

ECLOF UCO LLC

Management letter
On the audit of financial statements
As of and for the year ended 31 December 2015

Yerevan
March 2016

ECLOF UCO LLC
MANAGEMENT LETTER

On the audit of financial statements as of and for the year ended 31 December 2015

Disclaimer

The accompanying document was initially prepared in Armenian and then translated into English for the convenience of users. In case there are discrepancies between the Armenian and English versions, the Armenian version shall prevail.

Ladies and Gentlemen,

We have conducted the audit of financial statements of ECLOF UCO LLC (hereinafter referred to as "the Company") as of and for the year ended 31 December 2015.

We carried out our audit in accordance with International Auditing Standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Company's accounts are free of material misstatements.

In planning and performing our audit we considered the Company's internal control structure in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control structure and reveal errors or irregularities, which cannot materially impact the accounts.

During our audit, we noted certain matters involving internal control structure and its operation that we believe warrant management's attention. Our discussion of these matters supported by our detailed observations and recommendations is attached to this letter.

This letter is intended to be used for information and application purposes by the Company's management. No excerpts from or reference to this letter, full or partial may be made without our prior written consent. We bear no responsibility against third parties with respect to this letter.

We would like to thank the staff of the Company for their excellent cooperation and assistance during the audit.

"BDO Armenia" CJSC

Director

Auditor

23 March 2016
Yerevan



V. Sahakyan

A. Gevorgyan

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Contents

Observations and recommendations	5
1. Loan portfolio	5
1.1. Analysis of creditworthiness.....	5
1.2. Monitoring of loans.....	5
1.3. Movable property collateral appraisal	6
1.4. Insurance of the property pledged as collateral.....	6
1.5. Loans made without Credit Committee approval.....	6
1.6. Reflecting repayment of loan obligations in the system	7
2. Borrowings.....	8
2.1. Interest accrual on borrowings.....	8
3. Accounting for loans to customers and interest receivable	9
3.1. Accounting for impairment losses of interest receivable.....	9

Observations and recommendations

1. Loan portfolio

1.1. Analysis of creditworthiness

Observation

The Credit Committee approved several business loan applications, where analyses of the borrowers' creditworthiness were conducted inappropriately. In particular the following was missing:

- the analysis of business history of the borrower supported by the works performed in the past (contracts, invoices, etc.)
- review of the borrower's business proposal: there were no analysis of the borrowers funding, target market, competition, etc.
- evaluation of business risks, including financial risks, which may negatively impact the borrower's cash flows in the course of loan repayment
- risk analysis of the borrower's assets: for instance neither ageing analysis, nor collectability estimates were done on material accounts receivable
- evidence supporting the observation done by the loan officer on the borrower's assets (physical inventory documents, ownership documents, etc.)

Implication

Those loans which were provided without appropriate analysis of borrowers' creditworthiness may have a greater credit risk exposure, which may cause an impairment of the loan portfolio and financial losses.

Recommendation

We recommend revising the minimum conditions for loaning, the procedures of analysis of borrower's creditworthiness, developing mechanisms for measuring and minimizing the risks.

Management response

The recommendation is implemented in part as of the date of this letter. Draft procedures are being developed on risk measurement.

1.2. Monitoring of loans

Observation

No monitoring was conducted by the Company with respect to majority of the loans, including those to be done right after disbursement of the loan to review the use of the loan proceeds.

Implication

The quality of the loan portfolio may diminished, since the Company may not be informed in time on worsened creditworthiness of the borrower and therefore the actions taken by the Company may not be that effective.

Recommendation

We recommend developing loan monitoring procedures and conducting monitoring visits with reasonable frequency.

Management response

Draft procedures are being developed, which will be presented on the coming board meeting.

1.3. Movable property collateral appraisal

Observation

Some of the loans were secured by movable property, which were not appraised by independent appraiser. Instead the property value was determined by the parties (lender and borrower).

Implication

The property pledged may be overvalued, which may not after sale generate sufficient funds to meet all the loan contract obligations in case of the borrower's insolvency.

Recommendation

We recommend appraising all the property pledged as collateral, particularly motor vehicles, based on the appraisal done by an independent appraiser.

Management response

At this moment we have no loan products with motor vehicles collateral security. In accordance with the CBA requirements the Company signed cooperation agreements with four licensed appraisal companies.

1.4. Insurance of the property pledged as collateral

Observation

The property pledged as collateral, which is in possession of the borrower were not insured by insurance company in amount equivalent to loan contract obligations.

Implication

The property pledged may decrease in value, if damaged, which may not after sale generate sufficient funds to meet all the loan contract obligations in case of the borrower's insolvency.

Recommendation

We recommend insuring all the immovable and movable property pledged as collateral to secure loans made.

Management response

Insurance premiums with respect to real estate located in rural areas are not justified costs for the Company's customers.

1.5. Loans made without Credit Committee approval

Observation

The loan of seven million drams (sub-loan contract No DC4946 signed 13/03/2015) was provided without the Credit Committee approval and without analysis of the borrower's creditworthiness. Note, that no general loan agreement was signed with the borrower. Later a personal guarantee agreement was signed, where the guarantee party was represented by an individual who was a member of the Company management at the time the sub-loan contract was signed. Subsequent monitoring revealed that the loan proceeds were not used for the purpose defined.

Implication

The Company may incur losses, since the likelihood of impairment of the loans provided in a way mentioned above (i.e. without the Credit Committee approval, without analysis of creditworthiness, use of proceeds not on purpose) is quite high.

Recommendation

We recommend developing the respective control procedures to avoid provision of such loans.

Management response

Considered: the Company intends to develop control procedures to make one person decision on loans impossible.

1.6. Reflecting repayment of loan obligations in the system

Observation

The loan repayments were input into the system by the Deputy Chief Accountant based on the bank statements. These entries were not verified by any other official of the Company.

Implication

The repayments may mistakenly not be reflected on the payment making borrowers' accounts.

Recommendation

We recommend developing the respective control procedures to avoid possible mistakes when inputting repayment information into the system.

Management response

Although a double verification is not done in the system, the Chief Accountant does general verification of the borrowers' accounts. Moreover the loan managers make loan account reconciliations as well. A comprehensive solution of this problem lies on the instalment of automatic repayment system, which may be done, when the servicing bank systems and the Company's system are made identical.

2. Borrowings

2.1. Interest accrual on borrowings

Observation

The interest (799 thousand drams) accrued on the borrowing received from RFF, which related to the reporting year (2015), was reflected in the accounting books in the next year (2016).

Implication

Interest expense and interest payable may be misrepresented in the reporting year financial statements.

Recommendation

We recommend reflecting the interest charges accrued in the accounting books in the period, which they relate to.

Management response

Recording of interest accrued in the reporting year accounting books incomplete was caused by a late notification by the lender. In result of reconciliation done at the year-end, the inconsistency was revealed and corrected in the books.

3. Accounting for loans to customers and interest receivable

3.1. Accounting for impairment losses of interest receivable

Observation

The balance of allowance for impairment losses of interest receivable was not reflected in the balance of interest receivable in the Company's statement of financial position. Instead it was reflected in the balance of loans to customers.

Implication

Loans to customers and interest receivable may be misrepresented in the Company's financial statements.

Recommendation

We recommend reflecting allowance for impairment losses in those asset accounts, which they relate to.

Management response

The Company intends to report loans to customers (principal amounts) and interest receivable in one single account (line) in the financial statements.