financial assets granted from the various budget organizations at the date of transition amounted to AZN 2,512 (2013: AZN 4,630).

12. Interest-bearing loans and borrowings

Interest-bearing loans and borrowings comprised the following:

	31 December 2014	31 December 2013
Government loans financed by international financial institutions	90,204	100,922
Government loans from the Ministry of Finance	201,793	100,000
Loan from local bank	3,685	5,180
Total loans	295,682	206,102

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

12. Interest-bearing loans and borrowings (continued)

Current portion of loans of the Group were represented by the following financial institutions:

Financial institution	Contractual interest rate	Original currency	Maturity date	31 December 2014	31 December 2013
World Bank (IDA)	0.75%	SDR	May 2030	3,079	1,176
World Bank (IDA)	0.75%	SDR	November 2037	510	293
KfW	0.75%	EUR	December 2032	698	631
KfW	0.75%	EUR	June 2020	54	–
Natixis	2.45%	EUR	September 2030	2,973	2,062
ADB	2.5%	SDR	November 2036	453	346
Capital Bank	8%	AZN	June 2015	3,685	5,180
Ministry of Finance	0%	AZN	On demand	201,793	100,000
Total short-term loans and current portion of long-term loans				213,245	109,688

Non-current portion of loans of the Group were represented by the following financial institutions:

Financial institution	Contractual interest rate	Original currency	Maturity date	31 December 2014	31 December 2013
World Bank (IDA)	0.75%	SDR	May 2030	28,479	34,856
World Bank (IDA)	0.75%	SDR	November 2037	3,633	4,718
KfW	0.75%	EUR	December 2032	9,905	11,809
KfW	0.75%	EUR	June 2020	6,738	4,226
Natixis	2.45%	EUR	September 2030	27,798	34,749
ADB	2.5%	SDR	November 2036	5,884	6,056
Total long-term loans				82,437	96,414

Loans from international financial institutions

Loans from international financial institutions represent lending for the financing of projects related to development and improvement of water supply system of the Republic of Azerbaijan lent 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.

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 thousand (AZN 44,092). On 30 June 2003 the Government signed another loan agreement with IDA for the amount of SDR 9,673 thousand (AZN 10,993). The annual effective interest rate under these loan agreements is 0.75% and they are repayable until 2030 and 2037, respectively. These loans were lent for the financing of the project “Greater Baku Water Supply Rehabilitation Project”. There were no drawdowns in relation to these loans during 2014 and 2013.

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

12. Interest-bearing loans and borrowings (continued)

Loans from KfW

On 25 September 2006 two loans were lent to the Government by Kreditanstalt für Wiederaufbau (“KfW”) German government-owned development bank, in the amount of EUR 14,827 thousand (AZN 14,119) and EUR 26,350 thousand (AZN 25,091), at 0.75% and 0.75% annual effective interest rate and repayable until 2032 and 2020, respectively. The loans were lent for the financing of the project “Open Program Municipal infrastructure”. As at 31 December 2014 total drawn amount under the loans amounted EUR 13,518 thousand (AZN 12,871) and EUR 7,137 thousand (AZN 6,796), respectively (31 December 2013: EUR 13,046 thousand (AZN 11,478) and EUR 3,924 thousand (AZN 4,072), respectively).

Loan from Natixis

On 30 September 2006 the loan was lent 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 thousand (AZN 33,327) at 2.45% annual effective interest rate and repayable until 2030. The loan was lent 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 lent to the Government by the Asian Development Bank (“ADB”), in the amount of SDR 5,428 thousand (AZN 6,168) at 2.5% annual effective interest rate and repayable until 2036. The loan was lent for the financing of the project “Urban Water Supply and Sanitation Project”. There were no drawdowns in relation to this loan during 2014 and 2013.

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 March 2015 the loan is fully repayable in June 2015. The interest rate under the loan agreement is 8% per annum.

Loan from the Ministry of Finance

On 14 August 2013 the Group received interest free loan from the Ministry of Finance in the amount of AZN 100,000 that was fully utilized by the Group as at 31 December 2013 for financing of the ongoing infrastructure projects. The loan’s annual effective interest rate is 5.75%. The loan was settled subsequently in full on 29 January 2014 against the budgeted funds allotted to the Group from the State Budget.

On 28 February 2014, the Group received new interest free loan from the Ministry of Finance in the amount of AZN 203,554 which was utilized by the Group as at 31 December 2014 for financing of the ongoing infrastructure projects. The loan’s annual effective interest rate is 5%. The loan was settled subsequently in full in April 2015 against the budgeted funds allotted to the Group from the State Budget.

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

13. Provisions

Provisions comprised the following as at:

	31 December 2014	31 December 2013
Unused vacations	7,267	6,383
Provisions for environmental obligations (Note 23)	–	1,308
Provision for employee injuries	176	175
Provision for court cases	3,725	2,833
Total provisions	11,168	10,699

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 5.30% as at 31 December 2014 (31 December 2013: 7.02%). 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.

14. Other taxes and penalties payable

Other taxes and penalties payable comprised the following as at:

	31 December 2014	31 December 2013
VAT	33,253	19,446
Economic and financial sanctions	21,269	11,016
Property tax	2,417	1,084
Withholding tax	1,266	787
Land tax	991	51
Income tax	358	2,177
Road tax	250	143
Other taxes	–	4,558
Total other taxes and penalties	59,804	39,262

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

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

15. Trade and other payables

Trade and other payables comprised the following as at:

	31 December 2014	31 December 2013
Construction related payables	289,364	170,124
Trade payables	102,877	93,486
Accrued liabilities	19,617	13,148
Other payables	1,079	157
Total financial payables	412,937	276,915
Payable to Social Security Fund	21,393	18,542
Payables to employees	4,326	4,508
Payable to the Ministry of Finance	–	4,420
Total trade and other payables	438,656	304,385

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.

16. 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 2014 compensation of key management personnel totaled to AZN 143 (2013: AZN 123).

All transactions with the Government are disclosed in the Note 10, Note 11, Note 12 and Note 24.

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:

		Government and entities under government control	
	Note	31 December 2014	31 December 2013
Gross amounts of trade receivables		43,284	36,811
Impairment provisions for trade receivables		(37,243)	(19,397)
Other receivables		111	122
Cash and cash equivalents		119	108
Restricted cash	9	5,707	3,131
Long-term borrowings	12	(82,437)	(96,414)
Short-term borrowings		(209,561)	(104,508)
Trade and other payables		(45,549)	(38,044)

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

16. Balances and transactions with related parties (continued)

Key management compensation (continued)

The transactions with related parties for the year ended 31 December 2014 and 2013 were as follows:

	Note	Government and entities under government control	
		2014	2013
Sales revenue		34,125	30,008
Energy costs	19	(32,823)	(32,794)
Security costs		(3,813)	(3,487)
Water purchase		(5,000)	(4,974)
Other expenses		(24,019)	(20,358)
Communication		(129)	(158)

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 lent 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.

17. 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 program 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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

17. Financial risk management (continued)

Currency risk (continued)

The following tables demonstrate 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 2014	Change in rates (+/-)	Effect on profit
USD / AZN	35%	(6,552) / 6,552
EUR / AZN	35%	(15,212) / 15,212
SDR / AZN	1%	(336) / 336

31 December 2013	Change in rates (+/-)	Effect on profit
USD / AZN	1.37%	(267) / 267
EUR / AZN	10.16%	(4,931) / 4,931
SDR / AZN	1%	(380) / 380

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

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 2014	31 December 2013
Cash and cash equivalents	1,941	3,051
Trade and other receivables	10,388	14,921
Total maximum exposure to credit risk	12,329	17,972

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 consolidated financial statements for all debtors which are not expected to be recovered in a future.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

17. Financial risk management (continued)

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.

The maturity analysis of financial liabilities is as follows:

At 31 December 2014	Less than 3 months	3-12 months	1-5 years	More than 5 years	Total
Trade and other financial payables	411,380	–	–	–	411,380
Interest-bearing loans and borrowings	203,935	11,039	41,996	47,902	304,872
Total undiscounted financial liabilities	615,315	11,039	41,996	47,902	716,252

At 31 December 2013	Less than 3 months	3-12 months	1-5 years	More than 5 years	Total
Trade and other financial payables	276,915	–	–	–	276,915
Interest-bearing loans and borrowings	100,282	10,752	31,102	74,618	216,754
Total undiscounted financial liabilities	377,197	10,752	31,102	74,618	493,669

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 of Azerbaijan Republic and periodically receives funds in form of Government investment 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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

17. Financial risk management (continued)

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.

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 consolidated financial statements.

As at 31 December 2014	Carrying value	Fair value
Cash and cash equivalents	1,941	1,941
Trade and other financial receivables	10,388	10,388
Trade and other financial payables	(438,656)	(438,656)
Long-term bank loans	(82,437)	(57,597)
Short-term bank loans	(213,245)	(213,245)
As at 31 December 2013	Carrying value	Fair value
Cash and cash equivalents	3,051	3,051
Trade and other financial receivables	14,921	14,921
Trade and other financial payables	(276,915)	(276,915)
Long-term bank loans	(96,414)	(42,890)
Short-term bank loans	(109,688)	(109,688)

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

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

18. Sales revenue

Sales revenue comprised the following:

	Year ended 31 December 2014	Year ended 31 December 2013
Sales of water	119,162	110,304
Sewerage services	17,730	17,154
Other sales revenue	4,087	7,399
Total sales revenue	140,979	134,857

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

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

19. Expenses

For the year ended 31 December 2014 and 2013, cost of sales, administrative expenses, selling and distribution expenses and other operating expenses comprised the following:

2014	Cost of sales	Administrative expenses	Selling and distribution expenses	Other operating expenses	Total
Impairment of property, plant and equipment	–	–	–	836,171	836,171
Impairment of intangible assets	–	–	–	1,019	1,019
Wages, salaries and social security costs	30,635	4,230	40,263	–	75,128
Depreciation of property, plant and equipment	6,293	2,053	3,683	–	12,029
Amortization cost	–	165	–	–	165
Energy expenses	26,440	57	6,326	–	32,823
Raw materials and consumables used	9,067	782	4,771	–	14,620
Repairs and maintenance expenses	1,810	107	9,598	–	11,515
Training, Education and Business development costs	–	6,780	–	–	6,780
Economic sanctions and other Penalties	3,098	1,810	2,062	–	6,970
Security expenses	3,608	180	25	–	3,813
Fuel expenses	2,406	–	614	–	3,020
Taxes other than income tax	1,601	1,016	820	–	3,437
Change in other provisions and liabilities	–	1,775	–	–	1,775
Impairment of trade and other receivables	–	–	20,459	–	20,459
Bank expenses	244	1,663	352	–	2,259
Business trip expenses	254	143	209	–	606
Rent expenses	101	604	732	–	1,437
Communication expenses	110	324	443	–	877
Insurance expenses	318	151	391	–	860
Loss on disposal of property, plant and equipment	42	–	711	–	753
Provisions on prepayment	–	6,159	–	–	6,159
Other expenses	1,964	1,876	3,453	–	7,293
	87,991	29,875	94,912	837,190	1,049,968

“AZERSU” OJSC

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

19. Expenses (continued)

2013 (restated)	Cost of sales	Administrative expenses	Selling and distribution expenses	Other operating expenses	Total
Impairment of property, plant and equipment	–	–	–	987,521	987,521
Wages, salaries and social security costs	28,346	4,320	35,001	–	67,667
Depreciation of property, plant and equipment	17,085	4,245	8,176	–	29,506
Energy expenses	26,174	75	6,545	–	32,794
Raw materials and consumables used	6,865	669	6,421	–	13,955
Repairs and maintenance expenses	2,686	–	11,157	–	13,843
Training, Education and Business development costs	–	9,103	–	–	9,103
Economic sanctions and other Penalties	3,230	1,500	1,471	–	6,201
Security expenses	3,334	145	8	–	3,487
Fuel expenses	1,996	–	482	–	2,478
Taxes other than income tax	1,065	128	655	–	1,848
Change in other provisions and liabilities	–	3,630	–	–	3,630
Impairment of trade and other receivables	–	–	11,969	–	11,969
Bank expenses	237	867	376	–	1,480
Business trip expenses	288	223	267	–	778
Rent expenses	62	247	586	–	895
Communication expenses	115	359	328	–	802
Insurance expenses	362	17	115	–	494
Loss on disposal of property, plant and equipment	400	–	1,283	–	1,683
Other expenses	1,009	5,128	1,676	–	7,813
	93,254	30,656	86,516	987,521	1,197,947

20. Other income

Other income comprised the following:

	Year ended 31 December 2014	Year ended 31 December 2013 (restated)
Investment from Balakhany Social Development Fund	1,799	6,753
Investment from Ministry of Foreign Affairs and Trade of the Republic of Korea (KOICA)	4,606	6,158
Gain on reversal of provision for environmental damage	1,308	–
Foreign exchange gains	10,371	–
Other	5,254	2,182
Total other income	23,338	15,093

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

21. Income tax

Income tax expense comprised the following:

	Year ended 31 December 2014	Year ended 31 December 2013
Current income tax expense	(225)	(209)
Change in the deferred tax	214	271
Income tax (expense)/benefit for the year	(11)	62

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 2014	31 December 2013
Deductible temporary differences		
Property, plant and equipment	861	349
Trade and other payables	282	831
Provisions	34	61
Inventories	20	(258)
Other	2	2
Net deferred income tax asset	1,199	985

At 31 December 2014 and 31 December 2013 cumulative balance of unrecognized deferred tax asset from carry forward losses and other temporary differences amounted AZN 816,812 and AZN 641,643 respectively.

A reconciliation between tax expense and the product of accounting profit/(loss) multiplied by the Group's domestic tax rate for the year ended 31 December 2014 and 2013 is as follows:

	2014	2013
Loss before tax	(886,021)	(1,048,723)
Theoretical tax benefit at statutory rate of 20 per cent	177,204	209,745
Non-deductible expenses	(2,046)	(662)
Increase in unrecognized deferred tax asset	(175,169)	(209,021)
Income tax (expense)/benefit for the year	(11)	62

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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

22. 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:

	2014	2013
Construction works financed by the Government	408,307	839,829
Loan received from Ministry of Finance	203,554	100,000
Repayment of Group's loans by the Ministry of Finance	6,579	9,499
Grant Received from KOICA for the construction at Kurdaxani project	4,606	6,158
Grant received from KfW	1,610	–
Property, plant and equipment granted to the Group by the Government (Note 5)	2,512	4,630

As discussed in Note 9 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 years ended 31 December 2014 and 2013 amounted AZN 408,307 and AZN 839,829 respectively.

As discussed in Note 12, during 2014 the Group utilized loan facility in the amount of AZN 203,554 (2013: AZN 100,000) provided by the Ministry of Finance for financing of ongoing construction activities. All respective transactions have been processed through the Group's account at the State Treasury.

The Group received grant from KOICA for the construction project of water and sewage network at Kurdaxani region in the amounts of AZN 4,606 and AZN 6,158 during 2014 and 2013, respectively. All the disbursements were paid directly from KOICA to the vendors.

23. 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 does not possess a well-developed business and regulatory infrastructure that would generally exist in a more mature market economy.

The Republic of Azerbaijan continues economic reforms and development of its legal, tax and regulatory frameworks as required by the market economy. The future stability of the Azerbaijan economy is largely dependent upon these reforms and developments and the effectiveness of economic, financial and monetary measures undertaken by the government.

Considering significant drop in crude oil prices during second half of 2014, there continues to be uncertainty regarding economic growth, access to capital and cost of capital, which could negatively affect the Group's future financial position, results of operations and business prospects. In addition, as described in Note 24, Azerbaijani Manat has been devalued against major currencies by approximately 34% on 21 February 2015.

While management believes it is taking appropriate measures to support the sustainability of 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.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (continued)

(Amounts presented are in thousands of Azerbaijani manats, unless otherwise stated)

23. Contingences, commitments and operating risks (continued)

Operating environment (continued)

These 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.

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 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 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 liabilities for environmental damage.

24. Events after the reporting date

Following significant events took place subsequent to 31 December 2014:

- ▶ On 21 February 2015, Azerbaijani Manat has been devalued against US dollar and other major currencies by 34%. The exchange rates before and after devaluation was AZN 0.786 and AZN 1.050 to USD 1, respectively. This event could adversely affect the Group's future results and financial position. Management believes it is taking all necessary measures to support the sustainability and development of the Group's business in the foreseeable future.
- ▶ According to the Order of the Cabinet of Ministers of the Republic of Azerbaijan dated 30 December 2014, subsidies of AZN 415,390 were allocated to the Group for construction of the ongoing infrastructure projects and maintenance purposes. Respective financing has started from January 2015.
- ▶ As discussed in Note 12 the loan received from the Ministry of Finance in 2014 in the amount of AZN 203,554 was fully settled by the Group against subsidies allocated from the State Budget in April 2015.