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Audited Financial Statements

Ukraine International Airlines

*Years ended December 31, 1997 and 1996  
with Report of Independent Auditors*



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Ukraine International Airlines  
Audited Financial Statements  
Years ended December 31, 1997 and 1996

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## Report of Independent Auditors

The Board of Directors and Shareholders  
Ukraine International Airlines

We have audited the accompanying balance sheets of Ukraine International Airlines (hereinafter referred to as "the Company") as of December 31, 1997 and 1996, and the related statements of operations, shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As discussed in Note 9 to the financial statements, the Company has not amortized its route rights intangible asset. International Accounting Standard No. 4, "Depreciation Accounting", requires that such assets be amortized. Based on straight line amortization, the route rights intangible asset would be reduced by accumulated amortization of \$4.76 million, and the loss for the year and accumulated deficit would be increased by \$2.16 million and \$4.76 million, respectively (\$1.18 million and \$2.60 million for 1996, respectively).

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 1997 and 1996, and the results of its operations and its cash flows for the years then ended in accordance with International Accounting Standards issued by the International Accounting Standards Committee.

We have also audited the financial statements of the Company as of and for the years ended December 31, 1997 and 1996, not presented herewith, prepared in compliance with the regulations for bookkeeping and accounting for income tax and statutory reporting purposes in Ukraine and we expect to report separately on the statutory financial statements. The significant differences between accounting principles applied in preparing statutory financial statements and those applied for International Accounting Standards are summarized in Notes 2 and 18 to the financial statements.

*Ernst & Young Ukraine*

June 1, 1998

# Ukraine International Airlines

## Balance Sheets

	December 31,	
	1997	1996
	<i>(In thousands of US Dollars)</i>	
<b>Assets</b>		
Current assets:		
Cash	\$ 496	\$ 500
Restricted cash (Note 4)	417	745
Accounts receivable, net (Note 5)	1,851	1,880
Note receivable (Note 6)	-	6,000
Inventories	406	326
Prepayments and other current assets	2,131	1,475
	<u>5,301</u>	<u>10,926</u>
Aircraft purchase deposits (Note 16b)	3,973	-
Restricted cash (Note 4)	800	-
Spare parts and rotables, net (Note 7)	2,496	2,491
Property and equipment, net (Note 8)	756	838
Route rights (Note 9)	32,829	32,829
Start-up costs, net (Note 10)	-	374
	<u>\$ 46,155</u>	<u>\$ 47,458</u>
<b>Liabilities and shareholders' equity</b>		
Current liabilities:		
Short-term borrowings (Note 11)	\$ 3,164	\$ 1,886
Accounts payable and accrued expenses	5,041	5,617
Deferred revenue (Note 12)	1,858	1,986
Total current liabilities	<u>10,063</u>	<u>9,489</u>
Long-term borrowings (Note 11)	2,386	1,560
Commitments and contingent liabilities (Notes 16 and 17)		
Shareholders' equity:		
Common stock (Note 14)	49,000	49,000
Accumulated deficit	(15,294)	(12,591)
Total shareholders' equity	<u>33,706</u>	<u>36,409</u>
Total liabilities and shareholders' equity	<u>\$ 46,155</u>	<u>\$ 47,458</u>

See accompanying notes.

# Ukraine International Airlines

## Statements of Operations

	Year ended December 31,	
	1997	1996
	<i>(In thousands of US Dollars)</i>	
<b>Operating revenues:</b>		
Passenger services	\$ 39,641	\$ 39,518
Charter services	1,811	2,821
Cargo and other services	3,150	3,707
Other revenues	805	1,228
	<u>45,407</u>	<u>47,274</u>
<b>Operating expenses:</b>		
Aircraft lease costs	9,365	5,776
Aircraft landing and handling	6,508	6,715
Fuel	5,357	5,324
Maintenance	4,381	5,584
Navigation	4,490	4,744
Salaries	3,234	3,242
Commissions	2,187	2,854
Catering	2,251	2,508
Sales and distribution costs	1,797	1,529
Block seat costs	1,133	319
Insurance	769	1,766
Depreciation of inventory and fixed assets	384	386
Administration	2,559	2,669
Representative office expenditures	1,829	1,930
Value-added tax	526	182
Bad debt expense	123	92
	<u>46,893</u>	<u>45,620</u>
<b>Operating income (loss)</b>	<b>(1,486)</b>	<b>1,654</b>
<b>Other income (expenses):</b>		
Other income	1,031	-
Provision for impairment in value of construction-in-progress	(461)	-
Amortization of start-up costs	(374)	(374)
Interest expense	(402)	(1,160)
Other local taxes	(875)	(824)
Foreign exchange loss	(136)	(110)
	<u>(2,703)</u>	<u>(814)</u>
<b>Loss before income taxes</b>	<b>(2,703)</b>	<b>(814)</b>
<b>Income taxes (Note 13)</b>		
		-
<b>Net loss</b>	<b>\$ (2,703)</b>	<b>\$ (814)</b>

See accompanying notes.

Ukraine International Airlines

Statements of Shareholders' Equity

Years ended December 31, 1997 and 1996

	Common Stock	Accumulated Deficit	Total
	<i>(In thousands of US Dollars)</i>		
Balances at December 31, 1995	\$ 35,512	\$ (11,777)	\$ 23,735
Net loss	-	(814)	(814)
Capital contributions	13,488	-	13,488
Balances at December 31, 1996	49,000	(12,591)	36,409
Net loss	-	(2,703)	(2,703)
Balances at December 31, 1997	<u>\$ 49,000</u>	<u>\$ (15,294)</u>	<u>\$ 33,706</u>

*See accompanying notes.*

# Ukraine International Airlines

## Statements of Cash Flows

	Year ended December 31,	
	1997	1996
	<i>(In thousands of US Dollars)</i>	
<b>Operating activities</b>		
Net loss	\$ (2,703)	\$ (814)
Adjustments to reconcile changes in net loss to net cash (used in) provided by operating activities:		
Depreciation and amortization	758	760
Provision for impairment in value of construction-in-progress	461	-
Decrease in accounts receivable	29	752
(Increase) decrease in inventories	(80)	131
Increase in other assets and prepaid expenses	(656)	(81)
Decrease in accounts payable and accrued expenses	(576)	(714)
(Decrease) increase in deferred revenue	(128)	374
Cash (used in) provided by operating activities	(2,895)	408
<b>Investing activities</b>		
Aircraft purchase deposits	(3,973)	-
Purchases of spare parts and rotables	(142)	(251)
Purchases of property and equipment	(626)	(157)
Net cash used in investing activities	(4,741)	(408)
<b>Financing activities</b>		
Proceeds of sale of common shares	6,000	3,000
Proceeds from short-term borrowings	3,164	-
Proceeds from long-term borrowings	826	295
Repayment of short-term borrowings	(1,886)	(1,450)
Repayment of long-term borrowings	-	(2,945)
Deposits to restricted cash accounts	(472)	(745)
Net cash generated from (used in) financing activities	7,632	(1,845)
<b>Net decrease in cash</b>	(4)	(1,845)
<b>Cash at beginning of year</b>	500	2,345
<b>Cash at end of year</b>	\$ 496	\$ 500
<b>Supplementary cash flow information:</b>		
Interest paid	320	770
Income taxes paid	-	-

See accompanying notes.

# Ukraine International Airlines

## Notes to Financial Statements

December 31, 1997 and 1996

*(Amounts in tables in thousands of US Dollars)*

### 1. General

Ukraine International Airlines (hereinafter referred to as "the Company"), formerly named Air Ukraine International Airlines (renamed in the 1996 charter documents), was incorporated in Ukraine on October 29, 1992 as a joint venture between the Ukrainian Association of Civil Aviation ("UACA") and Guinness Peat Aviation ("GPA"), a company incorporated in the Republic of Ireland. Pursuant to legislation enacted by the Ukrainian Government during 1994, the State Property Fund of Ukraine ("SPF") became the successor as shareholder to the UACA. These changes came into effect in May 1996 upon re-registration of the Company's charter. In November 1996, the Company was again re-registered to reflect the investment made by U.I.A. Beteiligungsgesellschaft mbH ("UIAB"), a company incorporated in Austria and wholly-owned by Austrian Airlines and Swissair. The current shareholding is SPF 335,000 shares, UIAB 90,000 shares and GPA 65,000 shares, which represents 68.37%, 18.37% and 13.26% of the total authorized share capital, respectively.

The principal activities of the Company consist of the provision of commercial passenger and cargo transportation primarily between selected destinations in Western Europe and Ukraine. The Company's headquarters are located in Kyiv, Ukraine.

### 2. Significant Accounting Policies

#### Basis of Presentation

The accompanying financial statements have been prepared under the historical cost convention and in conformity with International Accounting Standards ("IAS").

The Company maintains its accounting records and prepares its financial statements in Ukrainian Hryvnia ("UAH") in accordance with the requirements of Ukrainian accounting and tax legislation. The accompanying financial statements differ from the financial statements prepared for statutory purposes in Ukraine in that they reflect certain adjustments, not recorded in the Company's accounting books, which are appropriate to present the financial position, results of operations and cash flows in accordance with IAS. The principal adjustments are related to provisions for doubtful debts, timing of revenue and expense recognition, accounting for low-value, short-life inventory, deferred income taxes, foreign currency translation, and depreciation and valuation of long term tangible and intangible assets. A reconciliation of the 1997 loss as reported in the Ukrainian statutory financial statements to the 1997 results of operations reported in the accompanying financial statements prepared in accordance with IAS is included in Note 18.

Certain 1996 balances have been reclassified to conform to the 1997 presentation.



## Ukraine International Airlines

### Notes to Financial Statements (continued)

#### 2. Significant Accounting Policies (continued)

##### Foreign Currency Translation

On September 2, 1996, Ukraine introduced a new currency, the Ukrainian Hryvnia, to replace the Ukrainian Karbovanets ("UAK"). The Hryvnia was introduced at an exchange rate of UAH 1 = UAK 100,000. All transactions occurring prior to the currency conversion have been restated into Hryvnia in the accompanying financial statements.

The Company's financial statements have been presented in US Dollars because it is the Company's functional currency, i.e. the majority of its revenues, costs, property and equipment purchased, and debt and trade liabilities are either priced, incurred, payable or otherwise measured in US Dollars. Accordingly, transactions and balances not already measured in US Dollars (primarily Ukrainian Hryvnia) have been remeasured into US Dollars in accordance with the temporal translation method. Under this remeasurement method, revenues, costs, capital and non-monetary assets and liabilities are translated at historical exchange rates prevailing on the transaction dates. Monetary assets and liabilities are translated at exchange rates prevailing on the balance sheet date. Exchange gains and losses arising from remeasurement of monetary assets and liabilities that are not denominated in US Dollars are credited or charged to operations.

The Hryvnia is not a convertible currency outside the territory of Ukraine. Within Ukraine, the official exchange rates were determined principally by the National Bank and are generally considered to be a reasonable approximation of market rates. The translation of Hryvnia denominated assets and liabilities into US Dollars for the purpose of these financial statements does not indicate that the Company could realize, settle or distribute in US Dollars the reported values of the assets, liabilities and capital.

The exchange rate used to translate the Ukrainian Hryvnia balances at December 31, 1997 was the official exchange rate of the National Bank of Ukraine of UAH 1.899 for one US Dollar (December 31, 1996: UAH 1.889 for one US Dollar). At June 1, 1998, the official exchange rate had changed to UAH 2.057 for one US Dollar. The effect of the devaluation of the Hryvnia since December 31, 1997 on monetary assets and liabilities has not been determined.

##### Use of Estimates

The preparation of financial statements in accordance with IAS requires management to make estimates and assumptions that affect the amounts and balances reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

##### Cash

The Company considers cash to include all cash on hand and cash held with banks.

## Ukraine International Airlines

### Notes to Financial Statements (continued)

#### 2. Significant Accounting Policies (continued)

##### Accounts Receivable

Accounts receivable are stated at their net realizable value. A provision is made for accounts specifically identified as doubtful.

##### Spare Parts and Other Inventories

Spare parts and other inventories primarily consist of rotatable aircraft spare parts and are stated at the lower of cost and net realizable value. Cost is based on the average unit cost method. Depreciation of rotatable spare parts is computed on a straight-line basis using an estimated useful life of sixteen years. Net realizable value is based on the estimated selling price less any further costs expected to be incurred to disposal.

##### Property and Equipment

Office premises and equipment and vehicles are stated at historical cost and are depreciated on a straight-line basis using an estimated useful life of five years. In determining the recoverable amount of property and equipment, expected future cash flows have not been discounted to their present value.

##### Operating Leases

Leases for aircraft and spare parts are classified and accounted for as operating leases in accordance with IAS No. 17, "Accounting for Leases".

##### Start-up Costs

Expenditures incurred on the initial training of pilots, staff and other start-up costs were capitalized and are amortized on a straight-line basis over five years. Costs related to training in subsequent years are charged to operations as incurred. As of December 31, 1997, the start-up costs have been fully amortized.

##### Leased Aircraft Maintenance

Operating lease payments, routine maintenance and airframe and engine overhauls for leased flight equipment are charged to operations when incurred. To the extent that the actual costs incurred associated with major engine and airframe overhauls exceed the cumulative supplemental rent charges, the Company pays the excess.

##### Borrowing Costs

Borrowing and interest costs are expensed as incurred.

##### Deferred Taxes

Deferred taxes are accounted for under the liability method and reflect the tax effect of all significant temporary differences between the tax basis of assets and liabilities and their reported amounts in the accompanying financial statements to the extent that there is a reasonable expectation of their realization.

## Ukraine International Airlines

### Notes to Financial Statements (continued)

#### 2. Significant Accounting Policies (continued)

##### Revenue Recognition and Revenue-based Taxes

Revenues are recognized net of value-added tax ("VAT") and other taxes charged to customers, in the period in which the transportation or other service is provided. Deferred revenue includes the air traffic liability, which represents the estimated value of sold but unused passenger tickets as well as interline amounts due other carriers at year end.

Revenue-based taxes, which were levied at an effective rate of approximately 1.9% of revenue in 1997, are recorded as other local taxes.

##### Government Pension and Social Funds

The Company contributes to the Ukrainian state pension, social insurance, medical insurance and unemployment funds on behalf of its employees. The Company's total contributions in 1997 amount to approximately 47.5% (1996: 51.0%) of the employees' salaries and are expensed as incurred. During the year ended December 31, 1997, the total amount of the Company's contributions to the government pension fund on behalf of its employees was approximately \$0.60 million (1996: \$0.56 million).

##### Non-monetary Transactions

As with many companies operating in Ukraine, a portion of the Company's business is conducted via non-monetary transactions. These transactions are accounted for at normal arm's length selling prices of the items transferred. During the year ended December 31, 1997, the total value of these transactions as reported in the accompanying financial statements amounted to approximately \$0.47 million (1996: \$0.35 million).

##### Fair Value of Financial Instruments

The fair value of financial instruments, consisting of cash, deposits, receivables, payables and obligations under debt instruments, are considered to be equal to their carrying values.

##### Concentrations of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of excess cash holdings, deposits and accounts receivable. The Company places its deposits and excess cash with reputable companies and financial institutions and limits the amount of credit exposure to any one institution. Management constantly monitors the status of banks where deposits are maintained. The credit risk associated with trade accounts receivable is limited due to the Company's customer base and ongoing procedures which monitor the credit worthiness of customers.

## Ukraine International Airlines

### Notes to Financial Statements (continued)

#### 3. Going Concern

As of December 31, 1997, the Company has incurred aggregate losses of \$15.29 million, of which \$2.70 million was incurred in 1997, has a working capital deficiency of \$4.76 million, and an operating cash flow deficit of \$2.90 million for 1997. The losses are primarily the result of establishing the airline, building an operations infrastructure, developing the route network and the result of high cost short-term aircraft leasing. These facts have resulted in a deterioration of the Company's financial condition and, in the absence of sufficient corrective actions, raises doubt about its ability to continue as a going concern.

Management recognizes the Company must obtain additional sources of capital and improve operating performance. In this regard, management has taken the following actions in 1998:

- Negotiated and received approximately \$3.00 million in loans from Austrian Airlines, which are repayable beginning August 1998 in monthly installments through to December 1999;
- received a \$1.20 million advance on pool revenue from Austrian Airlines in relation to the sharing of revenue on the Kyiv / Vienna route through to November 1999;
- negotiated and is in the process of securing a further \$1.50 million loan from GPA, which is expected to be repayable over 3 years;
- leased two additional B737-300 aircraft for five years. Costly short-term leases were entered into in 1997 and resulted in an incremental cost of approximately \$2.00 million which is not expected to be required or to recur in the future.

In addition, management has recognized the need to obtain additional equity and/or debt financing for working capital and to fund future potential asset acquisitions. The Company has received preliminary proposals from potential financiers however, these have not been accepted since management believes that better terms and conditions can be negotiated. In any event, in relation to the ability of the Company to raise the additional finance, there can be no assurances that these plans will be successful.

The accompanying financial statements, which were prepared on a going concern basis, do not include any adjustments relating to the recoverability and classification of recorded asset amounts or to amounts and classification of liabilities that may be necessary if the Company is unable to continue as a going concern.

#### 4. Restricted Cash

The current portion of restricted cash consisted of deposits due within one year which the Company was required to provide for certain trade creditors and aircraft lessors. The long-term portion of restricted cash consisted of deposits relating to agreements with aircraft lessors which do not expire within one year.

Ukraine International Airlines  
Notes to Financial Statements (continued)

**5. Accounts Receivable**

Accounts receivable consisted of the following at December 31:

	1997	1996
Travel agents	\$ 946	\$ 1,556
Cargo agents and customers	887	503
Credit card companies	257	252
Other	12	-
	<u>2,102</u>	<u>2,311</u>
Provision for doubtful accounts receivable	(251)	(431)
	<u>\$ 1,851</u>	<u>\$ 1,880</u>

**6. Note Receivable**

In 1996 UIAB issued a \$6.00 million non-interest bearing promissory note in connection with its charter contribution which was collected by the Company in the first quarter of 1997 (refer Note 14).

**7. Spare Parts and Rotables**

Spare parts and rotables consisted of the following at December 31:

	1997	1996
Spare parts and rotables	\$ 2,926	\$ 2,784
Accumulated depreciation	(430)	(293)
	<u>\$ 2,496</u>	<u>\$ 2,491</u>

**8. Property and Equipment**

Property and equipment consisted of the following at December 31:

	1997	1996
Cost:		
Office premises and equipment	\$ 1,136	\$ 931
Vehicles	420	460
Construction-in-progress	461	-
	<u>2,107</u>	<u>1,391</u>
Provision for impairment in value of construction-in-progress	(461)	-
	<u>\$ 1,556</u>	<u>\$ 1,391</u>
Accumulated depreciation:		
Office premises and equipment	\$ (514)	\$ (324)
Vehicles	(286)	(229)
	<u>\$ (800)</u>	<u>\$ (553)</u>
	<u>\$ 756</u>	<u>\$ 838</u>

Ukraine International Airlines  
Notes to Financial Statements (continued)

**8. Property and Equipment (continued)**

A reconciliation of the carrying amount of property and equipment at December 31:

	1996	Additions	Disposals	Depreciation	1997
Office premises and equipment	\$ 607	\$ 205	\$ -	\$ (190)	\$ 622
Vehicles	231	-	(40)	(57)	134
	<u>\$ 838</u>	<u>\$ 205</u>	<u>\$ (40)</u>	<u>\$ (247)</u>	<u>\$ 756</u>

**9. Route Rights**

In April 1996, at a general assembly shareholder meeting, several changes to the Company's authorized share capital were agreed upon. The contribution of the SPF to the authorized share capital was revalued to \$33.50 million. This consisted of cash contributed of \$0.67 million and a guarantee provided to the Company of exclusive rights to operate twenty air routes until December 31, 2010 ("route rights"). The total value of the SPF share capital contributed is based on the same per share value as that paid in by other shareholders in cash. In addition, the Company may apply for and operate other air routes, but without the guarantee of exclusivity.

Management believes these route rights provide an ongoing benefit after the period of exclusivity and have not suffered economic depreciation in value and, accordingly, no amortization has been reflected in the financial statements. However, IAS No. 4, "Depreciation Accounting", requires that such assets be amortized. Based on straight line amortization over the period of guaranteed exclusivity, the route rights intangible asset would be reduced by accumulated amortization of \$4.76 million, and the loss for the year and accumulated deficit would be increased by \$2.16 million and \$4.76 million, respectively (\$1.18 million and \$2.60 million for 1996, respectively).

**10. Start-up Costs**

Start-up costs consisted of the following at December 31:

	1997	1996
Cost:		
Guinness Peat Aviation	\$ 3,118	\$ 3,118
Ukrainian Association of Civil Aviation	671	671
	<u>3,789</u>	<u>3,789</u>
Accumulated amortization	<u>(3,789)</u>	<u>(3,415)</u>
	<u>\$ -</u>	<u>\$ 374</u>

# Ukraine International Airlines

## Notes to Financial Statements (continued)

### 11. Borrowings

Borrowings consisted of the following at December 31:

	1997	1996
First Ukrainian International Bank	\$ 2,386	\$ 1,560
Austrian Airlines Lease and Finance	2,493	-
Ost-West Handelsbank	671	-
Guinness Peat Aviation	-	1,392
Boeing	-	294
Willis Corroon	-	200
	<u>5,550</u>	<u>3,446</u>
Non-current portion	<u>(2,386)</u>	<u>(1,560)</u>
	<u>\$ 3,164</u>	<u>\$ 1,886</u>

The Company had signed an agreement with First Ukrainian International Bank ("FUIB") whereby FUIB committed to provide up to \$1.56 million of credit with repayment due in January 1997. This line of credit bore interest at an annual rate of 12%. According to the terms of this agreement, FUIB had the right to acquire a maximum of 5% of the outstanding common shares, however, this option was not exercised and no longer exists. The credit line was renewed in January 1997, and is secured by spare parts inventory, accounts receivable and cash flows through the account. The renewed credit line will terminate in February 1999, and is for \$2.50 million of which only \$1.56 million can be used as working capital and the balance can only be drawn down for deposits for an aircraft purchase. Interest charged on this account is fixed at 18%, charged monthly in arrears on the actual amount outstanding.

In connection with the purchase of a B737-300 aircraft, the Company entered into an agreement with Austrian Airlines Lease and Finance Company ("AALF") on July 3, 1997 whereby progress payments to The Boeing Company ("Boeing") will be financed by AALF. The total amount of financing to be provided by AALF is \$5.46 million, of which \$3.51 million was provided in 1997 (\$1.10 million in principal was repaid in 1997) and the remainder will be provided in 1998. Interest is accrued monthly at the 12 month LIBOR rate (fixed as of 30 June 1997 at 6.125%) plus 3.69%. Repayments of principal and interest are made monthly according to an agreed schedule and the financing is expected to be completely repaid by April 1999 upon delivery of the aircraft. Security for the financing consists of an assignment option of the Company's rights and obligations under the purchase agreement with Boeing, as well as an assignment of all claims the Company may have with Austrian Airlines.

On November 27, 1997 the Company entered into a credit agreement with Ost-West Handelsbank which expires on December 1, 1998. The agreement provides for a line of credit up to \$1.00 million which is secured by the Company's hard currency assets and a \$0.15 million deposit. The credit line may be used only in connection with the aircraft purchase. Interest is charged quarterly at an annual rate of 11%.

Ukraine International Airlines  
Notes to Financial Statements (continued)

**12. Deferred Revenue**

Deferred revenue consisted of the following at December 31:

	1997	1996
Air traffic liability	\$ 1,858	\$ 1,467
Deferred pool revenue (Austrian Airlines)	-	500
Other	-	19
	<u>\$ 1,858</u>	<u>\$ 1,986</u>

The deferred pool revenue relates to prepayments received during 1996 in accordance with a revenue sharing agreement between the Company and Austrian Airlines. As of December 31, 1997, a receivable of \$0.10 million from Austrian Airlines relating to this agreement is included in accounts receivable.

**13. Income Taxes**

Ukraine is the only tax jurisdiction in which the Company's income is subject to tax.

The following is a reconciliation of the income tax expense to the amount that would arise by applying 30% to the income before income taxes reported in the accompanying financial statements for the year ended December 31, 1997:

Income tax benefit computed on accounting loss before taxes at statutory tax rate of 30%	\$ 810
Tax effects of permanent differences:	
Non-tax deductible expenses	(169)
Utilization of tax loss not previously recognized to offset taxable income of the first half of the year	(516)
Foreign exchange loss	(41)
Temporary differences not recognized as measured by the change in the valuation allowance	<u>(84)</u>
Income tax expense reported in the accompanying financial statements	<u>\$ -</u>



# Ukraine International Airlines

## Notes to Financial Statements (continued)

### 13. Income Taxes (continued)

Deferred tax assets and liabilities, calculated by applying the statutory tax rate of 30% in effect at the balance sheet date to the temporary differences between the tax basis of assets and liabilities and the amounts reported in the accompanying financial statements, consisted of the following at December 31, 1997:

Deferred tax assets, arising from:	
Provision for doubtful debts	\$ 75
Provision for impairment in value of construction-in-progress	138
Differences in depreciation	296
Accruals of expenses and other write-offs	324
Deferred revenue	126
	<u>959</u>
Deferred tax liabilities, arising from:	
Accrual of revenue	(121)
Other	(324)
	<u>(445)</u>
Net deferred tax asset	514
Valuation allowance	<u>(514)</u>
Net deferred tax asset	<u><u>\$ -</u></u>

For financial reporting purposes, a valuation allowance has been recognized because the environment encompassing the tax regime in Ukraine does not provide reasonable expectation of realization of deferred tax assets.

### 14. Common Stock

The authorized share capital of the Company consists of 490,000 shares of common stock with a par value of \$100 per share. All 490,000 common shares were issued and outstanding at December 31, 1997 and 1996.

Contributed common stock of the Company consisted of the following as of December 31:

	1997	1996
State Property Fund of Ukraine	\$ 33,500	\$ 33,500
UIA Beteiligungsgesellschaft mbH	9,000	9,000
Guinness Peat Aviation	6,500	6,500
	<u>\$ 49,000</u>	<u>\$ 49,000</u>

# Ukraine International Airlines

## Notes to Financial Statements (continued)

### 14. Common Stock (continued)

In May 1996, the Company was re-registered to reflect the transfer of ownership from UACA to the SPF of Ukraine pursuant to legislation enacted by the Ukrainian Government. It was again re-registered in 1996 to reflect the investment in the Company by UIAB. As of December 31, 1996, UIAB had only contributed \$3.00 million of its share capital contribution. The remaining \$6.00 million was received in the first quarter of 1997.

In accordance with Ukrainian regulations, the Company can distribute all statutory accounting profits as dividends or transfer them to reserves. The subsequent use of amounts transferred to reserves is legally restricted; amounts transferred to reserves must be used for the purpose designated when the transfer is made. Dividends may be declared from undistributed earnings as shown in the Ukrainian statutory financial statements. As of December 31, 1997 and 1996, there were no retained earnings available for distribution.

### 15. Related Party Transactions

Included in 1997 and 1996 expenses were payments to General Electric Capital Aviation Services ("GECAS"), a company responsible for the management of GPA's aircraft assets, in the amount of \$4.10 million (1996: \$6.90 million) for aircraft rentals, maintenance reserves and political risk insurance. The amounts paid were on normal terms and conditions.

In November 1997, a contract was signed to lease two Boeing 737-300 aircraft from February 1998 and April 1998, respectively. Austrian Airlines Lease and Finance have guaranteed these lease payments up to a maximum of \$1.50 million.

### 16. Commitments

#### a) Lease Commitments

The future minimum lease payments required under non-cancellable operating leases with terms greater than one year beyond the balance sheet date consisted of the following at December 31, 1997:

1998	\$	7,940
1999		9,283
2000		7,272
2001		6,444
2002		5,907
2003		805
	\$	<u>37,651</u>

In addition to lease rental payments, the Company pays a per flight hour supplemental rent with respect to the heavy overhaul of the airframe, engines and landing gear to lessors. Rentals under operating leases are charged to operations over the lease term. Supplemental rent for maintenance accruals is \$251 and \$280 per flight hour for the B737-200 aircraft and B737-300 aircraft, respectively, and is expensed as incurred.

## Ukraine International Airlines

### Notes to Financial Statements (continued)

#### 16. Commitments (continued)

##### b) Airplane Purchase Commitment

In March 1997 the Company signed an agreement to purchase a B737-300 aircraft from Boeing. The delivery date has been set for April 1999. The Company's future payment schedule has been agreed as follows although certain discounts and concessions have been negotiated which will reduce the total payment:

1998	\$ 1,949
1999	<u>33,134</u>
	<u>\$ 35,083</u>

In 1997 payments totaling \$3.90 million were made to Boeing and are recorded as aircraft purchase deposits.

The Company has elected to defer certain advance payments totaling 15% of the total purchase price of the plane until delivery. In addition to the above payments, the purchase agreement stipulates that interest at the LIBOR rate plus 3.69% will accrue on the deferred payments and become payable upon delivery. This interest, which approximates \$0.15 million as of December 31, 1997, has not been accrued in the accompanying financial statements.

AALF has agreed to finance future progress payments to Boeing which the Company will reimburse to AALF as per an agreed schedule prior to delivery of the aircraft (refer Note 11).

The Company plans to purchase and take possession of another aircraft in 2001, however at this time no agreement has been signed. A \$0.08 million deposit has been paid to Boeing which is recorded as aircraft purchase deposits.

#### 17. Contingent Liabilities

Legislation and regulations regarding taxation, foreign currency transactions and licensing of foreign currency loans in Ukraine continue to evolve as the central government manages the transformation from a command to a market-oriented economy. The various legislation and regulations are not always clearly written and their interpretation is subject to the opinions of the local tax inspectors, National Bank officials and the Ministry of Finance. Instances of inconsistent opinions between local, regional and national tax authorities and between the National Bank and Ministry of Finance are not unusual.

The current regime of penalties and interest related to reported and discovered violations of Ukraine's laws, decrees and related regulations are severe. Fines are levied when an understatement of tax liability is discovered by the tax administration at a rate of 30% of the understatement. Interest is assessable at a rate of 120% of the National Bank of Ukraine discount rate or 0.3% per day of the balance outstanding, depending on the type of tax. As a result, penalties and interest can result in amounts that are multiples of any unreported taxes.

## Ukraine International Airlines

### Notes to Financial Statements (continued)

#### 17. Contingent Liabilities (continued)

The Company believes that it has paid or accrued all taxes that are applicable. Where practice concerning the provision for taxes is unclear, the Company has accrued tax liabilities based on management's best estimate. The Company's policy is to accrue for contingencies in the accounting period in which a loss is deemed probable and the amount is reasonably determinable. No such accruals have been made.

A number of legislation and other changes occurred during 1997 and 1996 that have caused uncertainty as to the tax consequences related to certain costs and payments. In particular, this relates to the amount and extent of VAT and withholding tax on and tax-deductibility of imported services and offshore aircraft lease and related payments. The Company is reviewing its lease and imported services related payments and agreements and has considered the actions that are necessary and possible to mitigate these uncertainties. The Company has not been challenged by the tax authorities in relation to such payments and costs; however, there can be no assurances that it will not be challenged by the authorities and, if challenged, will not be assessed additional taxes as well as penalties.

Because of the uncertainties associated with the Ukrainian tax and legal systems, the ultimate amount of taxes, penalties and interest assessed, if any, may be in excess of the amount expensed to date and accrued at December 31, 1997. Although such amounts are possible and may be material, it is the opinion of the Company's management that these amounts are either not probable, not reasonably determinable, or both.

The Company's operations and financial position will continue to be affected by Ukrainian political developments, including the application of existing and future legislation and tax regulations. The likelihood of such occurrences and their effect on the Company could have a significant impact on the Company's operations. The Company does not believe that these contingencies, as related to its operations, are any more significant than those of similar enterprises in Ukraine.

# Ukraine International Airlines

## Notes to Financial Statements (continued)

### 18. Reconciliation of Ukrainian Statutory Financial Statements to Financial Statements Prepared in Accordance with International Accounting Standards

The following is a reconciliation of the 1997 loss as reported in the Ukrainian statutory financial statements to the 1997 results of operations reported in the accompanying financial statements prepared in accordance with IAS for the year ended December 31, 1997:

Loss reported in the Ukrainian statutory financial statements	\$ (1,406)
Adjustments to present financial statements in accordance with IAS:	
Differences in timing of revenue recognition	1,444
Ukrainian tax refunds and write-backs recognized in 1996 for IAS purposes	(1,000)
Differences in timing of expense recognition	(147)
Provision for impairment in value of construction-in-progress	(461)
Amortization of start-up costs	(374)
Depreciation of spare parts and rotables	(137)
Depreciation of property and equipment	(247)
Additional provision for doubtful debts	(123)
Foreign exchange loss	(136)
Other adjustments	(116)
Results of operations in accompanying IAS financial statements	<u>\$ (2,703)</u>