

## Report of Independent Auditors

To the State Oil Fund of the Republic of Azerbaijan:

We have audited the accompanying statements of financial position of the State Oil Fund of the Republic of Azerbaijan (the "Fund") as of December 31, 2003 and 2002, and the related statements of financial performance, changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with International Standards on Auditing issued by the International Federation of Accountants. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Fund at December 31, 2003 and 2002, and the results of its financial performance and its cash flows for the years then ended in conformity with International Public Sector Accounting Standards issued by the Public Sector Committee of the International Federation of Accountants.

April 15, 2004  
Baku, Azerbaijan

## Financial Statements

### Statements of Financial Position

(Amounts presented are in millions of Azeri Manats)

	Note	December 31, 2003	2002
<b>ASSETS</b>			
<b>Current assets</b>			
Cash and cash equivalents	3	1,781,665	2,217,180
Trading securities	4	601,565	644,330
Other short-term investments	6	307,672	–
Interest receivable		20,957	11,688
Contributions receivable		5,186	–
Other current assets		269	979
		<b>2,717,314</b>	2,874,177
<b>Non-current assets</b>			
Investments in securities held to maturity	7	1,304,121	513,765
Property and equipment, net	8	3,457	1,092
Intangible assets		156	163
		<b>1,307,734</b>	515,020
<b>TOTAL ASSETS</b>		<b>4,025,048</b>	3,389,197
<b>LIABILITIES</b>			
<b>Current liabilities</b>			
Payable to the State Budget	15	55,977	–
Payable to the Azerbaijan Treasury for the BTC Company		–	15,276
Other current liabilities		946	–
<b>TOTAL LIABILITIES</b>		<b>56,923</b>	15,276
<b>NET ASSETS</b>		<b>3,968,125</b>	3,373,921
<b>NET ASSETS / EQUITY</b>			
Contributed capital		3,566,607	3,108,411
Accumulated surplus		401,518	265,510
<b>TOTAL NET ASSETS / EQUITY</b>		<b>3,968,125</b>	3,373,921

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

### Statements of Financial Performance

(Amounts presented are in millions of Azeri Manats)

	Note	Year ended December 31,	
		2003	2002
<b>Operating revenue</b>			
Interest income		<b>86,382</b>	52,078
Income generated from money market funds		<b>16,969</b>	6,939
Net dealing gains		<b>12,896</b>	1,040
<b>Total operating revenue</b>		<b>116,247</b>	60,057
<b>Operating expenses</b>			
Bank commissions		<b>515</b>	255
Wages, salaries and employee benefits		<b>398</b>	238
Communications charges		<b>241</b>	115
Depreciation		<b>174</b>	51
Professional services		<b>160</b>	223
Business trip expenses		<b>114</b>	69
S.W.I.F.T expenses		<b>114</b>	–
Publication fees		<b>40</b>	37
Training		–	25
Other operating expenses		<b>233</b>	191
<b>Total operating expenses</b>	<b>12</b>	<b>1,989</b>	1,204
<b>Surplus from operating activities</b>		<b>114,258</b>	58,853
<b>Non-operating activities</b>			
Foreign exchange gains		<b>67,196</b>	64,075
<b>Total non-operating gains</b>		<b>67,196</b>	64,075
<b>Surplus before taxes</b>		<b>181,454</b>	122,928
<b>Income taxes</b>	<b>9</b>	<b>45,446</b>	–
<b>Net surplus for the year</b>		<b>136,008</b>	122,928

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

### Statements of Changes in Net Assets

(Amounts presented are in millions of Azeri Manats)

	Note	Contributed Capital	Accumulated Surplus	Total
<b>Balance at December 31, 2001</b>		2,207,384	142,582	2,349,966
Contributions received	<b>10</b>	1,089,680	–	1,089,680
Net surplus for the period		–	122,928	122,928
Transfers to the Refugees Committee		(188,653)	–	(188,653)
<b>Balance at December 31, 2002</b>		3,108,411	265,510	3,373,921
Contributions received	<b>10</b>	<b>1,361,727</b>	–	<b>1,361,727</b>
Net surplus for the period		–	<b>136,008</b>	<b>136,008</b>
Transfers to the State Budget	<b>11</b>	<b>(533,000)</b>	–	<b>(533,000)</b>
Transfers in respect of the BTC Company	<b>11</b>	<b>(280,532)</b>	–	<b>(280,532)</b>
Transfers to the Refugees Committee	<b>11</b>	<b>(89,999)</b>	–	<b>(89,999)</b>
<b>Balance at December 31, 2003</b>		<b>3,566,607</b>	<b>401,518</b>	<b>3,968,125</b>

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

## Statements of Cash Flows

(Amounts presented are in millions of Azeri Manats)

	Year ended December 31,	
	2003	2002
<b>Cash flows from operating activities</b>		
Surplus before taxes	181,454	122,928
Adjustments to reconcile surplus to net cash provided by operating activities:		
Interest income	(105,074)	(54,191)
Foreign exchange gain	(67,196)	(64,075)
Depreciation	148	51
Changes in operating assets and liabilities:		
Trading securities	50,745	(643,294)
Other short-term investments	(307,672)	–
Other current assets	(4,476)	(48)
Other current liabilities	946	–
Interest received	95,805	43,431
Income tax paid	(12,469)	–
<b>Net cash used in operating activities</b>	<b>(167,789)</b>	<b>(595,198)</b>
<b>Cash flows from investing activities</b>		
Purchases of investments in securities held to maturity	(787,038)	(512,939)
Purchase of property and equipment	(2,513)	(1,720)
Purchase of intangible assets	–	(170)
<b>Net cash used in investing activities</b>	<b>(789,551)</b>	<b>(514,829)</b>
<b>Cash flows from financing activities</b>		
Proceeds received as contributed capital	1,361,727	1,092,430
Receipts from the Azerbaijan Treasury for the BTC Company	320,752	257,631
Transfers to the Azerbaijan Treasury for the BTC Company	(616,615)	(242,300)
Transfers to the State Budget	(510,000)	–
Transfers to the Refugees Committee	(89,813)	(188,839)
<b>Net cash provided by financing activities</b>	<b>466,051</b>	<b>(918,922)</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(491,289)</b>	<b>191,105</b>
Effect of exchange rate changes on cash and cash equivalents	55,774	62,258
Cash and cash equivalents, beginning of year	2,217,180	2,346,027
<b>Cash and cash equivalents, end of year</b>	<b>1,781,665</b>	<b>2,217,180</b>

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

## Notes to the Financial Statements

### 1. Fund information

The State Oil Fund of the Republic of Azerbaijan (the "Fund") was established by Decree #240 of the President of the Azerbaijan Republic "On the Establishment of the State Oil Fund of the Republic of Azerbaijan" (the "Decree") dated December 29, 1999. The purpose of the Fund is to ensure the accumulation, effective management, and use of income and other inflows generated from agreements signed in the field of oil and gas exploration and development, as well as from the Fund's own activities for the benefit of citizens of the Azerbaijan Republic and their future generations. This Decree also granted the Cabinet of Ministers the right to resolve issues arising upon implementation of the Decree.

In accordance with the Decree and the Regulations, the Fund is an extra-budgetary institution, formed as a separate legal entity, which is accountable and responsible to the President of the Azerbaijan Republic.

The Fund's assets are formed in accordance with the Presidential Decree #511 as amended by the Presidential Decree #849 "On amending certain legislative acts regulating operations of the State Oil Fund of the Republic of Azerbaijan" effective February 7, 2003. Decree #849 excluded from the list of sources of the Fund's assets the rental fees from the use of state property under contracts signed with foreign companies as well as revenues from the sale of hydrocarbons related to the participating interest or investment of SOCAR in a project in which SOCAR is an investor, participant or a contracting party, and other revenues generated from joint activities with foreign companies. The Fund's assets are formed from the following sources:

- revenues generated from implementing agreements on exploration, development and production sharing for oil and gas fields in the territory of the Republic of Azerbaijan including the Azerbaijan Sector of the Caspian Sea, as well as other agreements on oil and gas exploration, development and transportation entered into between State Oil Company of the Azerbaijan Republic ("SOCAR") or other authorized state body and investors, including:
  - Net revenues from the sale of hydrocarbons related to the share of the Republic of Azerbaijan (after a deduction of expenditures incurred for hydrocarbons transpiration, custom clearance and bank costs, marketing, insurance and independent surveyor fees) excluding revenues related to the participating interest or investment of SOCAR in a project in which SOCAR is an investor, participant or a contracting party;
  - Oil and gas agreements signature and / or performance bonuses paid by investors under the production sharing agreements to SOCAR or an authorized state body;
  - Acreage payments due to SOCAR and / or an authorized state body of the Republic of Azerbaijan from investors for the use of contract area in connection with oil and gas exploration and development;
  - Revenues generated from oil and gas transported over the territory of the Republic of Azerbaijan with the use of Baku-Supsa oil export pipeline;
  - Revenues generated from transfer of assets from investors to SOCAR and/or an authorized state body within the framework of oil and gas agreements.
- Revenues generated from placement and management of the Fund's assets, including interest, dividend, asset revaluation and other revenues.
- Dividends and profit participation revenues related to the share of the Republic of Azerbaijan in connection with oil and gas agreements excluding revenues related to a participating interest or investment of SOCAR in a project in which SOCAR is an investor, participant or a contracting party;
- Revenues generated from oil and gas transport over the territory of the Republic of Azerbaijan with the use of Baku-Tbilisi-Ceyhan ("BTC") and the Baku-Tbilisi-Erzurum pipelines;
- Grants and free aids;
- Other revenues and receipts in accordance with Azerbaijan legislation.

Under the provisions of the Regulations SOCAR or an Authorized Government Body shall implement the collection of the fees and revenues listed above and their transfer to the Fund.

In 2003, the Fund retained two custody agreements and three investment management agreements with reputable financial institutions. Under custody agreements the financial institutions

hold securities purchased by the Fund, whereas in accordance with the investment management agreements the financial institutions manage the Fund's investments based on general investment policies established by the Fund.

The Fund's registered office address is: 20, Bulbul Avenue, Baku, Azerbaijan, AZ1014.

The number of employees in the Fund at December 31, 2003 and 2002 equaled to 19 and 12, respectively.

These financial statements for the year ended December 31, 2003 were approved by the Fund's Executive Director on April 15, 2004.

## 2. Significant accounting policies

### *Basis of presentation*

The financial statements of the Fund have been prepared in accordance with International Public Sector Accounting Standards (IPSAS) issued by the Public Sector Committee of the International Federation of Accountants. IPSAS are developed by adapting International Financial Reporting Standards (IFRS) to the public sector context.

IFRS comprise standards and interpretations approved by the International Accounting Standards Board, and IFRS and Standing Interpretations Committee interpretations approved by the International Accounting Standards Committee. The public sector refers to national governments, regional governments, local governments and related governmental entities.

The Fund has elected to apply every IPSAS issued as of December 31, 2003 and 2002. As permitted by IPSAS, the Fund follows the provisions of IFRS pronouncements in the absence of equivalent IPSAS.

The financial statements have been prepared on the historical cost basis, except for the measurement at fair value of investment properties.

The Fund maintains its records in Azeri Manats in accordance with Azeri accounting standards. The accompanying financial statements have been prepared from the Azeri accounting records for presentation in accordance with IPSAS.

Although the majority of the Fund's assets and revenues are denominated in foreign currencies, the Fund's measurement currency is the Azeri Manat because all costs and distributions are incurred or priced in Azeri Manats and the valuation of the Fund's financial performance is compared against an annual budget measured in Azeri Manats.

In accordance with IPSAS No. 4 "The Effects of Changes in Foreign Exchange Rates" transactions and balances denominated in currencies other than Azeri Manats (primarily US dollar) have been remeasured into Azeri Manats. Revenues and costs are translated at monthly average exchange rates that approximate historical exchange rates. Capital and non-monetary assets and liabilities are translated at historical exchange rates prevailing on the transaction dates. Monetary assets and liabilities are translated at exchange rates prevailing on the balance sheet date. Exchange gains and losses arising from the remeasurement of monetary assets and liabilities that are not denominated in Azeri Manats are credited or charged to operations.

The Azeri Manat is not a fully convertible currency outside the territory of the Azerbaijan Republic. Within the Azerbaijan Republic, official exchange rates are determined daily by the National Bank. Market rates may differ from the official rates but the differences are, generally, within narrow parameters monitored by the National Bank. As of December 31, 2003 and 2002, the official rates of exchange were 4,923 Azeri Manats for one US Dollar and 4,893 Azeri Manats for one US Dollar, respectively.

### *Use of estimates*

The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, revenues and expenses, contributions and distributions, and related disclosures. On an on-going basis, the management evaluates their estimates, including those related to revenue recognition and contingencies. The management bases their estimates on various market specific assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making assumptions about the carrying values of assets that are not readily apparent from other sources. Actual results may differ significantly from these estimates under different assumptions or conditions.

### *Recognition of financial instruments*

A purchase or sale of financial assets is recognized using settlement date accounting. The settlement date is the date that an asset is delivered to or by the Fund. Settlement date accounting refers to (a) the recognition of an asset on the day it is transferred to the Fund and (b) derecognition of an asset on the day that it is transferred by the Fund. The Fund account for any change in the fair value of the asset to be received during the period between the trade date (the date that the Fund commits to purchase or sell an asset) and the settlement date in the same way as it will account for the acquired asset. That is, the value change is not recognized for assets carried at cost or amortized cost; it is recognized in net profit or loss for assets classified as trading; and it is recognized in net profit or loss or in equity for assets classified as available for sale.

Financial assets and liabilities are initially recognized at cost, which is the fair value of consideration given or received, respectively, including or net of any transaction costs incurred, respectively. The accounting policies for subsequent re-measurement of these items are disclosed in the respective accounting policies set out in this note.

### *Cash and cash equivalents*

Cash and cash equivalents are defined as cash on hand, deposits maturing within three months from the financial statements date and short-term, highly liquid investments readily convertible to known amounts of cash and subject to low risk of changes in value, with an original maturity of three months or less. Cash on hand, cash in banks and deposits are carried at cost plus interest.

### *Commercial papers and certificates of deposits*

Commercial papers and certificates of deposits are carried at their fair value.

### *Trading Securities*

Securities purchased principally for the purpose of generating a profit from short-term fluctuations in price or dealers' margin are classified as trading securities. Trading securities are initially recognized under the policy for financial instruments and are subsequently measured at fair value, based on market values as of the balance sheet date. Realized and unrealized gains and losses resulting from operations with trading securities are recognized in the statement of financial performance as part of net dealing gains. Interest earned on trading securities is reported as interest income.

In determining estimated fair value, securities are valued at the last trade price if quoted on an exchange, or the last bid price if traded over-the-counter. When market prices are not available or if liquidating the Fund's position would reasonably be expected to impact market prices, fair value is determined by reference to price quotations for similar instruments traded in different markets or objective and reliable management's estimates of the amounts that can be realized.

### *Investment Securities*

The Fund classifies its investment securities into two categories:

- Securities with fixed maturities and fixed or determinable payments that management has both the positive intent and the ability to hold to maturity are classified as held to maturity; and
- Securities that are not classified by the Fund as held to maturity or trading (see above) are included in the available-for-sale portfolio. The Fund had not available-for-sale securities at December 31, 2003 and 2002.

The Fund classifies investment securities depending upon the intent of management at the time of the purchase.

Investment securities held to maturity are initially recognized in accordance with the policy stated above and subsequently re-measured at amortized cost using the effective interest method. Allowance for impairment is estimated on a case-by-case basis. Gains and losses from held to maturity securities are recorded in the statement of financial performance.

### *Property and equipment*

Property and equipment is stated at historical cost less accumulated depreciation. Office equipment, furniture, and vehicles are depreciated using the straight-line method over estimated useful lives ranging from four to five years. Depreciation is charged starting the first day of the next month

after the asset was put into use. Maintenance costs relating to items of property, plant and equipment are expensed as incurred.

#### **Impairment of assets**

In accordance with International Accounting Standard No. 36, "Impairment of Assets", the Fund's property and equipment, intangible assets and financial assets are reviewed to determine whether an event or change in circumstances indicates that the carrying amount of the asset may not be recoverable. The Fund bases its evaluation on such impairment indicators as the nature of the assets, any historical or future profitability measurements, as well as other external market conditions or factors that may be present. Should there be indication of impairment, the Fund will compare the carrying amount of the asset to its recoverable amount – the higher of the asset's net selling price and its value in use. The value in use of an asset is the present value of the future cash flows expected to arise from its continued use over its remaining useful life and from its disposal whereas the net selling price is the amount obtainable from the sale of an asset in an arm's length transaction less the costs of disposal. If the recoverable amount of the asset is lower than its carrying amount, the difference is recognized as an impairment loss.

An impairment loss is reversed if the subsequent increase in the recoverable amount can be related objectively to an event occurring after the impairment loss was recognized. An impairment loss is only reversed to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation, if no impairment loss had been recognized.

No impairment loss was recognized in 2003 or 2002.

#### **Net assets/Equity**

Transfers are recognized as the fair value of the consideration paid by the Fund to the government and government-controlled entities on the date of payment. Actual transfers are made once the request letters sent by the government and government-controlled entities are supported by appropriate documentation.

Transfers to the State Committee for Work with Refugees and Internally Displaced People (the "Refugees Committee") are recognized when approved by the Fund's management.

Transfers to the Azerbaijan Treasury in respect of the Baku-Tbilisi-Ceyhan project are recognized when the Fund receives cash calls from BTC Company.

Transfers to the State Budget are approved by the Presidential Decrees and recognized when actually transferred by the Fund.

Net revenues generated from the sales of the Azerbaijan Republic's share of crude oil and gas are recognized as contributions to the Fund when SOCAR notifies the Fund of the amounts to be transferred.

Contributions of rental fees paid by the Azerbaijan International Operating Company ("AIOC") and pipeline transit tariffs are recorded when the payments become due.

Contributions of bonus and acreage payments made by foreign companies are recorded when received by SOCAR or the Fund.

Termination and concession area abandonment payments as well as net revenues from sales of local market oil obligations received by SOCAR under onshore production sharing agreements are not contributed to the Fund's assets, in accordance with the Presidential Decrees.

The transfers and contributions referred to above are recognized through the Fund's equity in accordance with IPSAS No. 1 "Presentation of Financial Statements".

#### **Income and expense recognition**

Revenue is recognized to the extent that it is probable that the economic benefits will flow to the Fund and the revenue can be reliably measured. Interest income is recognized on an accrual basis.

Expenses are recognized on an accrual basis.

#### **Income tax**

As discussed in Note 9 the Fund has become a taxpayer effective January 1, 2003.

Deferred income tax is provided, using the liability method, on all temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred tax liabilities are recognized for all taxable temporary differences. Deferred tax assets is recognized for all deductible temporary differences and carry-forward of unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences and carry-forward of unused tax losses can be utilized.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred tax asset to be utilized.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates and tax laws that have been enacted or substantively enacted at the balance sheet date.

#### **State social protection fund**

The Fund contributes to the Azerbaijan Republic's State Social Protection Fund with respect to its employees.

#### **Reclassification**

Certain previously reported amounts have been reclassified to conform to current year presentation.

#### **3. Cash and cash equivalents**

Cash and cash equivalents consisted of the following at December 31:

	2003	2002
Deposits	1,437,752	998,507
Money market funds	254,451	910,876
Cash on hand and other bank accounts	87,154	284,477
US Dollar bank account with the National Bank	2,308	23,320
	<b>1,781,665</b>	<b>2,217,180</b>

#### *Deposits*

At December 31, 2003, the Fund had six deposits with banks bearing fixed interest from 1.05% to 9.5%. All deposits have matured in January 2004. Bank deposits were placed in different banks with a long-term credit rating ranging from A to AA (Standard & Poor's). Two out of six deposits are represented by Dual Currency Deposits held at JP Morgan Chase (London) and the Royal Bank of Scotland in the amounts of 196,920 million Azeri Manats and 295,380 million Azeri Manats, respectively, and bear interest rates of 9% and 9.5%, respectively.

At December 31, 2002, the Fund had eight deposits with banks bearing fixed interest from 1.24% to 5%. All deposits have matured in January 2003 except one in the amount of 97,860 million Azeri Manats, which matured on March 28, 2003.

#### *Money market funds*

Investments in money market funds represent share ownership in funds payable on demand. Money market funds invest their assets in a diversified portfolio of US Dollar denominated short-term debt and debt related instruments, such as commercial paper, certificates of deposit, and asset-backed securities. Interest and dividends payable to the Fund are reinvested on a monthly basis or more frequently.

#### *Cash on hand and other bank accounts*

All cash and cash equivalents held on December 31, 2003 are denominated in US Dollars with the exception of 42,652 million Azeri Manats and 624 million Azeri Manats held in the National Bank and International Bank of the Republic of Azerbaijan, respectively, denominated in Azeri Manats, and 17 million Azeri Manats and 35 million Azeri Manats held in Clariden Bank (Credit Suisse), denominated in Euro and British Pounds, respectively. The Fund's bank accounts held in the National Bank in Azeri Manats at December 31, 2003 are not interest bearing.

All cash and cash equivalents held at December 31, 2002 were denominated in US Dollars with the exception of 20 million Azeri Manat and 1,107 million Azeri Manats held in the National Bank and International Bank of the Republic of Azerbaijan, respectively, denominated in Azeri Manats. The Fund's bank accounts held in the National Bank in Azeri Manats at December 31, 2003 were not interest bearing.

#### *US Dollar bank account with the National Bank*

The Fund has a bank account in US Dollars in the National Bank. In accordance with an agreement between the National Bank and the Fund, all cash deposited by the Fund in the National Bank is transferred to a special investment account held in the Federal Reserve Bank of New York. All interest income earned on this account is accumulated on the account with the National Bank and recognized by the Fund on a daily basis.

#### **4. Trading securities**

Trading securities consisted of the following at December 31:

	<b>2003</b>	<b>2002</b>
Government securities	<b>299,937</b>	44,744
Financial institution securities	<b>93,997</b>	185,752
Corporate securities	<b>81,843</b>	30,090
American agencies securities	<b>61,398</b>	364,054
SPDR Trust	<b>52,044</b>	–
Multilateral institution bonds	<b>12,346</b>	19,690
	<b>601,565</b>	<b>644,330</b>

Trading securities of 601,565 million Azeri Manats held under asset management in Deutsche Bank, Clariden Bank and Societe Generale at December 31, 2003 bear fixed and floating interest rates ranging from 1.08% to 13.625%. Trading securities of 644,330 million Azeri Manats held under custody in Deutsche Bank AG New York and asset management in Clariden Bank at December 31, 2002 had fixed interest rates yielding from 1.17% to 7.5%.

#### *Government securities*

Government securities at December 31, 2003 are represented by US treasury notes, as well as bonds issued by European and Asian governments bearing interest ranging from 1.75% to 8.75% and maturing during the period from September 2004 to April 2011. Government securities were purchased and held by the Fund's asset managers Clariden Bank and Deutsche Bank AG.

Government securities at December 31, 2002 were represented by investments in US treasury notes bearing interest rates from 2.125% to 3.25% and maturing between October 2004 and August 2007.

#### *Financial institution securities*

Financial institution securities at December 31, 2003 were represented by investments in the debt securities issued by Deutsche Bank SSD, KfW and other European banks. These securities bear interest ranging from 1.17% to 7% and mature during the period from July 2004 to October 2008.

Financial institution securities at December 31, 2002 were represented by investments in the debt securities issued by Landwirtschaftliche Rentenbank, KfW, Credit Suisse Finance and other European banks bearing interest rates from 2.875% to 7.125% and maturing during the period from January 2003 to December 2005.

#### *Corporate securities*

Corporate securities at December 31, 2003 are mainly represented by investments in the debt securities issued by Bristol-Myers Squibb Company, Morgan Stanley and other European and American companies bearing interest from 1.211% to 6.25% and maturing during the period from October 2006 to May 2008.

Corporate securities at December 31, 2002 consisted of bonds issued by American and European corporations bearing interest rates from 2.75% to 6% and maturing during the period from February 2003 to October 2006.

#### *American agencies securities*

Investments in the American agencies securities at December 31, 2003 consisted of bonds issued by Fannie Mae, Freddie Mac and Federal Home Loan Banks bearing interest rates from 1.875% to 2.75% and maturing from March 2006 to December 2006.

Investments in the American agencies held by the Fund at December 31, 2002 consisted of bonds issued by Fannie Mae and Federal Home Loan Banks bearing interest rates from 2% to 4.85% and maturing during the period from November 2003 to July 2007.

#### *SPDR Trust*

At December 31, 2003 the Fund held 95,000 shares of SPDR Trust ("Standard & Poor's Depository Receipts"). SPDR Trust is an exchange traded fund designed to generally correspond to the price and yield performance of the Standard & Poor's 500 Index.

There were no SPDR Trust shares held at December 31, 2002.

#### *Multilateral institution bonds*

Investment to multilateral institution bonds at December 31, 2003 consisted of bonds issued by the European Investment Bank and Asian Development Bank bearing interest rate 2.35% and 2.375% and maturing in April 2006 and March 2006, respectively.

Multilateral institution bonds held by the Fund at December 31, 2002 consisted of the bonds issued by the International Finance Corporation and International Bank for Reconstruction and Development bearing interest rates from 5.5% to 5.625% and maturing in February 2003 and March 2003, respectively.

#### **5. Asset management agreements**

At December 31, 2003 the Fund held 802,804 million Azeri Manats under the Asset Management Agreements with reputable international financial institutions (320,746 million Azeri Manats – at December 31, 2002).

#### **6. Other short-term investments**

At December 31, 2003 other short-term investments represented the following:

- investments in the commercial paper and certificates of deposits held under asset management in Societe Generale Bank in the amount of 209,212 million Azeri Manats bearing interest rate from 1.08% to 1.2% and maturing during the period from January 2004 to August 2004; and
- deposit in the amount of 98,460 million Azeri Manats bearing interest rate 4.995% and maturing on June 26, 2004.

There were no other short-term investments at December 31, 2002.

#### **7. Investments in securities held to maturity**

Securities held to maturity consisted of the following at December 31:

	<b>2003</b>	<b>2002</b>
Financial institution securities	<b>1,033,387</b>	513,765
American agencies securities	<b>270,734</b>	–
	<b>1,304,121</b>	<b>513,765</b>

#### *Financial institution securities*

At December 31, 2003 investments in financial institution securities held to maturity amounted to 1,033,387 million Azeri Manats consisted of the financial institution bonds bearing an interest rate ranging from 1% to 8.5% and maturing during the period from March 2008 to July 2013.

Securities held to maturity of 513,765 million Azeri Manats held under custody agreements at December 31, 2002 represented investments in financial institutions securities bearing fixed interest rates ranging from 1.5% to 5.35% and maturing during the period from October 2005 to December 2009. Subsequent to December 31, 2002 these securities have been redeemed by the financial institutions at their nominal value.

#### *American agencies securities*

At December 31, 2003 the Fund had 270,734 million Azeri Manats invested in securities issued by American agencies bearing interest rate 2.375% to 4.625% and maturing during the period from June 2007 to May 2013.

There were no American agencies securities held to maturity at December 31, 2002.

All securities at December 31, 2003 have a long-term credit rating of at least AA- (Standard & Poor's) and are denominated in US Dollars and Euro. Securities at December 31, 2002 had a long-term credit rating of at least AA- (Standard & Poor's) and were denominated in US Dollars.

### 8. Property and equipment

An analysis of activity in property and equipment for the years ended December 31, 2003 and 2002 was as follows:

	Vehicles	Office equipment	Furniture	Construction in progress	Total
<b>Cost</b>					
December 31, 2002	157	175	60	762	1,154
Additions	–	65	96	2,352	2,513
Assets put into operation	–	762	–	(762)	–
<b>December 31, 2003</b>	<b>157</b>	<b>1,002</b>	<b>156</b>	<b>2,352</b>	<b>3,667</b>
<b>Accumulated depreciation</b>					
December 31, 2002	(22)	(25)	(15)	–	(62)
Depreciation charge	(34)	(75)	(9)	(30)	(148)
<b>December 31, 2003</b>	<b>(56)</b>	<b>(100)</b>	<b>(24)</b>	<b>(30)</b>	<b>(210)</b>
<b>Net book value:</b>					
<b>December 31, 2003</b>	<b>101</b>	<b>902</b>	<b>132</b>	<b>2,322</b>	<b>3,457</b>
December 31, 2002	135	150	45	762	1,092

In accordance with a resolution of Cabinet of Ministers #99 dated May 27, 2002 the Fund was given an administrative building with a net book value of 390 million Azeri Manats previously reported by the Ministry of Culture in its accounting records. Because there was no available fair market value of the asset transferred, the Fund has not recognized the building on its statement of financial position as permitted by IPSAS No. 17 "Property, Plant and Equipment". The asset will be reported on the statement of financial position when the fair value of the transferred asset is determined by an independent appraiser.

Construction in progress is represented by 2,352 million Azeri Manats of renovation expenses incurred in respect of the Fund's administrative building.

### 9. Income taxes

Income taxes consisted of the current tax payable to the State Budget. As mentioned above, in accordance with the amendments to the Tax Code starting from January 1, 2003 the Fund's income became subject to profit tax. The total amount of income tax accrued for the year was 45,446 million Azeri Manats. Income tax expense is calculated at 25% of surplus before taxes. The Fund does not have deferred taxes at December 31, 2003 as there are no temporary differences between its tax and accounting books.

### 10. Contributed capital

Capital contributions for the years ended December 31, 2003 and 2002 include the following:

	Net revenue received from sales of profit oil, net of deductions	Pipeline transit tariffs	Rental fees	Acreage fees	Bonuses	Total
<b>Contributions for 2003</b>	<b>909,624</b>	<b>68,767</b>	<b>586</b>	<b>94,556</b>	<b>288,194</b>	<b>1,361,727</b>
<b>Contributions for 2002</b>	972,966	61,681	2,329	52,704	–	1,089,680

Contributions amounting to 909,624 million Azeri Manats were made by SOCAR in 2003 and represent sales proceeds in respect of the Azerbaijan Republic's share of the profit oil (972,966 million Azeri Manats in 2002).

Rental fee of 586 million Azeri Manats was received and recognized before the Presidential Decree #849 "On amending certain legislative acts regulating operations of State Oil Fund of the Republic of Azerbaijan", dated February 7, 2003, came in force (2,329 million Azeri Manats in 2002).

### 11. Transfers made by the Fund

#### Transfers to the State Budget

Transfers to the State Budget are represented by 500,000 million Azeri Manats transferred in accordance with the Decree #848 of the President of the Azerbaijan Republic "On the Budget of the State Oil Fund of the Azerbaijan Republic for the year 2003" dated January 27, 2003, for the purposes of sustaining the state budget, and 33,000 million Azeri Manats of VAT transfers.

There were no transfers to the State Budget made by the Fund in 2002.

#### Transfers to the Azerbaijan Treasury for the BTC Company

In accordance with Decree #739 of the President of the Azerbaijan Republic "On financing the participating interest share of the State Oil Company of the Azerbaijan Republic in the Baku-Tbilisi-Ceyhan main export pipeline project" dated July 30, 2002, the Fund provides part of the funding required for the construction of the Main Export Pipeline from Baku over Georgian territory to the Turkish Mediterranean port of Ceyhan (the "BTC project"). Decree #739 authorizes the use of financial reserves under the responsibility of the Fund for investment in the pipeline. The Ministry of Economic Development of the Republic of Azerbaijan ("MED"), through Azerbaijan (BTC) Limited, holds a twenty-five percent share in the oil pipeline consortium – BTC Company.

BTC Company intends to provide up to thirty percent of the project cost through equity contributions of the participants including Amerada Hess (BTC) Limited, Azerbaijan (BTC) Limited, BP Pipelines (BTC) Limited, ConocoPhillips (BTC) Limited, Eni BTC Limited, INPEX BTC Pipeline, Limited, ITOCHU Oil Exploration (BTC) Inc., Statoil BTC Caspian AS, TOTAL (BTC) Limited, Turkish Petroleum BTC Ltd., Unocal BTC Pipeline, Ltd., BTC International Investment Company and to raise the remaining seventy percent from international financial institutions, export credit agencies and private banks.

In accordance with the Fund's budget for 2003 approved by the President, the Fund continued to finance approximately seventy percent of MED's equity investment in the Azerbaijan (BTC) Limited.

During 2003 the Fund transferred from its net assets an amount of 280,532 million Azeri Manats to the Azerbaijan Treasury for the financing of MED's share in the Azerbaijan (BTC) Limited. There were no transfers to the Azerbaijan Treasury for BTC Company from the Fund's equity in 2002.

#### Transfers to the Refugees Committee

In accordance with Decrees of the President of the Azerbaijan Republic #562 dated August 22, 2001 and #577 September 7, 2001, the Fund has provided a financing of 89,999 million Azeri Manats to the Refugees Committee (188,653 million Azeri Manats in 2002).

### 12. Operating expenditures

In accordance with Decree #848 of the President of the Azerbaijan Republic "On the Budget of the State Oil Fund of the Azerbaijan Republic for the year 2003" dated January 27, 2003 amending Decree #811 dated November 1, 2002, the Fund's operating expenditures for 2003 were budgeted at 5,338 million Azeri Manats. In 2003 the Fund incurred operating expenses of 1,989 million Azeri Manats and spent 2,513 million Azeri Manats on the acquisition of property and equipment resulting in total actual expenditures of 4,502 million Azeri Manats.

### 13. Risk management policies

Management of risk is an essential element of the Fund's operations. The main risks inherent to the Fund's operations are those related to credit and market movements in interest and foreign exchange rates. A summary description of the Fund's risk management policies in relation to those risks is discussed below.

The Fund is subject to credit risk from its portfolio of cash and cash equivalents, and investments. In accordance with the Rules approved by Decree #511 of the President of the Azerbaijan Republic dated June 19, 2001, the Fund manages the credit risk by investing its assets in financial

instruments of financial institutions with a long-term credit rating of at least A (Standard & Poor's, Fitch) or A2 (Moody's). Asset management and custodian services are performed by financial institutions with a credit rating of not lower than AA- (Standard & Poor's, Fitch) or Aa3 (Moody's). The Fund keeps its clearing bank accounts outside the Republic of Azerbaijan at banks with credit ratings not lower than AA- (Standard & Poor's, Fitch) or Aa3 (Moody's).

The Fund also places its assets in the National Bank, which are automatically transferred to a special investment account held in the Federal Reserve Bank of New York. The goals of the Fund's investment strategy, in order of priority, are safety and preservation of principal, diversification of risk, and a competitive rate of return.

The Fund is exposed to effects of fluctuation in the prevailing foreign currency exchange rates on its financial position and cash flows. In accordance with Decree #1134 of the President of the Azerbaijan Republic "On the Implementation of the Budget of the State Oil Fund of the Azerbaijan Republic for the year 2003" dated January 27, 2003, the Fund's investment portfolio is expected to be diversified into US Dollars (60-70%), Euro (25-35%) and British Pounds (0-10%) in order to mitigate the risk of currency fluctuations.

At December 31, 2003 and 2002 deposits, securities, cash on hand and other bank accounts, as well as the US Dollar bank account with the National Bank were interest-bearing and, therefore, were exposed to interest rate risk. Floating interest on securities is re-priced at intervals of less than one year. Fixed interest on trading securities is fixed until the maturity of the financial instrument.

The geographical concentration of the Fund's assets and liabilities is set out below:

	2003				2002			
	Azerbaijan	Europe	USA	Total	Azerbaijan	Europe	USA	Total
<b>Assets:</b>								
Cash and cash equivalents	45,585	1,731,750	4,330	1,781,665	171,272	1,775,536	270,372	2,217,180
Trading securities	-	549,521	52,044	601,565	-	280,618	363,712	644,330
Other short-term investments	98,460	209,212	-	307,672	-	-	-	-
Interest receivable	-	6,170	14,787	20,957	-	4,828	6,860	11,688
Contributions receivable	5,186	-	-	5,186	979	-	-	979
Other current assets	269	-	-	269	-	-	-	-
	<b>149,500</b>	<b>2,496,653</b>	<b>71,161</b>	<b>2,717,314</b>	<b>172,251</b>	<b>2,060,982</b>	<b>640,944</b>	<b>2,874,177</b>
Investments held to maturity	-	-	1,304,121	1,304,121	-	-	513,765	513,765
Property and equipment, net	3,457	-	-	3,457	1,092	-	-	1,092
Intangible assets	156	-	-	156	163	-	-	163
	<b>3,613</b>	<b>-</b>	<b>1,304,121</b>	<b>1,307,734</b>	<b>1,255</b>	<b>-</b>	<b>513,765</b>	<b>515,020</b>
	<b>153,113</b>	<b>2,496,653</b>	<b>1,375,282</b>	<b>4,025,048</b>	<b>173,506</b>	<b>2,060,982</b>	<b>1,154,709</b>	<b>3,389,197</b>
<b>Liabilities:</b>								
Payable to the State Budget	55,977	-	-	55,977	-	-	-	-
Payable to the Azerbaijan Treasury for the BTC Company	-	-	-	-	15,276	-	-	15,276
Other current liabilities	946	-	-	946	-	-	-	-
	<b>56,923</b>	<b>-</b>	<b>-</b>	<b>56,923</b>	<b>15,276</b>	<b>-</b>	<b>-</b>	<b>15,276</b>
<b>Net balance sheet position</b>	<b>96,190</b>	<b>2,496,653</b>	<b>1,375,282</b>	<b>3,968,125</b>	<b>158,230</b>	<b>2,060,982</b>	<b>1,154,709</b>	<b>3,373,921</b>

The Fund's exposure to foreign currency exchange rate risk follows:

	2003			2002		
	Azeri Manats	Freely convertible	Total	Azeri Manats	Freely convertible	Total
<b>Assets:</b>						
Cash and cash equivalents	1,738,389	43,276	1,781,665	1,127	2,216,053	2,217,180
Trading securities	-	601,565	601,565	-	644,330	644,330
Other short-term investments	98,460	209,212	307,672	-	-	-
Interest receivable	-	20,957	20,957	-	11,688	11,688
Contributions receivable	-	5,186	5,186	-	-	-
Other current assets	-	269	269	979	-	979
	<b>1,836,849</b>	<b>880,465</b>	<b>2,717,314</b>	<b>2,106</b>	<b>2,872,071</b>	<b>2,874,177</b>
Investments held to maturity	-	1,304,121	1,304,121	-	513,765	513,765
Property and equipment, net	3,457	-	3,457	1,092	-	1,092
Intangible assets	156	-	156	163	-	163
	<b>3,613</b>	<b>1,304,121</b>	<b>1,307,734</b>	<b>1,255</b>	<b>513,765</b>	<b>515,020</b>
	<b>1,840,462</b>	<b>2,184,586</b>	<b>4,025,048</b>	<b>3,361</b>	<b>3,385,836</b>	<b>3,389,197</b>
<b>Liabilities:</b>						
Payable to the State Budget	55,977	-	55,977	-	-	-
Payable to the Azerbaijan Treasury for the BTC Company	-	-	-	-	15,276	15,276
Other current liabilities	946	-	946	-	-	-
	<b>56,923</b>	<b>-</b>	<b>56,923</b>	<b>-</b>	<b>15,276</b>	<b>15,276</b>
<b>Net balance sheet position</b>	<b>1,783,539</b>	<b>2,184,586</b>	<b>3,968,125</b>	<b>3,361</b>	<b>3,370,560</b>	<b>3,373,921</b>

Freely convertible currencies in the table above are represented by US Dollars, British Pounds, and Euros.

#### 14. Fair values of financial instruments

Fair value is defined as the amount at which the instrument could be exchanged in a current transaction between knowledgeable willing parties on arm's length conditions, other than in forced or liquidation sale. Judgment is necessary in arriving at fair value, based on current economic conditions and the specific risks attributable to the instrument. The estimates presented herein are not necessarily indicative of the amounts the Fund could realize in a market exchange from the sale of its full holdings of a particular instrument.

The following methods and assumptions are used by the Fund to estimate the fair value of its financial instruments:

- for assets and liabilities maturing within one month, the carrying amount approximates fair value due to the relatively short-term maturity of these financial instruments.
- for longer-term deposits, the interest rates applicable reflect market rates and, consequently, the fair value approximates the carrying amounts.

The fair value of investments held to maturity at December 31, 2003 and 2002 approximated 1,293,942 million Azeri Manats and 513,765 million Azeri Manats, respectively. This amount is disclosed in accordance with International Accounting Standard No. 32 "Financial Instruments: Disclosure and Presentation" and is different from the amounts reported in these financial statements.

**15. Related parties**

Settlements with related parties consisted of the following at December 31, 2003:

<b>Related Party</b>	<b>Receipts from related parties</b>	<b>Transfers to related parties</b>	<b>Amounts owed to related parties</b>
Refugees Committee	–	89,999	–
Azerbaijan Treasury	320,752	616,615	–
State Budget	–	522,469	55,977
SOCAR	909,624	–	–

The amount of 89,999 million Azeri Manats represents transfers to the Refugees Committee made by the Fund.

The amount of 320,752 million Azeri Manats represents the amount received from the Azerbaijan Treasury for the purposes of financing the MED's share in Azerbaijan (BTC) Limited.

The amount of 616,615 million Azeri Manats represents transfers to the Azerbaijan Treasury in respect of the MED's share in Azerbaijan (BTC) Limited.

The amount of 522,469 million Azeri Manats transfers to the State Budget is represented by 500,000 million Azeri Manats transferred to the State Budget as discussed in Note 11, 10,000 million Azeri Manats VAT transfers and 12,469 million Azeri Manats profit tax transfers.

The amount of 55,977 million Azeri Manats payable to the State Budget is represented by 32,977 million Azeri Manats and 23,000 million Azeri Manats payables to the State Budget for profit tax and VAT, respectively.

The amount of 909,624 million Azeri Manats represents proceeds from the share of Azerbaijan Republic in a profit oil sale received from SOCAR.