

3 SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Sources of financing

Sources of financing represents the difference between financing received during the reporting year and the expenses incurred for the implementation of projects for which the financing was provided. Sources of financing are recognized as the financing is received, net of project expenses incurred. If the expenses of implemented projects accrued during the current year exceed the related financing received, then the difference included in the statement of changes in reserves is negative figure.

Loan revolving fund

Loan revolving fund represents donor funding received for the purposes of providing loan financing to municipalities, and is recognized at nominal value, when received. In the statement of changes in reserves increases or decreases of the loan revolving fund are presented net.

3.6.2. Unrestricted reserves

Reserves are unrestricted if their use is not restricted by donors. These include the MDF's retained earnings from its operations.

3.7. Income tax

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognized on temporary differences between the carrying amounts of asset and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit. Deferred tax liabilities are generally recognized for all taxable temporary differences.

The carrying amount of deferred tax assets is reviewed at the end of each reporting period and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the period in which the liability is settled or the asset realized, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

3.8. Income

Interest income

Interest income on loans to municipalities is recognized on an accrual basis of accounting using the effective interest rate method. Income earned on cash balances held at bank accounts is shown separately on the face of the statement of comprehensive income and are recognized on an accrual basis.

Other income

Other income mainly consists of income from released bank guarantees due to incompliance with tender regulations.

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4 PRIOR YEAR ADJUSTMENTS

The management has revealed that the income tax expense for the year ended 31 December 2011 amounting to GEL 504,419 was incorrectly recognized. The error has been corrected by adjusting prior year figures resulting in:

| | As restated | As previously reported |
|--|--------------------|-------------------------------|
| Current income tax assets / (Current income tax liability) | (191,712) | 312,707 |
| Retained surplus | 21,121,907 | 21,626,326 |
| Income tax expense | 786,050 | 281,631 |

5 PROPERTY AND EQUIPMENT

| | Leasehold improvement | Machinery and equipment | Motor vehicles | Furniture and other | Total |
|-----------------------------------|------------------------------|--------------------------------|-----------------------|----------------------------|------------------|
| COST | | | | | |
| 1 January 2011 | 911,159 | 1,335,503 | 1,210,577 | 274,067 | 3,731,306 |
| Additions | 242,588 | 88,147 | 606,659 | 4,287 | 941,681 |
| Disposals | - | (23,791) | (286,699) | (93,260) | (403,750) |
| 31 December 2011 | 1,153,747 | 1,399,859 | 1,530,537 | 185,094 | 4,269,237 |
| Additions | - | 45,343 | 113,171 | 45 | 158,559 |
| Disposals | - | (8,885) | (205,112) | (2,384) | (216,381) |
| 31 December 2012 | 1,153,747 | 1,436,317 | 1,438,596 | 182,755 | 4,211,415 |
| ACCUMULATED DEPRECIATION | | | | | |
| 1 January 2011 | 364,464 | 1,066,021 | 935,891 | 266,073 | 2,632,449 |
| Charge for the year | 229,862 | 98,129 | 170,359 | 8,587 | 506,937 |
| Eliminated on disposal | - | (23,791) | (286,699) | (93,260) | (403,750) |
| 31 December 2011 | 594,326 | 1,140,359 | 819,551 | 181,400 | 2,735,636 |
| Charge for the year | 230,749 | 84,138 | 190,714 | 2,963 | 508,564 |
| Eliminated on disposal | - | (739) | (196,836) | (2,284) | (199,859) |
| 31 December 2012 | 825,075 | 1,223,758 | 813,429 | 182,079 | 3,044,341 |
| NBV as at 31 December 2011 | 559,421 | 259,500 | 710,986 | 3,694 | 1,533,601 |
| NBV as at 31 December 2012 | 328,672 | 212,559 | 625,167 | 676 | 1,167,074 |

As at 31 December 2012 the cost of property and equipment with a carrying amount of nil is GEL 1,643,837 (2011: GEL 1,650,588). In 2012 the Fund received property and equipment of GEL 8,500 (2011: GEL 638,118) as in kind contribution.

In accordance with the Order No. 1-1/1419 of the Ministry of Economy of Georgia dated 20 September 2007; the Fund received the area on three floors of the administrative building situated at 150 Aghmashenebeli Avenue, Tbilisi, Georgia, and the respective portion of the land under the terms of "usufruct". The Fund may use the building and receive any economic benefits arising from its use, however the ownership title remain with the Ministry of Economy.

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6 LOANS TO MUNICIPALITIES

Major part of loans issued to municipalities represents loans issued within the scope of:

- Municipal Services Development Project – Phase I and II; and
- Regional and Municipal Infrastructure Development Project.

All the projects are implemented by the MDF under the loan agreements signed by the Government of Georgia with Asian Development Bank and with World Bank.

These projects foresee issuance of loans and grants to municipalities for subprojects for rehabilitation, construction and repair of existing municipal infrastructure. The projects include financing windows, as follows:

- Window 1 - sub-loans to municipalities that are deemed to be creditworthy, for subprojects with minimum beneficiary contribution of 20% of total subproject costs; and
- Window 2 - grants to municipalities that are not deemed to be creditworthy, for subprojects within minimum beneficiary contribution of 15% of total subproject costs.

Loans issued within the grant from Japanese Government are for the purpose of purchase of technical equipment and machinery for municipalities. Issuance of the loans started in 2006 and maturity for subprojects has not been yet reached.

Aforementioned loans carry interest rate of 12% and have maturity of 8 year for Japanese Government loans and 10 years for others, including grace period from 1 to 1.5 years.

There are also World Bank projects started in the period from 2000 to 2006:

- Municipal Development Decentralization Project 1 (MDDP1);
- Municipal Development Decentralization Project 2 (MDDP2).

These projects carry interest rate of 15% and have maturity period of 10 years. Insignificant portion of loan is left from MDDP1 by 31 December 2012, as maturity period for majority of subprojects was reached.

Loans to municipalities mature in 2013-2020 and bear a weighted average interest rate of 12.6% annually (2010: 12.8% annually). Loans to municipalities are stated in Georgian Lari and are not secured.

| | 2012 | 2011 |
|------------------------------------|-------------------|-------------------|
| Long-term loans to municipalities | 38,900,942 | 45,220,297 |
| Short-term loans to municipalities | 7,609,564 | 6,813,031 |
| | 46,510,506 | 52,033,328 |

Short-term loans to municipalities comprised of the following items:

| | 2012 | 2011 |
|-----------------------------|------------------|------------------|
| Principal amount receivable | 6,930,833 | 6,189,716 |
| Interest receivable | 673,014 | 621,520 |
| Penalties receivable | 5,717 | 1,795 |
| | 7,609,564 | 6,813,031 |

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6 LOANS TO MUNICIPALITIES (CONTINUED)

The gross amount of loans to municipalities is detailed below:

| Municipality | Current portion | Non-current portion | Total as at 31 December 2012 |
|---------------------|------------------------|----------------------------|-------------------------------------|
| Tbilisi | 2,126,571 | 4,440,533 | 6,567,104 |
| Rustavi | 651,965 | 4,824,350 | 5,476,315 |
| Zugdidi | 399,197 | 3,459,408 | 3,858,605 |
| Poti | 572,785 | 3,221,316 | 3,794,101 |
| Kobuleti | 271,265 | 3,438,465 | 3,709,730 |
| Gurjaani | 374,011 | 2,302,047 | 2,676,058 |
| Telavi | 355,660 | 2,030,519 | 2,386,179 |
| Batumi | 527,694 | 1,716,832 | 2,244,526 |
| Kutaisi | 603,585 | 1,446,650 | 2,050,235 |
| Bolnisi | 188,489 | 1,762,011 | 1,950,500 |
| Mtskheta | 184,252 | 1,648,843 | 1,833,095 |
| Dusheti | 191,763 | 1,600,800 | 1,792,563 |
| Marneuli | 111,023 | 1,042,773 | 1,153,796 |
| Akhalqalaqi | 96,694 | 904,298 | 1,000,992 |
| Ozurgeti | 260,710 | 713,490 | 974,200 |
| Khobi | 87,310 | 852,140 | 939,450 |
| Lagodekhi | 86,986 | 846,929 | 933,915 |
| Zestafoni | 111,155 | 738,346 | 849,501 |
| Gardabani | 61,035 | 611,500 | 672,535 |
| Gori | 161,698 | 428,132 | 589,830 |
| Borjomi | 84,504 | 504,316 | 588,820 |
| Tsalenjikha | 13,537 | 52,601 | 66,138 |
| Sighnaghi | 9,944 | 54,233 | 64,177 |
| Lentekhi | 9,370 | 53,630 | 63,000 |
| Sagarejo | 9,567 | 52,005 | 61,572 |
| Kaspi | 9,520 | 51,828 | 61,348 |
| Akhaltsikhe | 9,735 | 51,520 | 61,255 |
| Oni | 9,697 | 51,427 | 61,125 |
| Samtredia | 29,842 | - | 29,841 |
| | 7,609,564 | 38,900,942 | 46,510,506 |

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6 LOANS TO MUNICIPALITIES (CONTINUED)

| Municipality | Current portion | Non-current portion | Total as at 31 December 2011 |
|---------------------|------------------------|----------------------------|-------------------------------------|
| Tbilisi | 2,101,249 | 6,567,115 | 8,668,364 |
| Rustavi | 556,913 | 5,476,315 | 6,033,228 |
| Zugdidi | 370,538 | 3,858,592 | 4,229,130 |
| Kobuleti | 146,802 | 3,709,730 | 3,856,532 |
| Poti | 371,535 | 2,872,964 | 3,244,499 |
| Gurjaani | 265,963 | 2,464,043 | 2,730,006 |
| Kutaisi | 589,625 | 2,050,235 | 2,639,860 |
| Telavi | 273,691 | 2,233,030 | 2,506,721 |
| Batumi | 419,444 | 1,839,957 | 2,259,401 |
| Bolnisi | 167,275 | 1,950,500 | 2,117,775 |
| Mtskheta | 248,915 | 1,833,095 | 2,082,010 |
| Dusheti | 170,181 | 1,792,563 | 1,962,744 |
| Marneuli | 98,529 | 1,153,796 | 1,252,325 |
| Ozurgeti | 224,856 | 974,200 | 1,199,056 |
| Akhalqalaqi | 85,811 | 1,000,992 | 1,086,803 |
| Khobi | 143,421 | 939,565 | 1,082,986 |
| Lagodekhi | 77,196 | 933,915 | 1,011,111 |
| Zestafoni | 97,914 | 849,501 | 947,415 |
| Gori | 140,142 | 589,830 | 729,972 |
| Gardabani | 54,165 | 672,535 | 726,700 |
| Borjomi | 74,991 | 588,820 | 663,811 |
| Khelvachauri | 37,428 | 404,569 | 441,997 |
| Sighnaghi | 8,863 | 64,190 | 73,053 |
| Lentekhi | 8,316 | 63,000 | 71,316 |
| Tsalenjikha | 8,360 | 62,124 | 70,484 |
| Sagarejo | 8,491 | 61,572 | 70,063 |
| Akhaltzikhe | 8,639 | 61,254 | 69,893 |
| Kaspi | 8,446 | 61,348 | 69,794 |
| Oni | 8,607 | 61,128 | 69,735 |
| Samtredia | 25,708 | 29,819 | 55,527 |
| Ambrolauri | 11,017 | - | 11,017 |
| | 6,813,031 | 45,220,297 | 52,033,328 |

The right to borrow from the MDF under the programme funded by the World Bank and the Asian Development Bank is granted to the Municipality by the Governmental Decree, signed by the Prime Minister or Georgia. Prior to signing each loan agreement between the Ministry of Finance and donors, the MDF conducts the analysis creditworthiness of the municipalities. Information regarding the municipalities' solvency positions is provided by the Ministry of Finance.

6 LOANS TO MUNICIPALITIES (CONTINUED)

Telavi Municipality (Kakheti region). The total balance of the loan outstanding as at 31 December 2012 amounted to GEL 2,386,179. Delays in loan repayments from Telavi Municipality appeared because of the natural disaster that occurred in Telavi in August 2012. Based on the mutual agreement between the Ministry of Finance, the Ministry of Regional Development and Infrastructure (the MRDI), the MDF and the Telavi Municipality, the loan was rescheduled. GEL 370,000 of the overdue amount will be repaid during one year ending June 2014. GEL 130,000 including principal, interest and penalties will be repaid during 2013. In total, until 31 December 2013, Telavi municipality is expected to repay the total of GEL 360,000 including the portion of rescheduled overdue debt and the remaining amount due under the original loan repayment schedule.

Gurjaani Municipality (Kakheti Region) The total balance of the loan outstanding as at 31 December 2012 amounted to GEL 2,676,058. In 2010, the MDF started the implementation of Gurjaani water supply and rehabilitation project (World Bank RMIDP financed). The project was completed only in 2013 due to implementation delays and resulting amendments to the original credit agreement. The last amendment was in connection with the additional works requested by the Municipality. The original project value of GEL 1.5 million was increased to GEL 1.76 million. The current act of completion of works has not been submitted as of the current date and therefore no amendment in the loan repayment schedule has been submitted and signed by Municipality. As soon as the official procedure is completed, Gurjaani will start the repayment of the loan.

Poti Municipality (Samegrelo Region). The total balance of the loan outstanding as at 31 December 2012 amounted to GEL 3,794,101. The investment agreement relating to the rehabilitation of the water supply system was signed with the Poti municipality. In December 2012 the total rehabilitation project for the value of GEL 12.34 million was completed of which GEL 1.85 million constituted the loan receivable from Poti Municipality. At the same time the rehabilitation of sewage system implemented under the same donor financing was completed with the total value of GEL 599 thousand of which GEL 291 thousand constituted the loan receivable from Poti Municipality. Both of the completed assets were transferred by the Government decree to the United Water Supply Company (the UWSC). Based on the investment agreement clause 3.6, Poti's mayor's office had no right to transfer or to pledge in the form of collateral the assets completed under the above projects without prior consent of the MDF. Therefore, all liabilities relating to the repayment of the above loans formally remain with the Poti municipality. The MDF has requested the MRDI to settle the current issue as formally both the UWSC and the MDF report directly to the MRDI. The issue is currently being considered by the MRDI. The decision to be made is who is to be considered the borrower under the projects – the Poti Municipality or the UWSC.

Taking into consideration all the facts described above, the Management of MDF does not anticipate any problems related to the collectability of the amounts mentioned above, and, therefore, believes that no allowance for impairment needs to be recognised in the financial statements.

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7 RECEIVABLES AND ADVANCES

| | <u>2012</u> | <u>2011</u> |
|-------------------------|--------------------------|-------------------------|
| Advances to contractors | 17,298,189 | 6,832,393 |
| Other | 81,383 | 142,554 |
| | <u>17,379,572</u> | <u>6,974,947</u> |

Advances to contractors were paid in accordance with contracts signed within the framework of approved projects. Advances to contractors were paid in accordance with contracts signed within the framework of approved projects. Advances to contractors comprise of advances paid to construction companies for construction and rehabilitation of water supply systems, municipal roads, public schools, houses for internally displaced persons amounting to GEL 14,941,933 (2011: GEL 6,541,140), advances paid for acquisition of certain goods amounting to GEL 750,911 (2011: GEL 29,003) and for supervision of construction works amounting to GEL 1,605,345 (2011: GEL 262,250). Advances to contractors are redeemed proportionately to performance of works and services. According to contractual terms advances given to contractors are to be fully redeemed at the point of 80% of completion of construction works and services provided. All advances paid are fully secured by bank guarantees.

7 BANK BALANCES

| | <u>2012</u> | <u>2011</u> |
|--------------------------|--------------------------|--------------------------|
| Commercial bank accounts | 25,357,624 | 18,969,834 |
| State treasury accounts | 58,416,102 | 41,570,304 |
| | <u>83,773,726</u> | <u>60,540,138</u> |

8 DEFERRED INCOME TAX

The movement of deferred income tax is disclosed below:

| | <u>2012</u> | <u>2011</u> |
|---|----------------------|------------------------|
| Balance at the beginning of year | (26,720) | (61,361) |
| Credited to statement of comprehensive income (refer to Note 9) | 112,784 | 34,641 |
| | <u>86,064</u> | <u>(26,720)</u> |

Deferred income tax for the year ended 31 December 2012 is summarized as follows:

| | <u>1 January 2012</u> | <u>Recognized in the statement of comprehensive income</u> | <u>31 December 2012</u> |
|---|---------------------------|--|---------------------------------|
| <i>Deferred income tax assets/(liability)</i> | | | |
| Property and equipment | 89,188 | (2,580) | 86,609 |
| Intangible assets | (106) | (438) | (544) |
| Loans to municipalities | 16,223 | (16,223) | - |
| Receivables and advances | 5,524 | (5,524) | - |
| Bank balances | (131,371) | 131,371 | - |
| Accounts payable | (6,178) | 6,178 | - |
| Net position – deferred income tax asset/(liability) | <u>(26,720)</u> | <u>112,784</u> | <u>86,064</u> |

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9 DEFERRED INCOME TAX (CONTINUED)

Deferred income tax for the year ended 31 December 2011 is summarized as follows:

| | 1 January 2011 | Recognized in the statement of comprehensive income | 31 December 2011 |
|---|------------------------|---|------------------------|
| <i>Deferred income tax assets</i> | | | |
| Property and equipment | 44,819 | 111,875 | 156,694 |
| Intangible assets | 1,244 | - | 1,244 |
| Loans to municipalities | 12,665 | 3,944 | 16,609 |
| Receivables and advances | 5,524 | - | 5,524 |
| Accounts payable | 5,758 | 180 | 5,938 |
| | <u>70,010</u> | <u>115,999</u> | <u>186,009</u> |
| <i>Deferred income tax liabilities</i> | | | |
| Property and equipment | - | (67,506) | (67,506) |
| Intangible assets | - | (1,350) | (1,350) |
| Loans to municipalities | - | (386) | (386) |
| Receivables and advances | - | - | - |
| Bank balances | (131,371) | - | (131,371) |
| Accounts payable | - | (12,116) | (12,116) |
| | <u>(131,371)</u> | <u>(81,358)</u> | <u>(212,729)</u> |
| Net position – deferred income tax asset/(liability) | <u>(61,361)</u> | <u>34,641</u> | <u>(26,720)</u> |

10 ACCOUNTS PAYABLE

| | 2012 | 2011 |
|---------------------------------------|-------------------|------------------|
| Retentions payable to contractors | 8,130,360 | 4,523,594 |
| Payable to contractors and suppliers | 6,343,655 | 292,275 |
| Advances received from municipalities | 586,944 | 918,993 |
| Taxes other than income tax | 10,591 | 337,205 |
| Other payables | 56,209 | 11,651 |
| | <u>15,127,759</u> | <u>6,083,718</u> |

The Fund retains 5% of the invoice amounts under the category of "Construction works" in the framework of implemented project expenditures for possible future losses. Those amounts are subject to payment to constructors one year after the construction works are completed.

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11 PAYABLES TO GOVERNMENT

In the year ended 31 December 2012 the Fund received a guarantee payment from a bank amounting to GEL 2,400,278. The guarantee was related to the Renewable Energy Project that was not realised. The management recognised this amount as a liability to the Government of Georgia. However there is no ultimate decision regarding the status of this amount. A possible alternative treatment of this transaction is to recognise it as a gain. In this case an income tax amounting to GEL 360,042 and penalties related thereto might need to be recognised.

12 INTEREST INCOME FROM LOANS TO MUNICIPALITIES

| | <u>2012</u> | <u>2011</u> |
|-----------------------|-------------------------|-------------------------|
| Interest income | 6,209,180 | 6,408,133 |
| Income from penalties | <u>8,721</u> | <u>25,990</u> |
| | <u>6,217,901</u> | <u>6,434,123</u> |

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12 INCOME FROM LOANS TO MUNICIPALITIES (CONTINUED)

Interest income from loans to municipalities is detailed below:

| Municipality | 2012 | 2011 |
|---------------------|-------------------------|-------------------------|
| Tbilisi | 1,080,506 | 1,440,457 |
| Rustavi | 709,404 | 671,048 |
| Zugdidi | 487,199 | 516,809 |
| Kobuleti | 454,718 | 132,118 |
| Poti | 400,808 | 276,825 |
| Kutaisi | 350,142 | 441,928 |
| Batumi | 344,776 | 352,422 |
| Gurjaani | 305,198 | 316,978 |
| Telavi | 279,349 | 238,016 |
| Bolnisi | 245,129 | 263,445 |
| Mtskheta | 230,794 | 240,895 |
| Dusheti | 226,370 | 245,154 |
| Ozurgeti | 162,811 | 193,735 |
| Marneuli | 144,975 | 155,570 |
| Akhalqalaqi | 125,797 | 134,231 |
| Khobi | 117,721 | 124,415 |
| Lagodekhi | 113,578 | 120,117 |
| Zestafoni | 111,306 | 122,958 |
| Gori | 95,562 | 114,705 |
| Gardabani | 84,291 | 90,384 |
| Borjomi | 75,622 | 84,060 |
| Sighnaghi | 8,287 | 9,283 |
| Lentekhi | 8,112 | 9,045 |
| Tsalenjikha | 7,996 | 8,936 |
| Sagarejo | 7,949 | 8,906 |
| Kaspi | 7,922 | 8,873 |
| Akhaltzikhe | 7,921 | 8,895 |
| Oni | 7,906 | 8,874 |
| Samtredia | 6,614 | 10,177 |
| Ambrolauri | 417 | 3,636 |
| Khelvachauri | - | 55,238 |
| | <u>6,209,180</u> | <u>6,408,133</u> |

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13 OTHER INCOME

| | <u>2012</u> | <u>2011</u> |
|--|-----------------------|-------------------------|
| Income from insurance and court compensation | 184,304 | 49,995 |
| Income from management fees | 164,735 | 309,398 |
| Income from grants related to assets | 135,780 | 109,853 |
| Income from penalties related to projects | 31,817 | 1,641,733 |
| Other | 118,629 | 60,673 |
| | <u>635,265</u> | <u>2,171,652</u> |

14 ADMINISTRATIVE AND GENERAL EXPENSES

| | <u>2012</u> | <u>2011</u> |
|--|-------------------------|-------------------------|
| Employee benefits | 1,206,969 | 1,669,830 |
| Depreciation and amortization | 519,071 | 514,525 |
| Office expenses | 116,983 | 121,342 |
| Trips, transportation, advertising and representation expenses | 111,162 | 423,442 |
| Audit and consulting | 43,392 | 44,034 |
| Non-reimbursable taxes | 40,367 | 50,043 |
| Communication costs | 27,761 | 60,017 |
| Bank charges | 23,636 | 17,748 |
| Other | 47,232 | 43,396 |
| | <u>2,136,573</u> | <u>2,944,377</u> |

15 INCOME TAX EXPENSE

| | <u>2012</u> | <u>2011</u> |
|--------------------------------|-----------------------|-----------------------|
| Current tax | 787,264 | 820,691 |
| Deferred tax (refer to Note 9) | (112,784) | (34,641) |
| | <u>674,480</u> | <u>786,050</u> |

Reconciliation of effective tax rate is as follows:

| | <u>2012</u> | <u>Effective tax rate</u> | <u>2011</u> | <u>Effective tax rate</u> |
|--|-----------------------|-------------------------------|-----------------------|-------------------------------|
| Profit before taxation (under IFRS) | 9,062,463 | | 3,365,850 | |
| Tax calculated at the tax rate of 15% (2011: 15%) | 1,359,369 | 15.00% | 504,878 | 15.00% |
| Non taxable items, net / (Non- deductible items, net) | (684,889) | (7.56%) | 281,172 | 8.35% |
| Income tax expense | <u>674,480</u> | <u>7.44%</u> | <u>786,050</u> | <u>23.35%</u> |

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16 FINANCIAL INSTRUMENTS

17.1. Significant accounting policies

Details of the significant accounting policies and methods adopted, including the criteria for recognition and the basis on which income and expenses are recognized, in respect of each class of financial asset, financial liability and equity instrument are disclosed in the "Financial Procedures" which is part of "Operational Manual" of the Fund. Mentioned documents are adopted by Supervisory Board of the Fund.

17.2. Categories of financial instruments

| <i>Financial assets</i> | 2012 | 2011 |
|-------------------------------|--------------------|--------------------|
| Loans and receivables | 46,587,719 | 52,093,254 |
| Bank balances | 83,773,726 | 60,540,138 |
| | 130,361,445 | 112,633,392 |
| | | |
| <i>Financial liabilities</i> | 2012 | 2011 |
| Liabilities at amortized cost | 16,874,293 | 4,815,869 |
| | 16,874,293 | 4,815,869 |

17 RISK MANAGEMENT

Exposure to market risk (including currency risk and interest rate risk), credit risk and liquidity risk arises in the normal course of the MDF's business. All loans issued by the MDF are preliminary reviewed and approved by the Supervisory Board. Based on the World Bank consultant's market risk report the Supervisory Board reviews the MDF's forecasts and operational budget for its further activity. The MDF strongly follows the approved budget. Any changes in the budget or unexpected activities are subject of discussion and additional approval by the Supervisory Board.

18.1. Market risk

The MDF's activities expose it primarily to the financial risks of changes in foreign currency exchange rates, interest rates and credit risk (see below).

18 RISK MANAGEMENT

18.2. Foreign currency risk management

The MDF undertakes certain transactions denominated in foreign currencies. Hence, exposures to exchange rate fluctuations arise, but such fluctuations are related only with the World Bank financed projects, where exchange rate fluctuations primarily are reflected on the financing of mentioned projects:

- a) An increase of SDR exchange rate against USD respectively increases financing from the World Bank;
- b) An increase or decrease of GEL exchange rate against USD respectively reflects on the value of expenditures incurred in the framework of implemented projects.

The exposure of the MDF's financial assets and liabilities to the foreign currency risk is as follows:

| <i>Financial assets</i> | Freely convertible currencies | |
|------------------------------|--------------------------------------|-------------------|
| | 2012 | 2011 |
| Loans and receivables | - | 59,926 |
| Bank balances | 64,132,635 | 48,757,176 |
| | 64,132,635 | 48,817,102 |
| | | |
| <i>Financial liabilities</i> | 2012 | 2011 |
| Accounts payable | - | 45,570 |
| | - | 45,570 |
| Net position | 64,132,635 | 48,771,532 |

18.3. Interest rate risk management

MDF is exposed to interest rate risk as it issues loans to municipalities at the fixed interest rates. Interest rate for loans to municipalities is regulated by DCA, signed between Donor and Georgian Government.

The following table reconciles the average contractual and effective interest rates:

| | Average interest rate in 2012 | |
|--------------------------------|--------------------------------------|------------------|
| | Contractual | Effective |
| <i>Assets</i> | | |
| <i>Current bank accounts</i> | | |
| GEL | 10.5% | 11.0% |
| USD | 4.0% | 4.1% |
| EUR | 4.0% | 4.1% |
| <i>Loans to municipalities</i> | | |
| GEL | 12.6% | 13.4% |

18 RISK MANAGEMENT

| | Average interest rate in 2011 | |
|------------------------------------|--------------------------------------|------------------|
| | Contractual | Effective |
| Assets | | |
| <i>Current bank accounts</i> | | |
| GEL | 12.6% | 13.3% |
| USD | 7.8% | 8.1% |
| <i>Loans to municipalities</i> | | |
| GEL | 12.8% | 13.6% |

18.4. Credit risk management

Credit risk refers to the risk that counterparty will default on its contractual obligations resulting in financial loss to the MDF. The MDF has adopted a policy of only dealing with creditworthy counterparties as a means of mitigating risk of financial loss from defaults.

18.5. Liquidity risk management

The MDF's policy is to run a prudent liquidity management policy by means of holding sufficient cash and cash equivalents, as well as highly liquid assets for making all operational and debt service related payments when those become due.

18.6. Fair values

Management believes that the carrying amount of financial assets and financial liabilities recorded at amortized cost in the financial statements approximates their fair values.

Due to the lack of liquidity and published "indicator interest rates" in the Georgian market, and the fact that part of the MDF's transactions are with related parties and are of specialized nature, it has not been practicable to determine the fair values of receivables from and payables to related parties.

19 CONTINGENCIES

19.1. Operating environment

Georgia continues to undergo political and economic changes. As an emerging market, Georgia does not possess a regulatory infrastructure that generally exists in a more mature free market economy. Consequently, operations carried out in Georgia involve certain risks that are not typically associated with those in developed countries.

The Fund could be affected, for the foreseeable future, by these risks and their consequences. Financial statements of the Fund do not include any adjustments that may result from the future clarification of these uncertainties. Such adjustments, if any, will be reported in the Fund's financial statements in the period when they become known and estimable.

In addition, economic conditions continue to limit the volume of activity in the financial markets. Market quotations in generally illiquid markets may not be reflective of the values for financial instruments, which would be determined in an efficient, active market involving many willing buyers and willing sellers.

19 CONTINGENCIES (CONTINUED)

19.2. Insurance

The Georgian insurance industry is in its development stage and many forms of insurance protection common in other parts of the world are not yet generally available in Georgia. MDF does not have full coverage for its plant facilities, business interruption, or third party liability in respect of property or environmental damage arising from accidents on the MDF property or relating to the MDF operations. Until the Fund obtains adequate insurance coverage, there is a risk that the loss or destruction of certain assets or environmental damage could have a materially adverse effect on the Fund's operations and financial position.

19.3. Taxes

The taxation system in Georgia is relatively new and is characterized by frequently changing legislation, which is often subject to interpretation. Often differing interpretations exist among various taxation authorities and jurisdictions. Taxes are subject to review and investigations by tax authorities, which are enabled by law to impose severe fines and penalties.

These facts may create tax risks in Georgia substantially more than in other developed countries. Management believes that it has adequately provided for tax liabilities based on its interpretation of tax legislation. However, the relevant authorities may have differing interpretations and the effects could be significant.

19.4. Environmental matters

Management is of the opinion that the MDF has met the Government's requirements concerning environmental matters and, therefore, believes that the MDF does not have any current material environmental liabilities. However, environmental legislation in Georgia is in process of development and potential changes in the legislation and its interpretation may give rise to material liabilities in the future.

20 RELATED PARTY TRANSACTIONS

The Fund's related parties include Government of Georgia, all ministries and governmental agencies, key management and others as described below.

During 2012 and 2011, the Fund received co-financing from the Government of Georgia for Projects implementations.

20.1. Transactions with management and close family members

Directors of the Fund and their close family members as of 31 December 2012 and 31 December 2011 had no transactions or balance with the Fund.

Key management received the following remuneration of GEL 593,197 for the reporting year (2011: 1,079,557).

21 SUBSEQUENT EVENTS

In 2013 the Fund lost the litigation started in 2012. As a result the MDF is liable to pay GEL 74,018 in favour of Safari JSC.