Caspian Drilling Company LLC

Consolidated financial statements prepared under International Financial Reporting Standards

For the years ended 31 December 2018 and 2017, with independent auditor's report

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Responsibilities of management and the Supervisory Board for the consolidated financial statements

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

In preparing the consolidated financial statements, management is responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

The Supervisory Board is responsible for overseeing the Group's financial reporting process.

Auditor's responsibilities for the audit of the consolidated financial statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.

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- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with the Supervisory Board regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Ernst & Young Holdings (CIS) B.V.

10 March 2021

Baku, Azerbaijan

Consolidated statements of profit and loss and other comprehensive income

For the years ended 31 December 2018 and 2017

(All amounts are in thousands of US dollars)

	Note	2018	2017	2016 restated*
Revenue	6	323,928	345,959	423,102
Cost of sales	7	(183,931)	(136,517)	(260,815)
Gross profit		**139,997**	**209,442**	**162,287**
General and administrative expenses	8	(13,385)	(11,400)	(11,992)
Other income	9	9,108	2,217	2,029
Other expenses	10	–	(18,238)	(85,790)
Operating profit		**135,720**	**182,021**	**66,534**
Foreign exchange (loss)/gain, net		(509)	2,047	2,686
Profit before tax		**135,211**	**184,068**	**69,220**
Income tax expense	11	(28,383)	(33,706)	(26,206)
Profit for the year		**106,828**	**150,362**	**43,014**
Other comprehensive loss for the year, net of tax – currency translation differences		(3)	–	–
Total comprehensive income for the year		**106,825**	**150,362**	**43,014**

* *Certain amounts shown here do not correspond to the 2016 financial statements and reflect adjustment made, refer to Note 5.*

Signed and authorized for release on behalf of management:

Farid Akhundov
General Director

Ramin Aghaverdiyev
Deputy General Director, Finance

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

Consolidated statements of financial position

For the years ended 31 December 2018 and 2017

(All amounts are in thousands of US dollars)

	Note	31 December 2018	31 December 2017	31 December 2016 restated*	1 January 2016 restated*
Non-current assets					
Property, plant and equipment	12	310,707	346,410	377,502	391,070
Intangible assets	13	1,336	938	1,081	8,584
Deposit in bank	16	–	20,000	20,000	20,000
Prepayments (long-term)	21	–	1,605	4,703	18,311
Deferred income tax assets	11	12,446	13,866	32,984	–
Total non-current assets		**324,489**	**382,819**	**436,270**	**437,965**
Current assets					
Cash and cash equivalents	15	296,274	162,424	146,887	145,408
Deposit in bank	16	34,007	–	–	–
Restricted cash	17	18,282	5,981	10,000	10,000
Trade and other receivables	18	50,088	37,288	74,258	67,517
Due from related parties	19	–	10,000	10,373	–
Prepaid income tax	11	313	4,933	–	–
Inventories	20	27,753	7,393	10,574	11,337
Prepayments (short-term)	21	4,499	5,308	3,019	7,627
Other current assets	22	24	4,764	61,093	79,437
Total current assets		**431,240**	**238,091**	**316,204**	**321,326**
Total assets		**755,729**	**620,910**	**752,474**	**759,291**
Equity					
Charter capital	23	285,846	285,846	285,846	285,846
Additional paid-in capital		448	448	448	448
Retained earnings		328,154	251,378	113,998	120,003
Cumulative translation differences		8	11	11	11
Total equity		**614,456**	**537,683**	**400,303**	**406,308**
Non-current liabilities					
Deferred revenue (non-current portion)	6	5,426	–	60,680	5,763
Deferred income tax liability		–	–	–	19,205
Total non-current liabilities		**5,426**	**–**	**60,680**	**24,968**
Current liabilities					
Accounts payable and accrued liabilities	24	103,043	16,767	25,242	43,486
Advances received		5,000	–	–	115,191
Due to related parties	25	–	969	15,091	35,486
Deferred revenue	6	12,649	60,680	145,172	19,712
Income tax payable	11	15,104	–	44,915	34,748
Other current liabilities	22	51	4,811	61,071	79,392
Total current liabilities		**135,847**	**83,227**	**291,491**	**328,015**
Total liabilities		**141,273**	**83,227**	**352,171**	**352,983**
Total equity and liabilities		**755,729**	**620,910**	**752,474**	**759,291**

* *Certain amounts shown here do not correspond to the 2016 and 2015 financial statements and reflect adjustment made, refer to Note 5.*

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

Consolidated statements of changes in equity

For the years ended 31 December 2018 and 2017

(All amounts are in thousands of US dollars)

	Note	Charter capital	Additional paid-in capital	Retained earnings	Cumulative translation differences	Total equity
Balance at 1 January 2016 (as reported)		**285,846**	**448**	**153,712**	**11**	**440,017**
Restatement	5	–	–	(33,709)	–	**(33,709)**
Balance at 1 January 2016 (restated*)		**285,846**	**448**	**120,003**	**11**	**406,308**
Profit for the period (restated*)		–	–	43,014	–	**43,014**
Total comprehensive income		**–**	**–**	**43,014**	**–**	**43,014**
Dividends declared	23	–	–	(49,019)	–	**(49,019)**
Balance at 31 December 2016 (restated*)		**285,846**	**448**	**113,998**	**11**	**400,303**
Profit for the period		–	–	150,362	–	**150,362**
Total comprehensive income		**–**	**–**	**150,362**	**–**	**150,362**
Dividends declared	23	–	–	(12,982)	–	**(12,982)**
Balance at 31 December 2017		**285,846**	**448**	**251,378**	**11**	**537,683**
Impact of change in accounting policy	4	–	–	(6,012)	–	**(6,012)**
Adjusted balance at 1 January 2018		**285,846**	**448**	**245,366**	**11**	**531,671**
Profit for the period		–	–	106,828	–	**106,828**
Other comprehensive loss		–	–	–	(3)	**(3)**
Total comprehensive income		**–**	**–**	**106,828**	**(3)**	**106,825**
Dividends declared	23	–	–	(24,040)	–	**(24,040)**
Balance at 31 December 2018		**285,846**	**448**	**328,154**	**8**	**614,456**

* *Certain amounts shown here do not correspond to the 2016 and 2015 financial statements and reflect adjustment made, refer to Note 5.*

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

Consolidated statements of cash flows

For the years ended 31 December 2018 and 2017

(All amounts are in thousands of US dollars)

	Note	2018	2017	2016
Operating activities				
Profit before tax		**135,211**	**184,068**	**69,220**
Adjustments for:				
Depreciation and amortization	7, 8	43,709	38,890	36,796
Expected credit loss (reversal)	8	(404)	–	–
(Gain)/loss on disposal of property, plant and equipment	12	–	(20)	6
Impairment of property, plant and equipment	12	–	18,233	77,438
Derecognition of intangible assets	13	–	–	8,102
Foreign exchange loss/(gain), net		293	(2,130)	(7,471)
Working capital adjustments				
Change in trade and other receivables		(12,800)	36,970	(6,741)
Change in due from related parties		–	373	(373)
Change in prepayments		809	(2,289)	4,608
Change in restricted cash		(12,301)	4,019	–
Change in inventories		(20,360)	3,181	763
Change in other current assets and liabilities		(20)	69	–
Change in due to related parties		(969)	947	(3,339)
Change in advances received		5,000	–	(115,191)
Change in accounts payable and accrued liabilities		85,980	2,059	(9,931)
Change in deferred revenue		(42,605)	(145,172)	180,377
Cash generated from operations		**181,543**	**139,198**	**234,264**
Income tax paid		(7,239)	(59,281)	(57,879)
Net cash flows from operating activities		**174,304**	**79,917**	**176,385**
Investing activities				
Loan provided to the parent		–	–	(12,547)
Purchase of property, plant and equipment		(6,209)	(48,372)	(112,323)
Purchase of intangible assets		(590)	–	(709)
Placement of deposits		(15,000)	–	–
Net cash flows used for investing activities		**(21,799)**	**(48,372)**	**(125,579)**
Financing activities				
Dividends paid	23	(14,040)	(12,982)	(46,472)
Net cash flows used for financing activities		**(14,040)**	**(12,982)**	**(46,472)**
Expected credit losses for cash and cash equivalents		(4,615)	–	–
Net foreign exchange difference		–	(3,026)	(2,855)
Net increase in cash and cash equivalents		**133,850**	**15,537**	**1,479**
Cash and cash equivalents as at 1 January	15	162,424	146,887	145,408
Cash and cash equivalents as at 31 December		**296,274**	**162,424**	**146,887**

Non-cash transactions performed by the Group during 2018 are represented by settlement of declared dividends with loan receivable from shareholder in the amount of USD 10,000, while no such transaction occurred in 2017 (2016: USD 2,547).

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

(All amounts are in thousands of US dollars)

1. Corporate information

Caspian Drilling Company LLC (the "Company") is a limited liability company registered under the laws of the Republic of Azerbaijan by the State Oil Company of the Azerbaijan Republic ("SOCAR") and Union Grand Energy PTE LTD ("UGE") holding 92.44% and 7.56% of ownership interest, respectively.

The Company is providing drilling services in the Caspian Sea by means of "Dada-Gorgud" and "Istiglal" mobile offshore drilling units operated at ACG (oil) and Shah Deniz (gas) fields, respectively. In addition, the Company signed an agreement with Azerbaijan Rigs LLC for the lease of "Heydar Aliyev" mobile offshore drilling unit operated at Absheron field and began to provide drilling services to this drilling unit from 24 February 2018.

Caspian Drilling International Ltd. (CDI), Caspian Drilling Company USA LLC (CDC USA), Caspian Drilling Petrol Sanayi A.S. (CDPS), Caspian Drilling Company (Israel) Ltd. (CDC Israel) incorporated with 100% ownership by the Company are jointly referred to as "subsidiaries" within these consolidated financial statements.

The registered address of the Company is 86, Nasibbey Yusifbeyli street, Baku AZ1007, the Republic of Azerbaijan.

2. Basis of preparation and significant accounting policies

2.1 Basis of preparation

The consolidated financial statements of the Company and its subsidiaries (jointly referred to as "the Group") have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

The consolidated financial statements have been prepared on a historical cost basis, unless described otherwise in the accounting policy below. The consolidated financial statements are presented in United State dollars ("USD") and all values are rounded to the nearest thousands, except when otherwise indicated.

2.2 Basis of consolidation

The consolidated financial statements comprise the financial statements of the Company and its subsidiaries as at 31 December 2018 and 2017. Subsidiaries are fully consolidated from the date of incorporation or acquisition, being the date on which the Company obtains control, and continue to be consolidated until the date when such control ceases. The financial statements of the subsidiaries are prepared for the same reporting period as the parent company, using consistent accounting policies. All intra-group balances, transactions, unrealised gains and losses resulting from intra-group transactions and dividends are eliminated in full.

2.3 Summary of significant accounting policies

Foreign currency translation

The official currency of the Republic of Azerbaijan is Azerbaijani manat ("AZN"). However, according to International Accounting Standard ("IAS") No. 21 *The Effects of Changes in Foreign Exchange Rates*, and its interpretations, the Company's measurement currency, which reflects the economic substance of the underlying events and circumstances of the Company is the USD, as the majority of the Company's property, plant and equipment purchased, sales, purchases, trade receivables and payables are either priced, incurred, payable or otherwise measured in USD.

The functional currencies of the Group's Israeli and Turkish subsidiaries and currencies of the primary economic environment in which these subsidiaries operate are Israeli Shekel ("ILS") and USD, respectively.

Foreign exchange gains and losses resulting from the re-measurement into the functional currencies of respective Group's subsidiaries are recognized in consolidated statement of profit or loss and other comprehensive income.

(All amounts are in thousands of US dollars)

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

2.3 Summary of significant accounting policies (continued)

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

Monetary assets and liabilities denominated in foreign currencies other than functional currency of respective Group's subsidiaries are translated into the functional currency of that entity at the appropriate exchange rates prevailing at the reporting date. Foreign exchange gains and losses resulting from the re-measurement into the functional currencies of respective Group's entities are recognized in profit or loss.

At 31 December 2018 the principal rate of exchange used for translating foreign currency balances were AZN 1 = USD 0.5882, ILS 1 = USD 0.2653, TRY 1 = USD 0.1889 (31 December 2017: AZN 1 = USD 0.5882, ILS 1 = USD 0.2882; 31 December 2016: AZN 1 = USD 0.5647, ILS 1 = USD 0.2605).

Revenue recognition

Revenue is recognised to the extent that it is probable that the economic benefits will flow to the Group and the revenue can be reliably measured, regardless of when the payment is being made. Revenue is measured at the fair value of the consideration received or receivable, taking into account contractually defined terms of payment and excluding taxes or duty. The Group assesses its revenue arrangements against specific criteria in order to determine if it is acting as principal or agent.

Rendering of services

Revenue from the provision of drilling services is recognised based on agreed day rates for works performed on a monthly basis.

Sale of goods

For contracts with customers in which the sale of goods is generally expected to be the only performance obligation. The Group concluded that the revenue recognition occurs at a point in time when control of the asset is transferred to the customer, generally on delivery of the goods. Therefore, the adoption of IFRS 15 did not have an impact on the timing of revenue recognition.

Revenue from reimbursable items

Revenue from reimbursable items represents mark-ups on certain equipment, materials and supplies, third-party services and other expenses acquired at request of the customer. Revenue from reimbursable items is recognized on net basis and included into "Other income" in the consolidated statement of profit or loss and other comprehensive income.

Mobilization revenue

Fees received prior to the commencement of the drilling service agreement related directly to mobilization of drilling units, equipment and personnel are deferred over the primary contract term of the drilling project using the straight-line method.

Interest income

Interest income is recognized on a time-proportion basis using the effective interest rate method.

Since most of abovementioned services are rendered at contractually agreed rates, with company representative gives signed consensus that the service is satisfied at the point of time, company issues respective invoice. As a result of respective contract analysis no changes to revenue recognition methodology was implemented.

(All amounts are in thousands of US dollars)

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

2.3 Summary of significant accounting policies (continued)

Construction contract activities

Construction contracts are represented by a fixed price contract with Azerbaijan Rigs LLC for management of drilling unit construction.

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract is be recognized as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period.

For fixed price contract, the outcome of a construction contract can be estimated reliably when: (i) the total contract revenue can be measured reliably; (ii) it is probable that the economic benefits associated with the contract will flow to the entity; (iii) the costs to complete the contract and the stage of completion can be measured reliably; and (iv) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

For cost plus contract, the outcome of a construction contract can be estimated reliably when: (i) it is probable that the economic benefits associated with the contract will flow to the entity; and (ii) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

When the outcome of a construction cannot be estimated reliably (principally during early stages of a contract), contract revenue is recognized only to the extent of costs incurred that are expected to be recoverable.

In applying the percentage of completion method, revenue recognized corresponds to the total contract revenue (as defined below) multiplied by the actual completion rate based on the proportion of total contract costs (as defined below) incurred to date and the estimated costs to complete.

Contract revenue − contract revenue corresponds to the initial amount of revenue agreed in the contract and any variations in contract work, claims and incentive payments to the extent that it is probable that they will result in revenue; and they are capable of being reliably measured.

Contract costs − contract costs include costs that relate directly to the specific contract and costs that are attributable to contract activity in general and can be allocated to the contract. Costs that relate directly to a specific contract comprise: site labor costs (including site supervision); costs of materials used in construction; depreciation of equipment used under a contract; costs of design, and technical assistance that is directly related to the contract and are recognized as expenses in the period in which they are incurred.

Contract costs incurred that relate to future activity on the contract are recognized as an asset provided it is probable that they will be recovered.

When the outcome of a construction contract cannot be estimated reliably: (i) revenue shall be recognized only to the extent of contract costs incurred that it is probable will be recoverable; and (ii) contract costs shall be recognized as an expense in the period in which they are incurred.

When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognized in full as an expense immediately.

The Group presents amounts prepaid to subcontractors for estimated works under the construction contract as prepayment and other current assets.

The Group presents amounts received in advance from customer for estimated works under the construction contract as advances received and other current liabilities.

(All amounts are in thousands of US dollars)

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

2.3 Summary of significant accounting policies (continued)

Joint operations

Joint arrangement is an arrangement over which two or more parties have joint control. Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities (being those that significantly affect the returns of the arrangement) require unanimous consent of the parties sharing control.

A joint operation is a type of joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities, relating to the arrangement. In relation to its interests in joint operations, the Group recognizes its:

- Assets, including its share of any assets held jointly;
- Liabilities, including its share of any liabilities incurred jointly;
- Revenue from the sale of its share of the output arising from the joint operation;
- Share of the revenue from the sale of the output by the joint operation;
- Expenses, including its share of any expenses incurred jointly.

Property, plant and equipment

Property, plant and equipment is stated at cost, net of accumulated depreciation and/or accumulated impairment losses, if any. Such cost includes the cost of replacing part of the property, plant and equipment and borrowing costs for long-term construction projects if the recognition criteria are met. When significant parts of property, plant and equipment are required to be replaced at intervals, the Group recognizes such parts as individual assets with specific useful lives and depreciation, respectively. All other repair and maintenance costs are recognized in the consolidated statement of comprehensive income as incurred.

Depreciation is calculated on a straight-line basis over estimated useful lives of asset as follows:

Drilling units, buildings and installations	10 to 50 years
Machinery and equipment	5 to 10 years
Vehicles, furniture and tools	3 to 5 years
Other	up to 3 years

An item of property, plant and equipment and any significant part initially recognized is derecognized upon disposal or when no future economic benefits are expected from its use or disposal. Any gain or loss arising on derecognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is included in the consolidated statement of profit or loss and other comprehensive income when the asset is derecognized.

The assets' residual values, useful lives and methods of depreciation are reviewed at each financial year end and adjusted prospectively, if appropriate.

Spare parts and emergency stock necessary to support the Group's continuous operations and expected to be utilised during more than one-year period are classified as property, plant and equipment less an accumulated depreciation.

Leases

The determination of whether an arrangement is, or contains a lease is based on the substance of the arrangement at inception date, whether fulfillment of the arrangement is dependent on the use of a specific asset or assets or the arrangement conveys a right to use the asset, even if that right is not explicitly specified in an arrangement.

Operating lease payments are recognized as an operating expense in the consolidated statement of profit or loss and other comprehensive income on a straight-line basis over the lease term.

(All amounts are in thousands of US dollars)

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

2.3 Summary of significant accounting policies (continued)

Borrowing costs

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

Intangible assets

Intangible assets acquired separately are measured on initial recognition at cost. Following initial recognition, intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses, if any.

The useful lives of intangible assets are assessed as either finite or indefinite.

Intangible assets with finite lives are amortised over the useful economic life and assessed for impairment whenever there is an indication that the intangible asset may be impaired. The amortisation period and the amortisation method for an intangible asset with a finite useful life is reviewed at least at the end of each reporting period. Changes in the expected useful life or the expected pattern of consumption of future economic benefits embodied in the asset is accounted for by changing the amortisation period or method, as appropriate, and are treated as changes in accounting estimates.

The amortisation expense on intangible assets with finite lives is recognized in the consolidated statement of profit or loss and other comprehensive income in the expense category consistent with the function of the intangible asset.

Financial instruments − key measurement terms

Depending on their classification financial instruments are subsequently carried at fair value, or amortized cost as described below. Since the Group started to apply IFRS 9 *Financial Instruments* after 1 January 2018, the comparative information has not been restated and continues to be reported under IAS 39 *Financial Instruments: Recognition and Measurement*. Therefore, accounting policy under IAS 39 *Financial Instruments: Recognition and Measurement* which was disclosed in the Group's consolidated financial statements as of 31 December 2016 is not repeated here.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value measurement is based on the presumption that the transaction to sell the asset or transfer the liability takes place either in the principal market for the asset or liability, or in the absence of a principal market, in the most advantageous market for the asset or liability. The principal or the most advantageous market must be accessible to by the Group. The fair value of an asset or a liability is measured using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest.

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

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

Level 1 − quoted (unadjusted) market prices in active markets for identical assets or liabilities;

Level 2 − valuation techniques for which the lowest level input that is significant to the fair value measurement is directly or indirectly observable;

Level 3 − valuation techniques for which the lowest level input that is significant to the fair value measurement is unobservable.

(All amounts are in thousands of US dollars)

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

2.3 Summary of significant accounting policies (continued)

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

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument. An incremental cost is one that would not have been incurred if the transaction had not taken place. Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisors, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

Amortised cost is the amount at which the financial instrument was recognised at initial recognition less any principal repayments, plus accrued interest, and for financial assets less any allowance for expected credit losses ("ECL"). Accrued interest includes amortisation of transaction costs deferred at initial recognition and of any premium or discount to maturity amount using the effective interest rate method. Accrued interest income and accrued interest expense, including both accrued coupon and amortised discount or premium (including fees deferred at origination, if any), are not presented separately and are included in the carrying values of related items in the consolidated statement of financial position.

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

The effective interest rate discounts cash flows of variable interest instruments to the next interest repricing date except for the premium or discount which reflects the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates. Such premiums or discounts are amortised over the whole expected life of the instrument. The present value calculation includes all fees paid or received between parties to the contract that are an integral part of the effective interest rate.

Financial assets

Initial recognition and measurement

Financial assets are classified, at initial recognition, as subsequently measured at amortised cost, fair value through other comprehensive income ("FVOCI"), and fair value through profit or loss ("FVPL").

The classification of financial assets at initial recognition depends on the financial asset's contractual cash flow characteristics and the Group's business model for managing them. With the exception of trade receivables that do not contain a significant financing component or for which the Group has applied the practical expedient, the Group initially measures a financial asset at its fair value plus, in the case of a financial asset not at fair value through profit or loss, transaction costs. Trade receivables that do not contain a significant financing component or for which the Group has applied the practical expedient are measured at the transaction price determined under IFRS 15.

In order for a financial asset to be classified and measured at amortised cost or fair value through OCI, it needs to give rise to cash flows that are 'solely payments of principal and interest (SPPI)' on the principal amount outstanding. This assessment is referred to as the SPPI test and is performed at an instrument level.

The Group's business model for managing financial assets refers to how it manages its financial assets in order to generate cash flows. The business model determines whether cash flows will result from collecting contractual cash flows, selling the financial assets, or both.

Purchases or sales of financial assets that require delivery of assets within a time frame established by regulation or convention in the market place (regular way trades) are recognised on the trade date, i.e., the date that the Group commits to purchase or sell the asset.

(All amounts are in thousands of US dollars)

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

2.3 Summary of significant accounting policies (continued)

Subsequent measurement

For purposes of subsequent measurement, financial assets are classified in four categories:

- Financial assets at amortised cost (debt instruments);
- Financial assets at fair value through OCI with recycling of cumulative gains and losses (debt instruments);
- Financial assets designated at fair value through OCI with no recycling of cumulative gains and losses upon de-recognition (equity instruments);
- Financial assets at fair value through profit or loss.

Financial assets at amortised cost (debt instruments)

This category is the most relevant to the Group. The Group measures financial assets at amortised cost if both of the following conditions are met:

- The financial asset is held within a business model with the objective to hold financial assets in order to collect contractual cash flows;
- The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Financial assets at amortised cost are subsequently measured using the effective interest (EIR) method and are subject to impairment. Gains and losses are recognised in profit or loss when the asset is derecognised, modified or impaired.

The Group's financial assets at amortised cost includes deposit accounts (both current and non-current) as well as restricted accounts at several local and international banks and trade and loan receivables from third parties.

Derecognition

A financial asset (or, where applicable, a part of a financial asset or part of a group of similar financial assets) is primarily derecognised (i.e., removed from the Group's consolidated statement of financial position) when:

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

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

Impairment of financial assets

The Group recognises an allowance for ECLs for all debt instruments not held at FVPL. ECLs are based on the difference between the contractual cash flows due in accordance with the contract and all the cash flows that the Group expects to receive, discounted at an approximation of the original effective interest rate. The expected cash flows will include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms.

(All amounts are in thousands of US dollars)

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

2.3 Summary of significant accounting policies (continued)

ECLs are recognised in two stages. For credit exposures for which there has not been a significant increase in credit risk since initial recognition, ECLs are provided for credit losses that result from default events that are possible within the next 12-months (a 12-month ECL). For those credit exposures for which there has been a significant increase in credit risk since initial recognition, a loss allowance is required for credit losses expected over the remaining life of the exposure, irrespective of the timing of the default (a lifetime ECL).

For financial assets other than trade receivables and contract assets, the Group applies general approach in calculating ECLs.

For trade and other receivables and due from related parties, the Group applies a simplified approach in calculating ECLs. Therefore, the Group does not track changes in credit risk, but instead recognises a loss allowance based on lifetime ECLs at each reporting date. The Group has established a provision matrix that is based on its historical credit loss experience, adjusted for forward-looking factors specific to the debtors and the economic environment.

Financial liabilities

Initial recognition and measurement

Financial liabilities are classified, at initial recognition, as financial liabilities at fair value through profit or loss, loans and borrowings, payables, or as derivatives designated as hedging instruments in an effective hedge, as appropriate.

All financial liabilities are recognised initially at fair value and, in the case of loans and borrowings and payables, net of directly attributable transaction costs.

The Group’s financial liabilities include trade and other payables, loans and borrowings including bank overdrafts, and derivative financial instruments.

Subsequent measurement

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

Trade payables and accrued liabilities

Trade payables and accrued liabilities are accrued when the counterparty performed its obligations under the contract. Trade payables are recognised initially at fair value and subsequently measured at amortised cost using the effective interest rate method.

Derecognition

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

Offsetting of financial instruments

Financial assets and financial liabilities are offset and the net amount reported in the statement of financial position if, and only if, there is a currently enforceable legal right to offset the recognized amounts and there is an intention to settle on a net basis, or to realise the assets and settle the liabilities simultaneously.

Cash and cash equivalents

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

(All amounts are in thousands of US dollars)

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

2.3 Summary of significant accounting policies (continued)

Restricted cash

Restricted cash is presented separately from cash and cash equivalents. Restricted balances are excluded from cash and cash equivalents for the purposes of cash flow statement.

Inventories

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

Impairment of non-financial assets

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

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

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

Provisions

Provisions are recognized when the Group has a present obligation (legal or constructive) as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Where the Group expects some or all of a provision to be reimbursed, for example under an insurance contract, the reimbursement is recognized as a separate asset but only when the reimbursement is virtually certain. The expense relating to any provision is presented in the consolidated statement of profit or loss and other comprehensive income net of any reimbursement. If the effect of the time value of money is material, provisions are discounted using a current pre-tax rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognized as a finance cost.

(All amounts are in thousands of US dollars)

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

2.3 Summary of significant accounting policies (continued)

Prepayments

Prepayments are recognized and carried at the original amount of payment less provision for any amount at risk of non-performance by the counterparty. Prepayments made for non-current assets as well as prepayments which will be settled during more than one-year period are non-current prepayments.

Income taxes

Current income tax

Current income tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted, at the reporting date.

Current income tax relating to items recognized directly in equity is recognized in equity and not in the consolidated statement of profit or loss and other comprehensive income. Management periodically evaluates positions taken in the tax returns with respect to situations in which applicable tax regulations are subject to interpretation and establishes provisions where appropriate.

Deferred income tax

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

Deferred income tax liabilities are recognized for all taxable temporary differences, except:

- Where the deferred income tax liability arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss;
- In respect of taxable temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, where the timing of the reversal of the temporary differences can be controlled and it is probable that the temporary difference will not reverse in the foreseeable future.

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

- Where the deferred income tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss;
- In respect of deductible temporary differences associated with investments in subsidiaries, associates and interests in joint ventures, deferred income tax assets are recognized only to the extent that it is probable that the temporary differences will reverse in the foreseeable future and taxable profit will be available against which the temporary difference can be utilized.

The carrying amount of deferred income tax assets is reviewed at each statement of financial position 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 income tax asset to be utilized.

(All amounts are in thousands of US dollars)

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

2.3 Summary of significant accounting policies (continued)

Value added tax

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

VAT payable

VAT is payable to tax authorities upon collection of receivables from customers. VAT on purchases, which have been settled at the date of the statement of financial position, is deducted from the amount payable. In addition, VAT related to sales which have not been settled at the date of the statements of financial position (VAT deferred) is also included in VAT payable. Where provision has been made for impairment of receivables, impairment loss is recorded for the gross amount of the debtor, including VAT.

VAT receivable

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

Social and pension contributions

In accordance with the *Law on Social Insurance of the Republic of Azerbaijan*, as amended, the Company is obligated to contribute to the State Social Protection Fund of the Republic of Azerbaijan (the “State Fund”) on behalf of its employees that are citizens of the Republic of Azerbaijan.

The Company’s contributions represented 22% of the employees’ salaries reflected in the statutory records in 2018 and 2017. Additionally, employees are obligated to pay 3% of their salaries to the State Fund. Moreover, starting 2018 both the Company and the employees are obligated to pay 1% of their salaries as mandatory unemployment insurance.

Equity

Charter capital

The charter capital represents contributions made by the shareholders according to the ownership structure.

Additional paid-in capital

Additional paid-in capital represents the excess of the shareholder’s contribution over the charter capital.

Dividends

Dividends are recognized as a liability and deducted from equity at the date of the consolidated statement of financial position only if they are declared before or on the date of the consolidated statement of financial position. Dividends are disclosed when they are proposed before the date of the consolidated statement of financial position or proposed or declared after the date of the consolidated statement of financial position but before the financial statements are authorised for issue.

Transactions with related parties

For the purposes of these financial statements, parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial or operational decisions. In considering each possible related party relationship, attention is directed to the substance of the relationship, not merely the legal form.

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

(All amounts are in thousands of US dollars)

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

2.3 Summary of significant accounting policies (continued)

Carried interest arrangements

A carried interest arrangements where the Group participates as carried party is an agreement under which the carrying party agrees to pay for a portion or all of the pre-production costs of the carried party on a project in which both parties own participating interest. The carrying party will not be reimbursed for the pre-production costs that it has incurred on behalf of the carried party.

The Group does not recognize any carry related transactions and balances in the consolidated financial statements.

3. Significant accounting judgments, estimates and assumptions

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

Estimates and assumptions

The key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year, are described below. The Group based its assumptions and estimates on parameters available when the financial statements were prepared. Existing circumstances and assumptions about future developments however, may change due to market changes or circumstances arising beyond the control of the Group. Such changes are reflected in the assumptions when they occur.

Impairment of non-financial assets

Management assesses whether there are any indicators of possible impairment of all non-financial assets at each reporting date based on events or circumstances that indicate the carrying value of assets may not be recoverable. Such indicators include changes in the Group's business plans, changes in commodity prices leading to unprofitable performances and changes in product mixes. Other non-financial assets are tested for impairment when there are indicators that the carrying amounts may not be recoverable.

The carrying value of "Dada Gorgud" drilling unit at 31 December 2017 has been tested for impairment through comparison with its recoverable amount, since the drilling unit remained idle for an uncertain period after April 2017, upon expiration of the rental contract with BP Exploration (Caspian Sea) Limited. The recoverable amount of USD 3,904 as at 31 December 2017 (31 December 2016: USD 25,827) was derived under income and market approaches and was determined at the level of the respective CGU. As a result of the test performed, an impairment loss of USD 18,233 as at 31 December 2017 has been identified and charged to other expenses in the consolidated statement of profit or loss and other comprehensive income (31 December 2016: USD 76,700).

The following key assumptions were used for impairment test of the fixed assets:

Discount rate

The pre-tax discount rates applied to the cash flow projections were 11.3% and 12.6 % for 2017 and 2016, respectively and were the Group's weighted average cost of capital (WACC). In calculating WACC the cost of equity was estimated using peer group data and the cost of debt is based on market rates for interest bearing borrowings in the Republic of Azerbaijan. The beta factors are evaluated annually based on publicly available market data. If the estimated WACC used in the calculation had been 1% higher/lower than management's estimate, no change to the recognized impairment loss would be required.

(All amounts are in thousands of US dollars)

3. Significant accounting judgments, estimates and assumptions (continued)

Estimates and assumptions (continued)

Useful life of property, plant and equipment

The Group assesses the remaining useful lives of items of property, plant and equipment at least at each financial year-end. If expectations differ from previous estimates, the changes are accounted for as a change in an accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*

Assessment of the percentage of completion on services or construction contracts

The percentage of completion and the revenue to recognize are determined on the basis of a large number of estimates.

In particular, the Group reviews each reporting period the estimates of contract revenue and contract costs as the contract progress.

Deferred income tax

Management judgment is required for the calculation of current and deferred income taxes. Deferred income tax assets are recognized to the extent that their utilization is probable. The utilization of deferred income tax assets will depend on whether it is possible to generate sufficient taxable income in respective tax type and jurisdiction. Various factors are used to assess the probability of the future utilization of deferred income tax assets, including past operating results, operational plan, expiration of tax losses carried forward, and tax planning strategies.

Estimates of future taxable income are based on forecast cash flows from operations and the application of existing tax laws in each jurisdiction. If actual results differ from that estimates or if these estimates must be adjusted in future periods, the financial position, results of operations and cash flows may be negatively affected. In the event that the assessment of future utilization of deferred income tax assets must be reduced this reduction is recognized through profit or loss.

Contingencies

By their nature, contingencies will only be resolved when one or more future events will occur. The assessment of contingencies inherently involves the exercise of significant judgement and estimates of the outcomes of future events.

Provision for impaired or obsolete inventory

The Group reviews and if required reduces the carrying value of inventories for the amount of obsolete, impaired and slow-moving inventories at each reporting date. Such amount is estimated individually and in aggregate based on the percentage thresholds applied to obsolete or slow-moving inventories depending on the level of damage and frequency of use.

ECL measurement

The Group uses a provision matrix to calculate ECLs for financial assets. The provision rates are based on credit rating of financial institutions. The provision matrix is initially based on the Group's historical observed default rates. The Group calibrates the matrix to adjust the historical credit loss experience with forward-looking information. For instance, if forecast economic conditions (i.e., gross domestic product) are expected to deteriorate over the next year which can lead to an increased number of defaults in the sector, the historical default rates are adjusted. At every reporting date, the historical observed default rates are updated and changes in the forward-looking estimates are analysed. The assessment of the correlation between historical observed default rates, forecast economic conditions and ECLs is a significant estimate. The amount of ECLs is sensitive to changes in circumstances and of forecast economic conditions.

(All amounts are in thousands of US dollars)

3. Significant accounting judgments, estimates and assumptions (continued)

ECL measurement (continued)

Litigations

The Group exercises considerable judgment in measuring and recognizing provisions and the exposure to contingent liabilities related to pending litigations or other outstanding claims subject to negotiated settlement, mediation, arbitration or government regulation, as well as environmental liabilities or other contingent liabilities. Judgement is necessary in assessing the likelihood that a pending claim will succeed, or a liability will arise, and to quantify the possible range of the final settlement. Because of the inherent uncertainties in this evaluation process, actual losses may be different from the originally estimated provision. These estimates are subject to change as new information becomes available, primarily with the support of internal specialists, if available, or with the support of outside consultants, such as actuaries or legal counsel. Revisions to the estimates may significantly affect future operating results.

4. Adoption of new or revised standards and interpretations

4.1 Changes in Group's accounting policies

The Group applied for the first-time certain standards and amendments, which are effective for annual periods beginning on or after 1 January 2018. The Group has not early adopted any other standard, interpretation or amendment that has been issued but is not yet effective.

IFRS 9 Financial Instruments

IFRS 9 *Financial Instruments* replaces IAS 39 *Financial Instruments: Recognition and Measurement* for reporting periods beginning on or after 1 January 2018, bringing together all three aspects of the accounting for financial instruments: classification and measurement; impairment; and hedge accounting.

The Group applied IFRS 9 retrospectively choosing not to restate prior year figures. Prior year figures for the assets, which are now within the scope of IFRS 9, were presented in accordance with IAS 39 and will not be comparable to the information related to 2018. Differences arising from the adoption of IFRS 9, have been recognized directly in retained earnings as of 1 January 2018 and are disclosed below.

(a) Classification and measurement

Under IFRS 9, all debt financial assets that do not meet a "solely payment of principal and interest" (SPPI) criterion, are classified at initial recognition as FVPL. Debt financial assets that meet the SPPI criterion are measured either at FVPL, amortized cost or at FVOCI. The classification for the debt financial assets that meets the SPPI criterion is based on the Group's business model for managing these assets:

- Financial assets that are managed under "hold to collect" basis that are measured at amortized cost;
- Financial assets that are managed under "hold to collect and sell" basis that are measured at FVOCI;
- Financial assets that are managed under "held for trading" basis that are measured at FVPL.

The assessment of the Group's business models is made as of the date of initial application, 1 January 2018 and then applies retrospectively to those financial assets that were not derecognized before 1 January 2018. The assessment of whether contractual cash flows on debt instruments are solely comprised of principal and interest is made based on the facts and circumstances not only as at the date of the initial recognition of the assets, but also as at the date of substantial modification.

Debt instruments that are held within a business model with the objective to hold the financial assets in order to collect contractual cash flows that meet the SPPI criterion are required to be classified at amortized cost. This category includes Trade and other receivables, deposits, loan receivables and other financial assets included under other current and non-current assets.

The classification and measurement of financial liabilities remains largely unchanged from requirements of IAS 39 requirements.

(All amounts are in thousands of US dollars)

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

4.1 Changes in Group's accounting policies (continued)

(b) Impairment

The adoption of IFRS 9 has fundamentally changed the Group's accounting for impairment losses for financial assets by replacing IAS 39's incurred loss approach with a forward-looking ECL approach. IFRS 9 requires the Group to recognize an allowance for ECLs for all debt instruments not held at FVPL.

The ECL allowance is based on the credit losses expected to arise over the life of the asset (the lifetime expected credit loss or LTECL), unless there has been no significant increase in credit risk since origination, in which case, the allowance is based on the 12 months' expected credit loss (12mECL). The 12mECL is the portion of LTECL that represent the ECLs that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

The effect of adopting IFRS 9 as at 1 January 2018 was as follows:

	Retained earnings
Closing balance of retained earnings under previous IAS 39 (31 December 2017)	**251,378**
IFRS 9 ECL effect on accumulated loss	(6,012)
Restated opening balance under IFRS 9 (1 January 2018)	**245,366**
Total change in equity	**(6,012)**

Movement of provision as at 1 January 2018:

	Provision under IAS 39 at 31 December 2017	Remeasurement ECL	ECLs under IFRS 9 at 1 January 2018
Impairment allowance for:			
Cash and cash equivalents (Note 15)	–	(4,042)	(4,042)
Deposits (Note 16)	–	(1,970)	(1,970)
Total provision on financial assets	**–**	**(6,012)**	**(6,012)**

IFRS 15 Revenue from Contracts with Customers

IFRS 15 supersedes IAS 11 *Construction Contracts*, IAS 18 *Revenue* and related Interpretations and it applies, with limited exceptions, to all revenue arising from contracts with customers. IFRS 15 establishes a five-step model to account for revenue arising from contracts with customers and requires that revenue be recognised at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer.

IFRS 15 requires entities to exercise judgement, taking into consideration all of the relevant facts and circumstances when applying each step of the model to contracts with their customers. The standard also specifies the accounting for the incremental costs of obtaining a contract and the costs directly related to fulfilling a contract. In addition, the standard requires extensive disclosures.

The cumulative effect of initially applying IFRS 15 is recognised at the date of initial application as an adjustment to the opening balance of retained earnings. Therefore, the comparative information was not restated and continues to be reported under IAS 11, IAS 18 and related Interpretations.

As a result of the analysis performed by the Group, the conclusion was made that the standard has no significant impact on the consolidated financial statements.

(All amounts are in thousands of US dollars)

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

4.1 Changes in Group's accounting policies (continued)

Annual improvements 2015-2017 cycle

Annual improvements are part of the Board's process for maintaining IFRS Standards and contain Interpretations that are minor or narrow in scope. The amendments made during the 2015-2017 cycle are:

IAS 12 Income Taxes – income tax consequences of payments on financial instruments classified as equity

The amendments clarify that the income tax consequences of dividends are linked more directly to past transactions or events that generated distributable profits than to distributions to owners. Therefore, an entity recognises the income tax consequences of dividends in profit or loss, other comprehensive income or equity according to where the entity originally recognised those past transactions or events. An entity applies those amendments for annual reporting periods beginning on or after 1 January 2019, with early application is permitted. When an entity first applies those amendments, it applies them to the income tax consequences of dividends recognised on or after the beginning of the earliest comparative period. Since the Group's current practice is in line with these amendments, the Group does not expect any effect on its consolidated financial statements.

IAS 23 Borrowing Costs – borrowing costs eligible for capitalization

The amendments clarify that an entity treats as part of general borrowings any borrowing originally made to develop a qualifying asset when substantially all of the activities necessary to prepare that asset for its intended use or sale are complete. An entity applies those amendments to borrowing costs incurred on or after the beginning of the annual reporting period in which the entity first applies those amendments. An entity applies those amendments for annual reporting periods beginning on or after 1 January 2019, with early application permitted. Since the Group's current practice is in line with these amendments, the Group does not expect any effect on its consolidated financial statements.

IFRS 3 Business Combinations – definition of a business

The amendments clarify that to be considered a business, an integrated set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output. They also clarify that a business can exist without including all of the inputs and processes needed to create outputs. That is, the inputs and processes applied to those inputs must have 'the ability to contribute to the creation of outputs' rather than 'the ability to create outputs'.

The amendments specify that if a set of activities and assets does not have outputs at the acquisition date, an acquired process must be considered substantive only if: (a) it is critical to the ability to develop or convert acquired inputs into outputs; and (b) the inputs acquired include both an organized workforce with the necessary skills, knowledge, or experience to perform that process, and other inputs that the organized workforce could develop or convert into outputs. In contrast, if a set of activities and assets has outputs at that date, an acquired process must be considered substantive if: (a) it is critical to the ability to continue producing outputs and the acquired inputs include an organized workforce with the necessary skills, knowledge, or experience to perform that process; or (b) it significantly contributes to the ability to continue producing outputs and either is considered unique or scarce, or cannot be replaced without significant cost, effort or delay in the ability to continue producing outputs. The amendments narrowed the definition of outputs to focus on goods or services provided to customers, investment income (such as dividends or interest) or other income from ordinary activities.

The amendments introduced an optional fair value concentration test to permit a simplified assessment of whether an acquired set of activities and assets is not a business. Entities may elect to apply the concentration test on a transaction-by-transaction basis. The test is met if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. If the test is met, the set of activities and assets is determined not to be a business and no further assessment is needed. If the test is not met, or if an entity elects not to apply the test, a detailed assessment must be performed applying the normal requirements in IFRS 3. The amendments must be applied to transactions that are either business combinations or asset acquisitions for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2020. Consequently, entities do not have to revisit such transactions that occurred in prior periods. Earlier application is permitted and must be disclosed. The Group will apply amendment form its effective date.

(All amounts are in thousands of US dollars)

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

4.1 Changes in Group's accounting policies (continued)

Amendments to IAS 1 and IAS 8

In October 2018, the IASB issued amendments to IAS 1 *Presentation of Financial Statements* and IAS 8 to align the definition of 'material' across the standards and to clarify certain aspects of the definition. The new definition states that, 'Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.' The amendments clarify that materiality will depend on the nature or magnitude of information, or both. An entity will need to assess whether the information, either individually or in combination with other information, is material in the context of the financial statements. The amendments must be applied prospectively. Early application is permitted and must be disclosed. Although the amendments to the definition of material is not expected to have a significant impact on the Group's consolidated financial statements, the introduction of the term 'obscuring information' in the definition could potentially impact how materiality judgements are made in practice, by elevating the importance of how information is communicated and organised in the consolidated financial statements.

4.2 Standards issued but not yet effective

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

Amendments to IFRS 10 and IAS 28 Sale or Contribution of Assets between an Investor and its Associate or Joint Venture

The amendments address the conflict between IFRS 10 and IAS 28 in dealing with the loss of control of a subsidiary that is sold or contributed to an associate or joint venture. The amendments clarify that the gain or loss resulting from the sale or contribution of assets that constitute a business, as defined in IFRS 3, between an investor and its associate or joint venture, is recognized in full. Any gain or loss resulting from the sale or contribution of assets that do not constitute a business, however, is recognized only to the extent of unrelated investors' interests in the associate or joint venture. The IASB has deferred the effective date of these amendments indefinitely, but an entity that early adopts the amendments must apply them prospectively. These amendments are not expected to have any impact on the Group.

IFRS 16 Leases

IFRS 16 was issued in January 2016 and it replaces IAS 17 *Leases*, IFRIC 4 *Determining whether an Arrangement Contains a Lease*, SIC-15 *Operating Leases – Incentives* and SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*. IFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases and requires lessees to account for all leases under a single on-balance sheet model similar to the accounting for finance leases under IAS 17. The standard includes two recognition exemptions for lessees – leases of 'low-value' assets (e.g., personal computers) and short-term leases (i.e., leases with a lease term of 12 months or less). At the commencement date of a lease, a lessee will recognise a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset). Lessees will be required to separately recognise the interest expense on the lease liability and the depreciation expense on the right-of-use asset.

Lessees will be also required to remeasure the lease liability upon the occurrence of certain events (e.g., a change in the lease term, a change in future lease payments resulting from a change in an index or rate used to determine those payments). The lessee will generally recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset.

Lessor accounting under IFRS 16 is substantially unchanged from today's accounting under IAS 17. Lessors will continue to classify all leases using the same classification principle as in IAS 17 and distinguish between two types of leases: operating and finance leases.

(All amounts are in thousands of US dollars)

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

4.1 Changes in Group's accounting policies (continued)

IFRS 16, which is effective for annual periods beginning on or after 1 January 2019, requires lessees and lessors to make more extensive disclosures than under IAS 17.

Transition to IFRS 16

The Group plans to adopt IFRS 16 from effective date applying the modified retrospective transition method and will elect to apply the practical expedient that permits the entity not to reassess whether a contract is, or contains, a lease at the date of initial application. In addition, the Group will elect to use the exemptions applicable to the standard on lease contracts for which the lease terms end within 12 months as of the date of initial application, and lease contracts for which the underlying asset is of low value. The Group is in the process of impact assessment of IFRS 16.

IFRS 17 Insurance Contracts

In May 2017, the IASB issued IFRS 17 *Insurance Contracts* (IFRS 17), a comprehensive new accounting standard for insurance contracts covering recognition and measurement, presentation and disclosure. Once effective, IFRS 17 will replace IFRS 4 *Insurance Contracts* (IFRS 4) that was issued in 2005. IFRS 17 applies to all types of insurance contracts (i.e., life, non-life, direct insurance and re-insurance), regardless of the type of entities that issue them, as well as to certain guarantees and financial instruments with discretionary participation features. A few scope exceptions will apply. The overall objective of IFRS 17 is to provide an accounting model for insurance contracts that is more useful and consistent for insurers. In contrast to the requirements in IFRS 4, which are largely based on grandfathering previous local accounting policies, IFRS 17 provides a comprehensive model for insurance contracts, covering all relevant accounting aspects. The core of IFRS 17 is the general model, supplemented by:

- A specific adaptation for contracts with direct participation features (the variable fee approach);
- A simplified approach (the premium allocation approach) mainly for short-duration contracts.

IFRS 17 is effective for reporting periods beginning on or after 1 January 2021, with comparative figures required. Early application is permitted, provided the entity also applies IFRS 9 and IFRS 15 on or before the date it first applies IFRS 17. This standard is not applicable to the Group.

IFRIC Interpretation 23 Uncertainty over Income Tax Treatment

The Interpretation addresses the accounting for income taxes when tax treatments involve uncertainty that affects the application of IAS 12 and does not apply to taxes or levies outside the scope of IAS 12, nor does it specifically include requirements relating to interest and penalties associated with uncertain tax treatments.

The Interpretation specifically addresses the following:

- Whether an entity considers uncertain tax treatments separately;
- The assumptions an entity makes about the examination of tax treatments by taxation authorities;
- How an entity determines taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates;
- How an entity considers changes in facts and circumstances.

An entity must determine whether to consider each uncertain tax treatment separately or together with one or more other uncertain tax treatments. The approach that better predicts the resolution of the uncertainty should be followed. The interpretation is effective for annual reporting periods beginning on or after 1 January 2019, but certain transition reliefs are available. The Group will apply interpretation from its effective date. Since the Group operates in a complex multinational tax environment, applying the Interpretation may affect its consolidated financial statements and the required disclosures. In addition, the Group may need to establish processes and procedures to obtain information that is necessary to apply the Interpretation on a timely basis.

(All amounts are in thousands of US dollars)

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

4.1 Changes in Group's accounting policies (continued)

Prepayment Features with Negative Compensation – Amendments to IFRS 9

Under IFRS 9, a debt instrument can be measured at amortised cost or at fair value through other comprehensive income, provided that the contractual cash flows are 'solely payments of principal and interest on the principal amount outstanding' (the SPPI criterion) and the instrument is held within the appropriate business model for that classification. The amendments to IFRS 9 clarify that a financial asset passes the SPPI criterion regardless of the event or circumstance that causes the early termination of the contract and irrespective of which party pays or receives reasonable compensation for the early termination of the contract.

The basis for conclusions to the amendments clarified that the early termination can result from a contractual term or from an event outside the control of the parties to the contract, such as a change in law or regulation leading to the early termination of the contract. The amendments are effective for annual periods beginning on or after 1 January 2019. The Group does not expect any effect of this amendment on its consolidated financial statements.

Plan Amendment, Curtailment or Settlement (Amendments to IAS 19)

The amendments to IAS 19 address the accounting when a plan amendment, curtailment or settlement occurs during a reporting period. The amendments specify that when a plan amendment, curtailment or settlement occurs during the annual reporting period, an entity is required to:

- Determine current service cost for the remainder of the period after the plan amendment, curtailment or settlement, using the actuarial assumptions used to remeasure the net defined benefit liability (asset) reflecting the benefits offered under the plan and the plan assets after that event.
- Determine net interest for the remainder of the period after the plan amendment, curtailment or settlement using: the net defined benefit liability (asset) reflecting the benefits offered under the plan and the plan assets after that event; and the discount rate used to remeasure that net defined benefit liability (asset).

The amendments also clarify that an entity first determines any past service cost, or a gain or loss on settlement, without considering the effect of the asset ceiling. This amount is recognised in profit or loss. An entity then determines the effect of the asset ceiling after the plan amendment, curtailment or settlement. Any change in that effect, excluding amounts included in the net interest, is recognised in other comprehensive income. The amendments apply to plan amendments, curtailments, or settlements occurring on or after the beginning of the first annual reporting period that begins on or after 1 January 2019, with early application permitted. This amendment is not applicable to the Group.

5. Changes in comparative information

During the preparation of consolidated financial statements for the year ended 31 December 2017 the Company identified certain errors related to the recognition and measurement of deferred tax assets. The Company's functional currency is USD. However, the currency in which the Company calculates and pays income tax is Azerbaijani manat ("AZN"). Since the Company's taxable profit or tax loss (and, hence, the tax base of its non-monetary assets and liabilities) is determined in a currency that is not its functional currency, changes in the exchange rate give rise to temporary differences that may result in a recognized deferred tax liability or asset. The resulting deferred tax is charged or credited to profit or loss. The Company erroneously did not consider effect of changes in the exchange rate on the tax bases of its non-monetary assets and liabilities as part of deferred tax calculation. As a result, in prior reporting periods, deferred tax assets were overstated, and deferred tax expense and deferred tax liability were understated. In order, to correct this error, the comparative financial information as of 1 January 2016 and 31 December 2016 and for the year ended 31 December 2016 was restated as follows: