3. Taking into account our understanding that CES Mecon valuation comprise initial valuation of telecommunication business fixed assets, as of 30 June 1994 and subsequment movements of the above fixed assets up to 31 March 1997, and having in mind the findings of work performed on movements of fixed assets in the period from 1 January to 30 June 1997 in the PTT books, we are concerned regarding the amount of increases of fixed assets recorded in Telekom Srbija books, on the basis of working units data, thus adjusting figures treated as opening balances, as of 1 June 1997. Having said that, our view is that only two months movements (April and May 1997) posted in PTT books, and possible unrecorded transactions and eventual correction of errors, could comprise the movements in the period.

The management of Telekom Srbija is aware of the significance of the matters raised by auditors and ourselves and arise from its own consideration. It has been noted that certain corrective actions have already been taken to improve the Telekom Srbija accounting records and procedures regarding fixed assets.

# 2. Work in progress

## 2.1. Agreed Work Steps Summary

To address the points in Clause 5.1(h) from the Share sale and purchase agreement, you agreed for us to perform the following procedures:

| Work step | | Performed | Alternative Procedures/Notes |
|---|---|---|---|
| 1 | Obtain a post-separation work in progress listing for Telekom Srbija<br>- Foot listing<br>- Agree listing total to the opening balance sheet | <br>✓<br>✓ | |
| 2 | Obtain a pre-separation work in progress listing for PTT and agree listing to PTT's books. From listing select a sample and: (sample size: see note)<br>- Understand nature of work in progress asset;<br>- Determine if asset is to be transferred by reference to Clause 1.1.(d) "Telecommunication Business" of the Acknowledgement of Tranfer agreement;<br>- Agree to post separation Telekom Srbija work in progress listing, if appropriate | ✓<br>✓<br>✓<br>✓ | Complete listings were analyzed |
| 3 | Select the sample from post-separation Telekom Srbija work in progress listing: (sample size: 13 WIPs)<br>/i/ Physically verify existence of the work in progress, agreeing the asset and technical specification<br>/ii/ Agree the value of the work in progress to invoices, contracts, internal time sheets or other appropriate support. In the event internal costs have been capitalized, consider the documentary support and appropriateness of accounting treatment.<br>Step 3/i/ above will be performed by SIN engineer. | ✓<br>✓<br>✓ | Reduced to 5 WIPs to be physically verified by engineers<br>Separate report is issued |

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## 2.2. Work Performed

### Work step 1

We were supplied with pre-separation work in progress listing for PTT from Investment department including both work in progress to be transferred to Telekom Srbija and work in progress not to be transferred, such as buildings.

Total work in progress for PTT pre-separation as of 22 May 1997 amounts to 709.186 thousand Dinars. The work in progress that is not to be transferred, mainly buildings, to Telekom Srbija amounts to 160.194 thousand Dinars. Therefore, total work in progress initially to be transferred to Telekom Srbija amounts to 549.020 thousand Dinars. We have agreed this value to the Opening Balance Sheet of Telecom Serbia.

However, by discussing with management we understood that listing of work in progress (WIP), supplied to us by Investment department contains balances of WIP as of 31 March 1997. During negotiation process, PTT has entered into the Share Sale and Purchase agreement data for WIP provided by Investment Department. So, for the agreement purposes, Accounting Department had to adjust its books to be in compliance with Investment Department listing. However Accounting department has the listing of their evidence of WIP which does not reconcile with one from Investment Department. Therefore we could not agree totals of WIP between data from mentioned departments.

According to management explanation, during month of June 1997 Accounting Departments from all working units performed reconciliation and updating of each single WIP to bring them to accurate value. Accordingly following adjustments were required:

/i/ Increase of WIP for not posted changes
/ii/ Decrease of WIP for not posted changes
/iii/ Increase for new WIP
/iv/ Decrease due to activation
/v/ Clerical errors

Result of this exercise was bringing reasonably accurate value of WIP as of 30 June 1997 amounting to 715.371 thousand Dinars. It should be added to this amount the value of investments in stocks (accounts such as equipment, spare parts and materials) amounting to 191.409 thousand Dinars. Therefore, according to information received from Accounting department, total WIP as of 30 June 1997 amounts to 906.780 thousand Dinars, which is presented below:

In thousand of Dinars

| Description | Balance as of 1 June 97 | Net Corrections | Balance as of 30 June 97 |
|---|---|---|---|
| Work in progress | 549.020 | 166.351 | 715.371 |
| Stocks (materials, equipment and spare parts) related to work in progress | 212.390 | (20.982) | 191.408 |
| | [illegible] | [illegible] | [illegible] |

163

DRAFT - PRELIMINARY AND TENTITIVE, FOR DISCUSSION PURPOSES ONLY 

Work step 2

We have been supplied with listings of WIP balances as of the following dates: 31. May (PTT); 1 June (Telekom); 30 June (Telekom); 31 July (Telekom); 31 August (Telekom); 30 September (Telekom); 31 October (Telekom); 30 November (Telekom) and 31 December (Telekom) 1997.

We have analyzed the complete listings of WIP and obtained the understanding of WIP nature through discussion with management. We have come across certain issues:

/i/ Small number of WIP which, by its nature, do not belong to telecommunication business have been transferred to Telecom Serbia. However, during this period all those items have been posted out to PTT. We have found out that WIP, in CaCak working Unit, relating to construction of building for telecommunication purposes, which began before 1 June 1997 was included in 31 December 1997 WIP listing for Telekom Srbija. Management of that working unit has raised the issue, requiring the solution for accounting treatment in this case. However, according to management explanation, they did not receive the reply yet. There might be other cases with similar problems. From the contract it is not clearly stated should buildings in the course of construction, which will be used for telecommunication purposes once they are constructed and whose contraction has started before the separation between PTT and Telekom Srbija, is subject of transfer to Telecom.

/ii/ The description of several WIP does not reflected the real nature of WIP. We discussed with management all these WIPs and obtained valid documentation (e.g. interim calculation from the supplier), proving these WIPs relate to telecommunication business. Management is going to take actions to change the descriptions in order to reflect the real nature of WIP.

/iii/ One WIP item relates to costs of projects documentation for WIP purposes. In our opinion it should be posted as intangible asset and being amortized.

/iv/ For certain WIPs such as TT networks in Mirjevo and Zarkovo, not complete documentation have been available as these investments represent cumulative amounts of construction works originated from the period which was under special regulations. Although not material, this should be cleared.

By examining monthly WIP listings for Telekom Srbija, we have come across several WIPs not relating to telecommunication business. Management explains to us that mistakes have been identified and corrected. The mistakes are due to long period of clarifying of what belongs to PTT or Telekom. It is possible to find a WIP relating to PTT in June 1997 WIP listing of Telekom Srbija, and not in July 1977 listing. We have been provided with accounting records proving that the WIP was booked out to PTT.

According to management explanation, and our understanding of telecommunication business, the WIP listing as of 31 December 1997 for Telekom Srbija, with the exception of unsolved case in Cacak working unit, should not contain any of the significant WIP items not relating to telecommunication business.

Detailled listing of Work in Progress and movements occurred during June 1997 is provided in the Appendix I.8.

Work step 3

We have made the sample of 13 WIPs to be physically inspected by SIN/OTE engineers in the progress of sampling selection.. Our findings are as follows:

For certain WIP, Telekom did not have valid documentation such as TT networks in Mirjevo and Zarkovo (explained under /v/). Code no. 06367 of WIP, contains all expenditures for various project documentation (explained under /iii/). Four WIP items do not fit into our previously determined plan for physical verification. Therefore we sampled five WIP in Belgrade working unit to be physically verified.

Separate engineers report is prepared and presented under the Section - Fixed assets.

Our work relating to engineers' inspection comprises vouching procedures of sampled WIP. Out of five WIP items we have vouched only one contained discrepancies. Accounting record of WIP code 05592 "Optical cable Pancevo - Kovin" contained amounts related to another, but related WIP. Management is already informed of that and we have obtained reasonable explanation for such accounting treatment. Results of vouching test for other four WIP items appear reasonable.

Through discussion with management from working unit Gradski telefon we have obtained the understanding of WIP under own construction. Accordingly there are two types of WIP performed by the company itself:

1) Air TT lines
2) Cable lines

1) Air lines WIP is calculated as follows:
Investment Department receives twice a week an "working order" specifying the work done i.e. meters of air TT lines installed with the average price prescribed by General director. The last average price of meter installed was prescribed on 26 February 1997.

2) Cable lines WIP is calculated as follows:
General director prescribes an "average price" of labor used. Hours spent by workers of different qualifications are multiplied by this average price.

For material used Investment Department posses price lists including different items with relevant prices. However, two issue were identified:
/i/ the last price list issued is dated 4 April 1997;
/ii/ the price list does not contain all items.

Investment Department sometimes uses prices from the price list, and in situation when they know that there is a price change, use a current one.

We have selected two WIP items for each category of WIP under own construction and confirmed that the above stated procedures were followed

2.3 Issues

We have reported our findings, in details, under the appropriate work step employed. Certain adjustments might result from these issues and have impact on proper classification between fixed assets and WIP.

The management is aware of those issues and some corrective actions have already been taken.

165

# 3. Payments in advance

## 3.1. Agreed Work Steps Summary

To address the points in Clause 5.1(h) from the Share Sale and Purchase Agreement, you agreed for us to perform the following procedure.

| Work step | | Performed | Alternative Procedures/Notes |
|---|---|---|---|
| 1 | Identify per discussion with management and review of documentation (such as fixed assets listing and trade creditors listing) the large telecommunication equipment supply contracts (scope to be selected) | | We relied upon the adjustments made by PW. |
| | - Review contract and obtain history of payments made in advance | ✓ | |
| | - Agree payments in advance for these contracts to documentary support and cash records | ✓ | |
| | - Obtain understanding through discussion of nature of payments and management's comments on recoverability | ✓ | All balances were reviewed for recoverability. |

## 3.2. Work Performed

### Work Step 1

We were provided by Telekom Srbija trial balance as of 1 June 1997 with balance of payments in advance amounted to 431.840 thousand Dinars. Adjustments were made by PW for recognized WIP for which advances and related liabilities to suppliers were closed (amounted to 188.833 thousand Dinars), getting the opening balance in the amount of 243.007 thousand Dinars.

In addition to PW work on which we placed reliance, we extended the sample of 9 suppliers selected by PW with 2 additional suppliers to whom advances were paid (Telefonkabl and Beogradelektro) in order to verify the balance as of 1 June 1997. We rolledback the movements on those suppliers from 31 December 1997 to 1 June 1997 and by vouching relevant documentation we confirmed the balances.

### Work Step 1/1/

We have reviewed contracts signed with major foreign and domestic suppliers for plant and equipment. We have selected two major foreign suppliers Alcatel CIT, France and Siemens, Germany and reviewed the following contracts:

166

- Contract with Alcatel CIT, France, signed on 22 January 1997, as an Amendment IV, for delivery and installation of 300.000 equivalent lines during 1997 and 1998, in total amount of FRF 209.796.543.
  According to the contract 20% of the total amount for delivery to be made during 1997 is to be paid as an advance; and

- Contract with Siemens, Munich signed on 14 January 1997, as an Amendment III, for EWSD switches to be delivered during 1997 and 1998, in the total amount of DEM 66.924.000.
  According to the contract 20% of the total amount for delivery to be made during 1997 is to be paid as an advance.

We confirmed that advances due to be paid up to 1 June 1997, for both contracts, were paid by PTT.

We also reviewed, in conjunction with work on liabilities towards foreign suppliers major contracts with Siemens, Switzerland, Siemens, Germany and Alcatel CIT, France and found out that outstanding long term borrowings were recorded.

We have selected 4 to 5 contracts with the following domestic suppliers: Beogradelektro, Telefonkabl, Teletrade Iskra, DKTS and VF TEL; reviewed them and verified that advance payments were made in accordance with relevant conditions of the contract signed.

Work Step 1/ii/

In order to assess the recoverability of advances paid to suppliers we reviewed all balances comprising payments in advance. Based on the information provided by Telekom Srbija management and our finding, all advances relate to currently contracted equipment for which no invoices were received from suppliers, except for advance paid to EI Honeywell, Nis, for terminated project on Kosovo. It was proposed by PW and ourselves to write off the total advance payment recorded in the Telekom Srbija books in the amount of 3.397 thousand Dinars.

## 3.3. Issues

Except for suggested adjustment as to the recoverability of the above advance payment there is no other major issues concerning the payments in advance.

# 4. Stocks

## 4.1. Agreed Work Steps Summary

To address the points in Clause 5.1.(h) from the Share sale and Purchase Agreement we proposed in our Arrangement letter to perform the following procedures. Where we have been unable to carry out proposed work we employed alternative procedures as described below:

| Work Step | | Performed | Alternative Procedure/Notes |
|---|---|---|---|
| 1 | Obtain a post-separation stock listing for Telekom Srbija<br>- Foot listing<br>- Agree listing to the opening balance sheet | <br>✓<br>✓ | |
| 2 | Obtain a pre-separation stock listing for PTT. From listing select a sample of stock items (Sample size.....)<br>- Understand nature of stock item;<br>- Determine if stock item is to be transferred by reference to Clause 1.1 "Telecommu-nication Business" of the Acknowledgement of Transfer agreement;<br>- Agree to post-separation Telekom Srbija stock listing, if appropriate. | <br>✓<br>✓ | No stock count held at 1 June 1997. Review of stock count listing was made as of 31 December 1997. |
| 3 | Obtain copies of recent stock records and compare quantities (Scope to be selected) to stock listing. | | Work performed based on the stock count as of 31 December 1997. |
| 4 | Discuss with management the procedures and controls operating in connection with stock counts. | ✓ | We relied upon PW work performed. |
| 5 | Clarify with management the stock valuation methodology. | ✓ | |
| 6 | Agree on a scope basis the cost of stock items to invoices | | Procedures for recor-ding stock items were reviewed |
| 7 | Obtain a listing of all obsolete stock items and discuss with management. Review in context of historical write-offs, aging analysis and management comments. | ✓ | We relied upon PW work performed. |