

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

**CONSOLIDATED ANNUAL DIRECTORS' REPORT AND
CONSOLIDATED FINANCIAL STATEMENTS**

31 December 2016

FUND FOR LOCAL AUTHORITIES AND GOVERNMENTS IN BULGARIA – FLAG JSC

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General information

Board of directors

Dobromir Prodanov Simidchiev - Chairperson
Plamen Todorov Iliev - member
Malina Valentinova Krumova - member
Larisa Manastirli - member
Nadya Yordanova Dankinova – member and executive director
Maria Blagoeva Lazarova– member
Yulia Petkova Tsolova–Ilieva – member

Registered address

Sofia, 17-19 St. Saint Cyril and Methodius Street

Business address

1 Sixth September Street, Fourth Floor, Sofia

Legal advisors

Law Firm „Lozanova and Groysman”
Radostina Krasimirova Yaneva

Servicing banks

Unicredit Bulbank AD
CiBank EAD
DSK Bank EAD

Auditor

Baker Tilly Klitou and Partners OOD
1612 Sofia
104 Akademik Ivan Geshov Blvd., Seventh Floor

CONSOLIDATED REPORT
on the principal activities of
Fund for Local Authorities and Governments in Bulgaria – FLAG JSC in 2016

This Report has been drawn up in compliance with the requirements laid down in Article 23 of the Regulation laying down the rules for exercising the rights of the government in state-owned commercial undertakings and the Commercial Act.

1. Business program

1.1. Equity and loan resources

The share capital of the Group is BGN 90 million, and it is fully paid in four instalments, two in 2008, one in 2009 and one in 2014. As of 31.12.2016 the total equity of the Group including share capital, reserves and retained earnings altogether amounts to BGN 99 million.

In 2015 fund FLAG increased its borrowings with three new loans of BGN 40 million from DSK Bank EAD; EUR 20 million from CiBank EAD and BGN 14 million from Municipal Bank AD. As of 31.12.2016 the loan from Municipal Bank AD is fully repaid, the current exposure of the loans from DSK Bank EAD and CiBank EAD is BGN 0 and EUR 4,8 million, respectively.

In 2016 after conducting a research on the interest rates, offered from banks, negotiations with the European Bank for Reconstruction and Development were held for decreasing the interest on the two existing Loan agreements – from 22.12.2008 and from 31.10.2013. After the failure to reach market interest rates a selection procedure was held to choose a financing institution to refinance the obligations of FLAG to EBRD. Two banks were chosen – Unicredit Bulbank AD and CiBank EAD, with loan facilities of BGN 40 million and EUR 20 million respectively. As of 31.12.2016 both loans are fully utilized.

As at 31.12.2016 the agreed long-term credit resource from the European Bank for Reconstruction and Development (EBRD) granted by two loan agreements - from 22.12.2008 and 31.10.2013 is fully repaid.

Total agreed long-term credit resource as at 31.12.2016 amounts to BGN 158 million.

Total borrowed capital as at 31.12.2016 amounts to BGN 112 million.

According to an Operational agreement between European Investment Bank, Fund for Sustainable Urban Development of Sofia EAD and Fund for Local Authorities and Governments in Bulgaria – FLAG EAD, signed on 30.05.2012, a contingent loan in the amount of BGN 24,600 thousand was granted for financing urban development projects under the JESSICA initiative. On 14.12.2015 a transfer and substitution agreement was signed between the EIB, MRDPW, FSUDS EAD and FLAG EAD, according to which, as of 01.01.2016, due to the expiration of the EIB's commitment to the JESSICA initiative in Bulgaria, all rights and obligations of the EIB under the Operational Agreement are transferred to MRDPW until the Fund manager of financial instruments in Bulgaria EAD starts functioning. In 2016 all available resource of FSUDS has been successfully invested through the implementation of 13 sustainable urban projects.

1.2. Management

The affairs of the Fund are managed by a Board of Directors (BoD), which is composed of seven members and is responsible for all ongoing activities of the Fund. In 2016 fourteen board meetings were held.

During the reporting period the following changes in the composition of the BoD were made pursuant to a decision of the sole shareholder:

➤ On 09 March 2016 with Protocol № T3-24/09.03.2016 the Minister of Regional Development and Public Works, in his capacity of representative of Government as a sole shareholder, approved changes to the composition of the BoD. The Minister released Emil Rumenov Savov as a member of the BoD and elected on his place Malina Valentinova Krumova.

➤ On 22 March 2016 with Protocol № T3-34/22.03.2016 the Minister of Regional Development and Public Works, in his capacity of representative of Government as a sole shareholder, approved changes to the composition of the BoD. The Minister released Susan Mari Goranson as a member of the BoD and elected on her place Larisa Manastirli.

➤ On 28 July 2016 with Protocol № T3-73/28.07.2016 the Minister of Regional Development and Public Works, in his capacity of representative of Government as a sole shareholder, approved changes to the composition of the BoD. The Minister released Asya Petrova Stankova as a member of the BoD and elected on her place Plamen Todorov Iliev.

As of 31 December 2016, the Board of Directors is comprised of: Dobromir Simidchiev – Chairperson, Plamen Iliev – member, Mariya Lazarova - member, Malina Krumova - member, Yulia Tsoleva - member, Larisa Manastirli – member and Nadya Dankinova – member and executive director.

According to the Bulgarian legislation, the Management is required to prepare annual consolidated financial statements that provide a true and fair view on the financial position of the Group as at the year end, its financial results and cash flows.

Management confirms that adequate accounting policies have been consistently applied in preparing the annual consolidated financial statements as of 31 December 2016, and reasonable and prudent judgments, assumptions and estimates have been made.

Management also acknowledges that it has applied the existing accounting standards and the consolidated financial statements have been prepared under the going concern principle.

Management is responsible for the proper keeping of accounting records, for the appropriate asset management and for the undertaking of all necessary measures for avoidance and detection of fraud and other irregularities.

1.3. Human resources

In 2016 the Group has a core staff with appropriate qualifications and experience for the performance of its lending activity. The organizational structure includes 4 Directorates, as follows: „Lending and monitoring”, „Finance and financial instruments”, „Risk management”, „General Administration” and an Internal Audit Unit.

The approved number of personnel for 2016 is 21 employees. As of 31.12.2016 there are 4 vacant places for employees, and two employees are on maternity leave. The Group does not plan any significant changes to its human resources in 2017.

The legal services, as well as the maintenance of the computer network, are outsourced.

1.4. External auditor for 2016

With a decision from 10 August 2016, Protocol № 139 the BoD approved the results from public tender for external auditor for 2016 and approved „Baker Tilly Klitou and Partners” OOD.

Subsequently this selection has been confirmed with Protocol T3-77/24.08.2016 from the Minister of Regional Development and Public Works, in his capacity of representative of Government as a sole shareholder.

1.5. Borrowed capital

➤ **Loan agreements with EBRD and MRDPW (MA of OPRD)**

During 2016 the Fund fully repaid its obligations to the European Bank for Reconstruction and Development. Summarized payments during the year are as follows:

- Principal payments – BGN 96,8 million
- Interest payments – BGN 2,9 million
- Fees – BGN 0,53 million.

Out of the above mentioned the payments made in connection with the early repayment to EBRD amounted to BGN 80,5 million.

On 30 May 2012 an Operational Agreement was signed between the European Investment Bank, Fund for Sustainable Urban Development of Sofia EAD and Fund for Local Authorities and Governments - FLAG EAD for provision of contingent loan for financing of eligible urban development projects through Project funding agreements.

Amendment agreement №1 to the Operational Agreement was signed in 2014 under which the sanctions for breaching the first period for disbursement of funds to final recipients – 31.12.2013 are waived under condition. The Amendment was signed due to the inability for disbursement of the funds under the JESSICA initiative in the predetermined period. This was due to circumstances beyond the Fund's control. In particular, there was a six month delay in the signing of an Operational Agreement; another six months were needed for establishing the method for assessment of the state aid available for projects and the method for certification, through independent expert assessment, and selection of eligible experts to undertake the assessment. The volatile political situation and the frequent change of the governments, which deteriorated investors' confidence, as well as the innovative nature of the JESSICA financial instrument and the lack of experience in its application in Bulgaria, also played a role in delaying the investment process.

Under this additional agreement an "administration amount" of BGN 923 thousand was paid in exchange for future repayments by final recipients. The contingent loan was effectively reduced by this amount.

Amendment agreement №2 was signed on 18.12.2014. Under this agreement the period for disbursing funds under project funding agreements is extended to 31.12.2015 and the "administration amount" of BGN 923 thousand is specified as being deducted from the loan amount. The amount of the contingent loan is changed to BGN 23,685 thousand.

Amendment agreement №3 was signed on 10.07.2015 in relation to the changes in the criteria for selection of new partner bank of FSUDS. Under Amendment agreement №4 dated 11.12.2015, the final disbursement date for the funds provided under the Contingent loan was extended to 30.06.2016. The provision for reimbursement of the administrative amount withheld in line with Amendment agreement №1 is discarded. The amount of the Contingent loan remains BGN 23,685 thousand.

On 07.12.2015 FSUDS was informed that the Funding Agreement between Republic of Bulgaria and EIB will expire on 31.12.2015 and in line with the decision of the OPRD Managing Authority and the Investment Board, it will not be extended. On the basis of article 14.04B of the Operational Agreement, EIB assigns all of its rights, obligations and interests by way of novation to MRDPW (OPRD Managing Authority), which will take on its functions for a transition period until they are further transferred to the Fund Manager of Financial Instruments in Bulgaria EAD. A Transfer and Substitution Agreement was signed on 14.12.2015 between EIB, MRDPW, FSUDS and FLAG, where the transfer process and EIB's continuing obligations during the interim period are agreed.

