



**OJSC NOVOLIPETSK STEEL**

**CONSOLIDATED FINANCIAL STATEMENTS**

**PREPARED IN ACCORDANCE WITH ACCOUNTING PRINCIPLES  
GENERALLY ACCEPTED IN THE UNITED STATES OF AMERICA**

**AS AT AND FOR THE YEARS ENDED  
DECEMBER 31, 2005, 2004 AND 2003**

**(WITH REPORT OF INDEPENDENT AUDITORS THEREON)**

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**REPORT OF INDEPENDENT AUDITORS**

**To the Board of Directors of OJSC Novolipetsk Steel**

We have audited the accompanying consolidated balance sheets of OJSC Novolipetsk Steel and its subsidiaries (the "Group") as at December 31, 2005, 2004 and 2003, and the related consolidated statements of income, cash flows and stockholders' equity and comprehensive income for the years then ended. These consolidated financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 10 to the consolidated financial statements, the cost of certain property, plant and equipment was determined with the assistance of an independent appraiser, who provided US dollar estimates of the fair value of the Group's property, plant and equipment.

In our opinion, except for the effects of using the appraisal to determine the carrying value for certain property, plant and equipment as discussed in the preceding paragraph, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Group as at December 31, 2005, 2004 and 2003 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*ZAO PricewaterhouseCoopers Audit*

Moscow, Russian Federation  
April 17, 2006

**OJSC Novolipetsk Steel**  
**Consolidated balance sheets**  
**as at December 31, 2005, 2004 and 2003**



*(All amounts in thousands of US dollars, except for share data)*

	Note	As at December 31, 2005	As at December 31, 2004	As at December 31, 2003
<b>ASSETS</b>				
<b>Current assets</b>				
Cash and cash equivalents	4	1,896,741	1,348,615	729,641
Short-term investments	6	27,040	21,153	180,797
Accounts receivable, net	7	660,054	588,562	377,746
Inventories, net	8	501,556	475,303	301,303
Other current assets, net	9	208,920	148,748	63,336
Restricted cash	5	7,979	5,094	23,104
		<b>3,302,290</b>	<b>2,587,475</b>	<b>1,675,927</b>
<b>Non-current assets</b>				
Long-term investments	6	31,470	51,425	39,925
Property, plant and equipment, net	10	2,393,549	2,257,628	1,332,579
Intangible assets, net	11	16,655	21,594	-
Goodwill	11	173,357	179,815	-
Other non-current assets, net	9	133,747	67,984	36,834
		<b>2,748,778</b>	<b>2,578,446</b>	<b>1,409,338</b>
<b>Total assets</b>		<b>6,051,068</b>	<b>5,165,921</b>	<b>3,085,265</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>				
<b>Current liabilities</b>				
Accounts payable and other liabilities	12	507,637	455,042	251,687
Current income tax liability		40,639	78,638	23,032
Short-term capital lease liability		-	232	6,114
		<b>548,276</b>	<b>533,912</b>	<b>280,833</b>
<b>Non-current liabilities</b>				
Long-term capital lease liability		-	313	11,563
Deferred income tax liability	16	294,337	305,472	159,716
Other long-term liabilities	13	61,675	19,946	6,593
		<b>356,012</b>	<b>325,731</b>	<b>177,872</b>
<b>Total liabilities</b>		<b>904,288</b>	<b>859,643</b>	<b>458,705</b>
<b>Commitments and contingencies</b>	25	-	-	-
<b>Minority interest</b>	14	<b>92,576</b>	<b>85,787</b>	<b>16,652</b>
<b>Stockholders' equity</b>				
Common stock, 1 Russian ruble par value – 5,993,227,240, 5,993,227,240 and 5,987,240 shares issued and outstanding at December 31, 2005, 2004 and 2003	15	221,173	221,173	14,440
Statutory reserve	15	10,267	10,267	32
Additional paid-in capital		1,812	680	680
Other comprehensive income		71,899	242,387	27,672
Retained earnings		4,749,053	3,745,984	2,567,084
		<b>5,054,204</b>	<b>4,220,491</b>	<b>2,609,908</b>
<b>Total liabilities and stockholders' equity</b>		<b>6,051,068</b>	<b>5,165,921</b>	<b>3,085,265</b>

The consolidated financial statements as set out on pages 4 to 38 were approved on April 17, 2006.

**General Director**  
**Nastich V.P.**

**Chief Accountant**  
**Sokolov A.A.**

**OJSC Novolipetsk Steel**  
**Consolidated statements of income**  
**for the years ended December 31, 2005, 2004 and 2003**



*(All amounts in thousands of US dollars, except for earnings per share amounts)*

	Note	For the year ended December 31, 2005	For the year ended December 31, 2004	For the year ended December 31, 2003
<b>Sales revenue</b>	22	<b>4,468,726</b>	<b>4,538,686</b>	<b>2,468,022</b>
<b>Cost of sales</b>				
Production cost		(2,118,111)	(1,888,702)	(1,293,330)
Depreciation and amortization		(283,622)	(243,656)	(157,809)
		<b>(2,401,733)</b>	<b>(2,132,358)</b>	<b>(1,451,139)</b>
<b>Gross profit</b>		<b>2,066,993</b>	<b>2,406,328</b>	<b>1,016,883</b>
General and administrative expenses		(107,867)	(92,517)	(69,524)
Selling expenses		(62,614)	(57,839)	(40,760)
Taxes other than income tax		(36,473)	(33,108)	(24,325)
<b>Operating income</b>		<b>1,860,039</b>	<b>2,222,864</b>	<b>882,274</b>
Loss on disposals of property, plant and equipment		(11,812)	(12,231)	(7,949)
Gain / (loss) on investments		(1,523)	165,174	12,136
Interest income		98,872	50,069	33,633
Interest expense		(15,091)	(12,296)	(7,344)
Foreign currency exchange loss, net		(7,900)	(39,101)	(42,999)
Other income / (expense), net		(16,342)	(10,477)	11,983
<b>Income before income tax and minority interest</b>		<b>1,906,243</b>	<b>2,364,002</b>	<b>881,734</b>
Income tax	16	(495,683)	(572,221)	(223,035)
<b>Income before minority interest</b>		<b>1,410,560</b>	<b>1,791,781</b>	<b>658,699</b>
Equity in net earnings of associate		3,701	-	-
Minority interest	14	(28,925)	(19,280)	(2,243)
<b>Net income</b>		<b>1,385,336</b>	<b>1,772,501</b>	<b>656,456</b>
<b>Income from continuing operations per share (US dollars)</b>				
basic and diluted		0.2312	0.2958	0.1095
<b>Net income per share (US dollars)</b>				
basic and diluted	17	0.2312	0.2958	0.1095

**OJSC Novolipetsk Steel**  
**Consolidated statements of cash flows**  
**for the years ended December 31, 2005, 2004 and 2003**  
*(thousands of US dollars)*



	Note	For the year ended December 31, 2005	For the year ended December 31, 2004	For the year ended December 31, 2003
<b>CASH FLOWS</b>				
<b>FROM OPERATING ACTIVITIES</b>				
<b>Net income</b>		<b>1,385,336</b>	<b>1,772,501</b>	<b>656,456</b>
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>				
Minority interest	14	28,925	19,280	2,243
Depreciation and amortization		283,622	243,656	157,809
Loss on disposals of property, plant and equipment		11,812	12,231	7,949
(Gain) / loss on investments		1,523	(165,174)	(12,136)
Equity in net earnings of associate		(3,701)	-	-
Deferred income tax (benefit) / expense	16	162	(35,945)	(13,498)
Stock-based compensation	24(e)	1,132	-	-
Other movements		(21,609)	2,096	(19,342)
<b>Changes in operating assets and liabilities</b>				
Increase in accounts receivable		(96,486)	(158,628)	(86,853)
Increase in inventories		(47,077)	(132,375)	(71,038)
Decrease / (increase) in other current assets		(33,208)	331	328
Increase in loans provided by the subsidiary bank		(69,142)	(86,501)	(44,357)
Increase in accounts payable and other liabilities		107,377	146,731	86,360
Increase / (decrease) in current income tax payable		(33,990)	51,140	4,390
<b>Net cash provided by operating activities</b>		<b>1,514,676</b>	<b>1,669,343</b>	<b>668,311</b>
<b>CASH FLOWS</b>				
<b>FROM INVESTING ACTIVITIES</b>				
Acquisitions of subsidiaries, net of cash acquired of \$38,109	21	-	(173,856)	-
Proceeds from sale of property, plant and equipment		10,616	8,352	15,677
Purchases and construction of property, plant and equipment		(573,220)	(269,459)	(239,279)
Proceeds from sale of investments		72,872	518,866	17,650
Purchase of investments		(42,722)	(185,594)	(187,590)
Movement of restricted cash		(3,122)	3,378	(15,589)
<b>Net cash used in investing activities</b>		<b>(535,576)</b>	<b>(98,313)</b>	<b>(409,131)</b>
<b>CASH FLOWS</b>				
<b>FROM FINANCING ACTIVITIES</b>				
Proceeds from borrowings and notes payable		20,143	2,545	470
Repayment of borrowings and notes payable		(7,234)	(22,161)	(930)
Proceeds from issuance of additional stock in subsidiaries to minority stockholders		-	-	388
Capital lease payments		-	(40,818)	(6,648)
Payments to controlling shareholders for common control transfer of interests in a new subsidiary, net of cash of \$1,070 received in transferred subsidiary	21	-	(635,383)	-
Payments to controlling shareholders for common control transfers of interests in existing subsidiaries	24	-	(2,617)	-
Repayment of loan by controlling shareholders	24	-	-	71,415
Proceeds from controlling shareholders for sale of investments	24	-	5,554	38,104
Dividends to shareholders		(384,973)	(332,817)	(61,675)
<b>Net cash provided by / (used in) financing activities</b>		<b>(372,064)</b>	<b>(1,025,697)</b>	<b>41,124</b>
<b>Net increase in cash and cash equivalents</b>		<b>607,036</b>	<b>545,333</b>	<b>300,304</b>
Effect of exchange rate changes on cash and cash equivalents		(58,910)	73,641	46,380
Cash and cash equivalents at the beginning of the year	4	1,348,615	729,641	382,957
<b>Cash and cash equivalents at the end of the year</b>	4	<b>1,896,741</b>	<b>1,348,615</b>	<b>729,641</b>

**OJSC Novolipetsk Steel**  
**Consolidated statements of cash flows**  
**for the years ended December 31, 2005, 2004 and 2003**  
*(thousands of US dollars)*



	Note	For the year ended December 31, 2005	For the year ended December 31, 2004	For the year ended December 31, 2003
<b>Supplemental disclosures of cash flow information:</b>				
<b>Cash paid during the year for:</b>				
Income tax		434,885	479,732	190,810
Interest		13,623	12,002	7,369
<b>Non cash operating activities:</b>				
Offset of income tax payable with VAT receivable		96,427	76,251	41,333
<b>Non cash investing activities:</b>				
Capital lease liabilities incurred	18	-	19,920	17,059
Reclassification of restricted cash to long-term investments	5	-	15,000	-
<b>Non cash investing and financing activities as a result of:</b>				
Transfers of subsidiary interests from common control parties reflected as capital contribution, net of cash received of \$1,070	21	-	597,665	-
Fair value of net assets acquired from third parties in new subsidiaries, net of cash acquired of \$38,109 in OJSC TMTP and its subsidiaries	21	-	173,856	-

**OJSC Novolipetsk Steel**  
**Consolidated statements of stockholders' equity and comprehensive income**  
**for the years ended December 31, 2005, 2004 and 2003**  
*(thousands of US dollars)*



	Note	Common stock	Statutory reserve	Additional paid-in capital	Other comprehensive income	Retained earnings	Total stockholders' equity
<b>Balance at December 31, 2002</b>		<b>14,440</b>	<b>32</b>	<b>680</b>	<b>3,723</b>	<b>1,972,303</b>	<b>1,991,178</b>
<b>Comprehensive income:</b>							
Net income		-	-	-	-	656,456	656,456
Other comprehensive income:							
Net unrealized loss on a change in valuation of investments		-	-	-	(2,390)	-	(2,390)
Deferred income tax liability effect	2(b)	-	-	-	(145,133)	-	(145,133)
Cumulative translation adjustment	2(b)	-	-	-	171,472	-	171,472
<b>Comprehensive income</b>							<b>680,405</b>
Dividends to shareholders	15	-	-	-	-	(61,675)	(61,675)
<b>Balance at December 31, 2003</b>		<b>14,440</b>	<b>32</b>	<b>680</b>	<b>27,672</b>	<b>2,567,084</b>	<b>2,609,908</b>
<b>Comprehensive income:</b>							
Net income		-	-	-	-	1,772,501	1,772,501
Other comprehensive income:							
Net unrealized gain on a change in valuation of investments		-	-	-	66	-	66
Cumulative translation adjustment	2(b)	-	-	-	214,649	-	214,649
<b>Comprehensive income</b>							<b>1,987,216</b>
Stock split	15(a)	206,733	-	-	-	(206,733)	-
Increase in statutory reserve	15(a)	-	10,235	-	-	(10,235)	-
Dividends to shareholders	15(b)	-	-	-	-	(338,915)	(338,915)
Transfers of subsidiary interests from controlling shareholders	21	-	-	-	-	598,735	598,735
Payments to controlling shareholders for common control transfer of subsidiary interests	21	-	-	-	-	(636,453)	(636,453)
<b>Balance at December 31, 2004</b>		<b>221,173</b>	<b>10,267</b>	<b>680</b>	<b>242,387</b>	<b>3,745,984</b>	<b>4,220,491</b>
<b>Comprehensive income:</b>							
Net income		-	-	-	-	1,385,336	1,385,336
Other comprehensive income:							
Net unrealized gain on a change in valuation of investments		-	-	-	7	-	7
Cumulative translation adjustment	2(b)	-	-	-	(170,495)	-	(170,495)
<b>Comprehensive income</b>							<b>1,214,848</b>
Stock-based compensation	24(e)	-	-	1,132	-	-	1,132
Dividends to shareholders	15(b)	-	-	-	-	(382,267)	(382,267)
<b>Balance at December 31, 2005</b>		<b>221,173</b>	<b>10,267</b>	<b>1,812</b>	<b>71,899</b>	<b>4,749,053</b>	<b>5,054,204</b>

## **1 BACKGROUND**

OJSC Novolipetsk Steel (the “Parent Company”) and its subsidiaries (together – the “Group”) is one of the largest iron and steel holdings in the Russian Federation with facilities that allow the Group to operate an integrated steel production cycle. The Parent Company is a Russian Federation open joint stock company in accordance with the Civil Code of the Russian Federation. The Parent Company was originally established as a State owned enterprise in 1934 and was privatized in the form of an open joint stock company on January 28, 1993. On August 12, 1998 the Parent Company’s name was re-registered as an open joint stock company in accordance with the Law on Joint Stock Companies of the Russian Federation.

The Group’s principal activity is the production and sale of ferrous metals, primarily consisting of pig iron, steel slabs, hot rolled steel, cold rolled steel, galvanized cold rolled sheet and cold rolled sheet with polymeric coatings. These products are sold both in the Russian Federation and abroad. The Group also operates in the mining and has relatively insignificant interests in the financial and seaport segments (Note 22).

The Group’s main operations are in the Lipetsk region of the Russian Federation and are subject to the legislative requirements of both the Russian Federation and the Lipetsk regional authorities.

The Group’s primary subsidiaries, located in Lipetsk and other regions of the Russian Federation, comprise:

- Mining companies OJSC Stoilensky GOK (acquired in 2004), OJSC StAGDoK and OJSC Dolomite. The principal activity of these companies is mining and processing of iron-ore raw concentrate, fluxing limestone and metallurgical dolomite.
- Transport company OJSC Tuapse Trade Seaport (“OJSC TMTP”) and its subsidiaries (acquired in 2004). The principal business activity of OJSC TMTP is cargo loading and unloading, transshipment of cargo to sea transport and vice versa.
- Trading companies LLC Trading House NLMK, LLC Stahl, LLC Vimet and LLC Larmet. The principal activity of the trading companies is the purchase of raw materials for the Group’s metallurgical production and the sale of metal products.
- The commercial bank OJSC Lipetscombank and its subsidiary. The bank possesses a general banking license issued by the Central Bank of the Russian Federation, a license for foreign currency operations and a license for brokerage activity. The bank provides banking services to commercial and retail customers and other Group companies.
- The insurance company LLC LIS Chance and its subsidiaries. The principal business activities of these companies are corporate property insurance, voluntary medical insurance, vehicle insurance and public liability insurance to commercial and retail customers and other Group companies.

## **2 BASIS OF PREPARATION**

### **(a) Statement of compliance**

The Group maintains its accounting records in accordance with the legislative requirements of the Russian Federation. The accompanying consolidated financial statements have been prepared from those accounting records and adjusted as necessary to comply, in all material respects, with the requirements of accounting principles generally accepted in the United States of America (“US GAAP”).

### **(b) Functional and reporting currency**

The accounting records of the Group are maintained in Russian rubles and the Parent Company prepares its statutory financial statements and reports in that currency to its stockholders in accordance with the laws of the Russian Federation.

The Group’s functional currency is considered to be the Russian ruble. The accompanying consolidated financial statements have been prepared using the US dollar as the Group’s reporting currency. The translation into US dollars has been performed in accordance with the provisions of SFAS No. 52, *Foreign Currency Translation*.

## **2 BASIS OF PREPARATION (continued)**

The Russian economy ceased to be considered hyperinflationary as of January 1, 2003. At January 1, 2003, the monetary and non-monetary assets and liabilities of the Group as well as the related stockholders' equity balance were translated into Russian rubles at the current exchange rate prevailing at January 1, 2003. This translation established a new functional currency basis for the Group. For periods subsequent to January 1, 2003, the functional currency of the consolidated financial statements (Russian rubles) are translated into the reporting currency (US dollars) utilizing period-end exchange rates for assets and liabilities, period average exchange rates for consolidated income statement accounts and historic rates for equity accounts in accordance with the relevant provisions of SFAS No. 52. As a result of these translation procedures, a cumulative translation adjustment of (\$170,495), \$214,649 and \$171,472 as at December 31, 2005, 2004 and 2003, respectively, which accounts for such translation gains and losses, was recorded directly in stockholders' equity.

The deferred income tax effect of \$145,133 resulting from the change in functional currency was recorded directly in stockholders' equity as at January 1, 2003.

The Central Bank of the Russian Federation's closing rates of exchange at December 31, 2005, 2004 and 2003 were 1 US dollar to 28.7825, 27.7487 and 29.4545 Russian rubles, respectively. The annual weighted average exchange rates were 28.2864, 28.8150 and 30.6877 Russian rubles to 1 US dollar for the years ended December 31, 2005, 2004 and 2003, respectively.

### **(c) Consolidation principles**

These consolidated financial statements include all majority-owned and controlled subsidiaries of the Group. All significant intercompany accounts and transactions have been eliminated.

## **3 SIGNIFICANT ACCOUNTING POLICIES**

The following significant accounting policies have been applied in the preparation of the consolidated financial statements. These accounting policies have been consistently applied by the Group from one reporting period to another with the exception of newly adopted accounting pronouncements.

### **(a) Use of estimates**

The preparation of financial statements in accordance with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and revenue and expenses during the periods reported. Estimates are used when accounting for certain items such as allowances for doubtful accounts; employee compensation programs; depreciation and amortization lives; property, plant, and equipment valuation allowances; asset retirement obligations; legal and tax contingencies; inventory values; valuations of investments and determining when investment impairments are other than temporary; goodwill; assets and liabilities assumed in a purchase business combinations and deferred tax assets, including valuation allowances. Estimates are based on historical experience, where applicable, and other assumptions that management believes are reasonable under the circumstances. Actual results may differ from those estimates under different assumptions or conditions.

### **(b) Cash and cash equivalents**

Cash and cash equivalents comprise cash balances, cash on current accounts with banks, bank deposits and other highly liquid short-term investments with original maturities of less than three months.

### **(c) Restricted cash**

Restricted cash comprise funds legally or contractually restricted as to withdrawal.

### **(d) Accounts receivable**

Receivables are stated at cost less an allowance for doubtful debts. Management quantifies this allowance based on current information regarding the customers' ability to repay their obligations. Amounts previously written off which are subsequently collected are recognized as income.

### 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

#### (e) Value added tax

Value added tax related to sales and services rendered is payable to the tax authorities upon the collection of receivables from customers. Input VAT is reclaimable against sales VAT upon payment for purchases. VAT related to sales / purchases and services rendered / used which have not been settled at the balance sheet date (VAT deferred) is recognised in the balance sheet on a gross basis and disclosed separately as a current asset and liability. Where allowance has been made for doubtful debts, loss is recorded for the gross amount of the debtor, including VAT.

#### (f) Inventories

Inventories are stated at the lower of acquisition cost inclusive of completion expenses or market value. Inventories are released to production or written off otherwise at average cost. In the case of manufactured inventories and work in progress, cost includes an appropriate share of production overheads.

The provision for obsolescence is calculated on the basis of slow-moving and obsolete inventories analysis. Such items are provided for in full.

#### (g) Investments in marketable debt and equity securities

Marketable debt and equity securities consist of investments in corporate debt and equity securities where the Group does not exert control or significant influence over the investee. The Group classifies marketable debt and equity securities using three categories: trading, held-to-maturity and available-for-sale. The specific identification method is used for determining the cost basis of all such securities.

##### *Trading securities*

Trading securities are bought and held principally for the purpose of selling them in the near term. Trading securities are carried in the consolidated balance sheet at their fair value. Unrealized holding gains and losses on trading securities are included in the consolidated statement of income.

##### *Held-to-maturity securities*

Held-to-maturity securities are those securities which the Group has the ability and intent to hold until maturity. Such securities are recorded at amortized cost.

Premiums and discounts are amortized and recorded in the consolidated statement of income over the life of the related security held-to-maturity, as an adjustment to yield using the effective interest method.

##### *Available-for-sale securities*

All marketable securities not included in trading or held-to-maturity are classified as available-for-sale.

Available-for-sale securities are recorded at their fair value. Unrealized holding gains and losses, net of the related tax effect, are excluded from earnings and reported as a separate component of accumulated other comprehensive income in the stockholders' equity until realized. Realized gains and losses from the sale of available for sale securities, less tax, are determined on a specific identification basis. Dividend and interest income are recognized when earned.

#### (h) Investments in associates and non-marketable securities

##### *Investments in associates*

Associates are those enterprises in which the Group has significant influence, but not control, over the financial and operating policies. Investments in associates are accounted for using the equity method of accounting. The consolidated financial statements include the Group's share of the total recognized gains and losses of associates from the date that significant influence effectively commences until the date that significant influence effectively ceases.

### 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

#### *Investments in non-marketable securities*

Investments in non-marketable securities where the Group does not exercise control or significant influence over the investee are carried at cost less provisions for any other than temporary diminution in value. Provisions are calculated for the investments in companies which are experiencing significant financial difficulties for which recovery is not expected within a reasonable period in the future, or under bankruptcy proceedings.

#### (i) **Property, plant and equipment**

##### *Owned assets*

Items of property, plant and equipment are stated at acquisition cost less accumulated depreciation and impairment losses (Note 3(k)). The cost of self-constructed assets includes the cost of materials, direct labor and an appropriate proportion of production overheads.

Property, plant and equipment also includes assets under construction and plant and equipment awaiting installation.

Where an item of property, plant and equipment comprises major components having different useful lives, they are accounted for as separate items of property, plant and equipment.

##### *Leased assets*

Leases that meet the definition of capital leases under the requirements of SFAS No. 13, *Accounting for Leases*, are classified accordingly. Plant and equipment acquired by way of capital lease are stated at the lower of its fair value or the present value of the minimum lease payments at inception of the lease, less accumulated depreciation (refer below) and impairment losses (Note 3(k)).

##### *Subsequent expenditures*

Expenditures incurred to replace a component of an item of property, plant and equipment that is accounted for separately, are capitalized with the carrying amount of the component subject to depreciation. Other subsequent expenditures are capitalized only when they increase the future economic benefits embodied in an item of property, plant and equipment. All other expenditures are recognized as expenses in the consolidated statement of income as incurred.

##### *Capitalized interest*

Interest is capitalized in connection with the construction of major production facilities. The capitalized interest is recorded as part of the asset to which it relates, and is depreciated over the asset's useful life.

##### *Mineral rights*

Mineral rights acquired in business combinations are recorded in accordance with provisions of SFAS No. 141, *Business Combinations*, ("SFAS No. 141") at their fair values at the date of acquisition, based on their appraised fair value. The Group reports mineral rights as a separate component of property, plant and equipment in accordance with the consensus reached by Emerging Issues Task Force on Issue No. 04-2, *Whether Mineral Rights Are Tangible or Intangible Assets*.

### 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

#### *Depreciation and amortization*

Depreciation is charged on a straight-line basis over the estimated useful lives of the individual assets. Plant and equipment under capital leases and subsequent capitalized expenses are depreciated on a straight-line basis over the estimated useful life of the individual assets. Depreciation commences from the time an asset is put into operation. Depreciation is not charged on assets to be disposed of or land. The range of estimated useful lives is as follows:

Buildings and land and buildings improvements	20 – 45 years
Machinery and equipment	2 – 40 years
Vehicles	5 – 25 years

Mineral rights are amortized using the straight-line basis over the license term given approximately even production during the period of license.

#### **(j) Goodwill and intangible assets**

Goodwill represents the excess of purchase price over the fair value of net assets acquired. The Group adopted the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*, (“SFAS No. 142”) as of January 1, 2002. Under SFAS No. 142 goodwill and intangible assets with indefinite useful lives are subject to impairment test at least annually and on an interim basis when an event occurs or circumstances change between annual tests that would more-likely-than-not result in impairment.

Under SFAS No. 142, goodwill is assessed for impairment by using the fair value based method. The group determines fair value by utilizing discounted cash flows. The impairment test required by SFAS No. 142 includes a two-step approach. Under the first step, companies must compare fair value of a “reporting unit” to its carrying value. A reporting unit is the level at which goodwill impairment is measured and it is defined as an operating segment or one level below it if certain conditions are met. If the fair value of the reporting unit is less than its carrying value, step two is required to determine if goodwill is impaired.

Under step two, the amount of goodwill impairment is measured by the amount, if any, that the reporting unit’s goodwill carrying value exceeds its “implied” fair value of goodwill. The implied fair value of goodwill is determined by deducting the fair value of all tangible and intangible net assets of the reporting unit (both recognized and unrecognized) from the fair value of the reporting unit (as determined in the first step).

The Group performs the required annual goodwill impairment test at the end of each calendar year.

The excess of the fair value of net assets acquired over purchase cost is determined as negative goodwill, and is allocated to the acquired non-current assets, except for deferred taxes, if any, until they are reduced to zero.

Intangible assets that have limited useful lives are amortized on a straight-line basis over the shorter of their useful or legal lives.

#### **(k) Impairment of long-lived assets**

Long-lived assets, such as property, plant and equipment, mineral rights and purchased intangibles, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized for the amount by which the carrying amount of the asset exceeds the fair value of the asset, generally determined by reference to the discounted future cash flows. Assets held for sale that meet certain criteria are measured at the lower of their carrying amount or fair value less cost to sell.

### **3 SIGNIFICANT ACCOUNTING POLICIES (continued)**

#### **(l) Pension and postretirement benefits other than pensions**

The Group follows the Pension and Social Insurance legislation of the Russian Federation, which requires contributions to the Russian Federation Pension Fund by the employer calculated as a percentage of current gross salaries. Such contributions are expensed as incurred.

The Parent Company and some other Group companies have an agreement with a non-Government pension fund (the "Fund") in accordance with which contributions are made on a monthly basis. Contributions are calculated as a certain fixed percentage of the employees' salaries. These pension benefits are accumulated in the Fund during the employment period and distributed by the Fund subsequently. As such, all these benefits are considered as made under a defined contribution plan and are charged to expense as incurred. Accordingly, the Group has no long-term commitments to provide funding, guarantees, or other support to the Fund.

In addition, lump sum benefits are paid to employees of a number of the Group's companies on retirement depending on the employment period and the salary level of the individual employee. The scheme is considered as a defined benefit plan. The expected future obligations to the employees are assessed by the Group's management and accrued in the consolidated financial statements, however these are not material.

#### **(m) Asset retirement obligations**

The Group's land, buildings and equipment are subject to the provisions of SFAS No. 143, *Accounting for Asset Retirement Obligations*. Based on the current requirements under the laws of the Russian Federation and various contractual agreements associated with these assets, the Group has no material commitments related to the retirement of its long-lived assets.

#### **(n) Long-term borrowings**

Long-term borrowings are recognized initially at cost. Subsequent to the initial recognition, long-term borrowings are stated at amortized cost with any difference between cost and redemption value being recognized in the consolidated statement of income over the period of the borrowings.

When borrowings are repurchased or settled before maturity, any difference between the amount received and the carrying amount is recognized immediately in the consolidated statement of income.

#### **(o) Commitments and contingencies**

Contingent liabilities, including environmental remediation costs, arising from claims, assessments, litigation, fines, penalties and other sources are recorded when it is probable that a liability can be assessed and the amount of the assessment and / or remediation can be reasonably estimated.

Estimated losses from environmental remediation obligations are generally recognized no later than completion of remedial feasibility studies. Group companies accrue expenses associated with environmental remediation obligations when such expenses are probable and reasonably estimable. Such accruals are adjusted as further information becomes available or circumstances change.

#### **(p) Income tax**

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to be applied to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period when a different tax rate is enacted.

Pursuant to the provisions of SFAS No. 109, *Accounting For Income Taxes*, the Group provides valuation allowances for deferred tax assets for which it does not consider realization of such assets to be more likely than not.

### 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

The deferred tax effect associated with the temporary differences that arose from the change in the functional currency of the Group (from the US dollar to the Russian ruble) when Russia ceased to be considered highly inflationary on January 1, 2003, was reflected as an adjustment to the cumulative translation adjustment component of accumulated other comprehensive income on January 1, 2003.

#### (q) Dividends

Dividends are recognized as a liability in the period in which they are declared.

#### (r) Revenue recognition

##### *Goods sold*

Revenue from the sale of goods is recognized in the consolidated statement of income when there is a firm arrangement, the price is fixed and determinable, delivery has occurred, and collectibility is reasonably assured.

##### *Interest income*

Interest income is recognized in the consolidated statement of income as it is earned.

#### (s) Expenses

##### *Operating lease payments*

Operating leases are recognized as an expense in the consolidated statement of income as incurred.

##### *Interest expense*

All interest and other costs incurred in connection with borrowings are expensed as incurred as part of interest expense, except for interest which is incurred on construction projects and capitalized (Note 3(i)).

#### (t) Non-cash transactions

Non-cash settlements represent offset transactions between customers and suppliers, when exchange equivalent is defined and goods are shipped between the parties without exchange of cash.

The related sales and purchases are recorded in the same manner as cash transactions. The fair market value for such transactions is based on the value of similar transactions in which monetary consideration is exchanged with a third party.

Purchases of property, plant and equipment under capital lease arrangements are also recognized as non-cash transactions.

#### (u) Recent accounting pronouncements

In March 2005, the FASB issued Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*. The interpretation requires entities to record a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. The term "conditional asset retirement obligation" refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The interpretation shall be effective no later than December 31, 2005 and early adoption is encouraged. The adoption of this interpretation in 2005 did not have a material impact on its consolidated financial statements.

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*, ("SFAS No. 154") which replaces APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*. This Statement provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to the newly adopted accounting principle. The Statement shall be effective for accounting changes made in fiscal years beginning after December 15, 2005. The impact of SFAS No. 154 will depend on the accounting change, if any, in a future period.

### 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

#### (v) Segment reporting

According to SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, segment reporting follows the internal organizational and reporting structure of the Group. The Group's organization comprises two reportable segments:

- Steel segment, comprising production and sales of steel products, primarily pig iron, steel slabs, hot rolled steel, cold rolled steel, galvanized cold rolled sheet and cold rolled sheet with polymeric coatings,
- Mining segment, comprising mining, processing and sales of iron ore, fluxing limestone and metallurgical dolomite, which supplies raw materials to the steel segment and third parties,

and other segments, not reported separately in the consolidated financial statements.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

### 4 CASH AND CASH EQUIVALENTS

	<u>As at December 31, 2005</u>	<u>As at December 31, 2004</u>	<u>As at December 31, 2003</u>
Cash – Russian rubles	124,003	269,860	26,927
Cash – foreign currency	392,787	2,437	164,659
Deposits – Russian rubles	247,724	39,822	98,457
Deposits – US dollars	917,670	709,457	435,601
Deposits – Euro	214,378	310,782	3,000
Other cash equivalents	179	16,257	997
	<u><b>1,896,741</b></u>	<u><b>1,348,615</b></u>	<u><b>729,641</b></u>

Other cash equivalents as at December 31, 2004 include a deposit of \$16,217 made as a mandatory condition of participation in a privatization tender and recovered by the Group on its completion in February 2005.

### 5 RESTRICTED CASH

	<u>As at December 31, 2005</u>	<u>As at December 31, 2004</u>	<u>As at December 31, 2003</u>
Obligatory cash reserves	7,979	5,094	8,104
Long-term bank deposit	-	-	15,000
	<u><b>7,979</b></u>	<u><b>5,094</b></u>	<u><b>23,104</b></u>

Restricted cash balances as at December 31, 2005, 2004 and 2003 include obligatory cash reserves, placed with the Central Bank of the Russian Federation by the subsidiary bank in accordance with statutory requirements applicable to credit institutions.

Restricted cash balance as at December 31, 2003 also includes a US dollar denominated 6.5% bank deposit with a maturity date of October 2006. The Group pledged this deposit as a guarantee for a related party obligation to a third party. In 2004 the contract of pledge was discontinued due to the termination of the underlying obligation. The deposit was recorded within long-term investments as at December 31, 2004 (Note 6(e)).

## 6 INVESTMENTS

Balance sheet classification of investments:

	<u>As at December 31, 2005</u>	<u>As at December 31, 2004</u>	<u>As at December 31, 2003</u>
Short-term investments and current portion of long-term investments	27,040	21,153	180,797
Long-term investments	<u>31,470</u>	<u>51,425</u>	<u>39,925</u>
<b>Total investments</b>	<b><u>58,510</u></b>	<b><u>72,578</u></b>	<b><u>220,722</u></b>

### (a) Trading securities

	<u>As at December 31, 2005</u>	<u>As at December 31, 2004</u>	<u>As at December 31, 2003</u>
Investments in shares	3,990	-	158,280
Corporate bonds	7,971	-	3,378
Eurobonds	7,759	-	9,630
Government bonds	6,401	-	-
Other	<u>919</u>	<u>1,469</u>	<u>1,146</u>
	<b><u>27,040</u></b>	<b><u>1,469</u></b>	<b><u>172,434</u></b>

Investments in shares are represented by the securities of companies which are listed on the Russian Trade System. These shares and bonds are held by the Group's subsidiary bank

The income generated from trading securities for the years ended December 31, 2005, 2004 and 2003 amounts to \$439, \$162,874 and \$8,436, respectively. The Group's future return on such investments is affected by the operating environment of the Group (Note 23(a)).

### (b) Available-for-sale securities

	<u>As at December 31, 2005</u>	<u>As at December 31, 2004</u>	<u>As at December 31, 2003</u>
Russian government and other bonds with annual coupon rates ranging from 3% to 9.4%			
Acquisition cost	590	2,216	905
Gross unrealized gains / (losses)	(31)	1,784	1,718
Deposit certificates with interest rates ranging from 5.2% p.a. to 20% p.a.	<u>-</u>	<u>35,817</u>	<u>29,304</u>
<b>Fair value</b>	<b><u>559</u></b>	<b><u>39,817</u></b>	<b><u>31,927</u></b>

The maturities of debt securities classified as available-for-sale as at December 31, 2005, 2004 and 2003 are presented below.

	<u>As at December 31, 2005</u>	<u>As at December 31, 2004</u>	<u>As at December 31, 2003</u>
Due within one year	-	19,684	8,363
Due in one to five years	559	18,619	20,898
Due after five years	<u>-</u>	<u>1,514</u>	<u>2,666</u>
	<b><u>559</u></b>	<b><u>39,817</u></b>	<b><u>31,927</u></b>

Russian Government bonds with a face value \$2,908 and \$2,908 as at December 31, 2004 and 2003, respectively, are pledged to secure the redemption of the Parent Company's promissory notes issued in 2000.

**6 INVESTMENTS (continued)**

**(c) Investments in associates**

	As at December 31, 2005 Ownership	As at December 31, 2004 Ownership	As at December 31, 2003 Ownership	As at December 31, 2005	As at December 31, 2004	As at December 31, 2003
CJSC Korpus	-	-	40.00%	-	-	3,232
CJSC Stalconverst	-	-	36.80%	-	-	2,130
OJSC AKB Lipetskcredit	-	-	22.19%	-	-	1,116
OJSC Avron	-	-	26.70%	-	-	406
OJSC Lipetsky Giprommez	43.44%	43.44%	43.44%	8	8	8
OJSC Combinat KMAruda	32.89%	-	-	16,034	-	-
				16,042	8	6,892
Provision for other than temporary diminution in value				-	-	(3,652)
				<b>16,042</b>	<b>8</b>	<b>3,240</b>

During the year ended December 31, 2005 the Group sold 18% share in OJSC Combinat KMAruda to a third party for \$1,966, thereby reducing its stake to 32.89%.

**(d) Non-marketable securities**

	As at December 31, 2005 Ownership	As at December 31, 2004 Ownership	As at December 31, 2003 Ownership	As at December 31, 2005	As at December 31, 2004	As at December 31, 2003
<b>Non-marketable securities, net of current portion:</b>						
OJSC Lebedinsky GOK	11.96%	11.96%	11.96%	9,456	9,808	9,240
OJSC Yakovlevsky rudnik	-	-	9.48%	-	-	5,797
OJSC Lipetskenergo	14.11%	14.11%	12.21%	148	3,388	2,268
OJSC Lipetsk power generating company	14.11%	-	-	2,719	-	-
OJSC Lipetsk energy management company	14.11%	-	-	0.2	-	-
OJSC Lipetsk energy sales company	14.11%	-	-	33	-	-
OJSC Lipetsk mains systems	14.11%	-	-	366	-	-
OJSC Lipetskoblغاز	19.40%	19.40%	19.40%	712	738	695
OJSC Almetievsky Pipe Plant	-	-	14.53%	-	-	557
OJSC Moscow Pipe Plant Filit	-	-	12.00%	-	-	423
Other				788	1,686	708
				14,222	15,620	19,688
Provision for other than temporary diminution in value				(353)	(336)	(6,567)
				<b>13,869</b>	<b>15,284</b>	<b>13,121</b>

## 6 INVESTMENTS (continued)

In 2006 the Group sold 11.96% share in OJSC Lebedinsky GOK to a third party for \$400 million (Note 26(c)).

Shares in OJSC Lipetsk power generating company, OJSC Lipetsk energy management company, OJSC Lipetsk energy sales company and OJSC Lipetsk mains systems were acquired by the Parent Company due to reorganization of OJSC Lipetskenergo in 2005. There was no cash outflow to the Group as a result of this transaction.

### (e) Long-term bank deposits

Long-term bank deposits amounted to \$1,000 and \$16,000 as at December 31, 2005 and 2004. The long-term bank deposit of \$15,000 was recorded within restricted cash as at December 31, 2003 (Note 5).

## 7 ACCOUNTS RECEIVABLE

	<u>As at December 31, 2005</u>	<u>As at December 31, 2004</u>	<u>As at December 31, 2003</u>
Trade accounts receivable	401,770	357,948	245,404
Advances given to suppliers	55,589	57,260	23,834
Taxes receivable	194,848	157,736	95,634
Accounts receivable from employees	1,646	1,192	896
Other accounts receivable	18,633	22,765	18,556
	<u>672,486</u>	<u>596,901</u>	<u>384,324</u>
Allowance for doubtful debts	(12,432)	(8,339)	(6,578)
	<u><b>660,054</b></u>	<u><b>588,562</b></u>	<u><b>377,746</b></u>

As at December 31, 2005 and 2004, the Group had accounts receivable from Steelco Mediterranean Trading Ltd., Cyprus, Tuscany Intertrade (UK) and Moorfield Commodities Company, UK, each of which exceeded 10% of the gross trade accounts receivable balances. The outstanding balances owed by these debtors totaled \$155,798, \$108,670 and \$65,748 at December 31, 2005, \$140,265, \$102,908 and \$50,342 at December 31, 2004.

As at December 31, 2003 accounts receivable from Steelco Mediterranean Trading Ltd., Cyprus and Tuscany Intertrade (UK) exceeded 10% of the gross trade accounts receivable balances and totaled \$121,658 and \$87,272, respectively.

## 8 INVENTORIES

	<u>As at December 31, 2005</u>	<u>As at December 31, 2004</u>	<u>As at December 31, 2003</u>
Raw materials	348,860	333,414	201,610
Work in process	109,679	102,692	64,326
Finished goods and goods for resale	51,618	47,054	37,813
	<u>510,157</u>	<u>483,160</u>	<u>303,749</u>
Provision for obsolescence	(8,601)	(7,857)	(2,446)
	<u><b>501,556</b></u>	<u><b>475,303</b></u>	<u><b>301,303</b></u>



## 9 OTHER CURRENT AND NON-CURRENT ASSETS

	As at December 31, 2005	As at December 31, 2004	As at December 31, 2003
<b>Other current assets</b>			
Short-term loans provided by the subsidiary bank	163,055	131,267	53,904
Other current assets	51,875	20,047	12,781
	214,930	151,314	66,685
Allowance for doubtful loans	(6,010)	(2,566)	(3,349)
<b>Total other current assets</b>	<b>208,920</b>	<b>148,748</b>	<b>63,336</b>
<b>Other non-current assets</b>			
Long-term loans provided by the subsidiary bank	71,138	37,500	21,851
Other non-current assets	62,609	30,484	14,983
<b>Total other non-current assets</b>	<b>133,747</b>	<b>67,984</b>	<b>36,834</b>

Weighted average interest rates on loans, provided to companies (including other banks) and individuals in 2005 by the subsidiary bank of the Group were 10.7% p.a. for loans denominated in Russian rubles and 12.7% p.a. for foreign currency loans.

## 10 PROPERTY, PLANT AND EQUIPMENT

	As at December 31, 2005	As at December 31, 2004	As at December 31, 2003
Land	55,575	46,466	35,442
Mineral rights	522,802	500,996	-
Buildings	708,004	715,759	550,005
Land and buildings improvements	757,066	798,892	686,332
Machinery and equipment	4,234,424	4,320,088	3,831,976
Vehicles	219,431	205,297	105,027
Construction in progress and advances for construction and acquisition of property, plant and equipment	465,425	254,271	270,574
Leased assets	-	862	21,819
Other	37,229	38,787	7,011
	6,999,956	6,881,418	5,508,186
Accumulated depreciation	(4,606,407)	(4,623,790)	(4,175,607)
<b>Net book value</b>	<b>2,393,549</b>	<b>2,257,628</b>	<b>1,332,579</b>

According to US GAAP, the Group's property, plant and equipment should be reported at their actual historical depreciated cost. However, due to the absence of reliable US GAAP accounting records and impairment calculations, the book value of certain property, plant and equipment was determined with the assistance of an independent appraiser, which management considers provided the best basis for the recognition and depreciation of such items. The appraiser provided US dollar estimates of the fair value, determined on the basis of depreciated replacement cost, which the Group has recorded as its property, plant and equipment balance as of January 1, 2000. As at December 31, 2005, 2004 and 2003, the net book value of these items amounted to 21%, 28% and 49% of total net book value of property, plant and equipment, respectively.

## 10 PROPERTY, PLANT AND EQUIPMENT (continued)

In August 2005, the Group acquired a license for exploration and mining of Zhernovsky coal deposit, expiring in 2025. The carrying value of this license as at December 31, 2005 is \$38,272.

The remaining part of mineral rights was acquired by Group in 2004 through a business combination (Note 21). They expire January 1, 2016 and management believes that they will be extended at the initiative of the Group.

## 11 GOODWILL AND OTHER INTANGIBLE ASSETS

### (a) Goodwill

	<u>Goodwill</u>
Balance as at January 1, 2004	-
Acquired in new subsidiaries (Note 21)	173,677
Cumulative translation adjustment (Note 2(b))	<u>6,138</u>
<b>Balance as at December 31, 2004</b>	<b>179,815</b>
Cumulative translation adjustment (Note 2(b))	<u>(6,458)</u>
<b>Balance as at December 31, 2005</b>	<b><u>173,357</u></b>

Goodwill arising on acquisitions was allocated to the appropriate business segment in which each acquisition took place. Goodwill arising from the acquisition of a controlling interest in OJSC Stoilensky GOK amounted to \$95,501 was allocated to the mining segment. Goodwill related to the acquisition of OJSC TMTP and its subsidiaries of \$78,176 was allocated to other non-reportable segments (Note 21).

Negative goodwill of \$110,837 generated on acquisitions of minority interest in OJSC Stoilensky GOK was allocated to the acquired assets other than current assets in accordance with SFAS No. 141.

The Group performed a test for impairment of goodwill at December 31, 2005 and 2004 which indicated no impairments at such dates.

### (b) Other intangible assets

	<u>Total useful life, months</u>	<u>Gross book value as at December 31, 2005</u>	<u>Gross book value as at December 31, 2004</u>
Customers relationships OJSC TMTP (oil)	66	10,865	11,270
Customers relationships OJSC TMTP (dry cargo)	<u>66</u>	<u>12,036</u>	<u>12,484</u>
		22,901	23,754
Accumulated amortization		<u>(6,246)</u>	<u>(2,160)</u>
<b>Total intangible assets</b>		<b><u>16,655</u></b>	<b><u>21,594</u></b>



## 11 GOODWILL AND OTHER INTANGIBLE ASSETS (continued)

The intangible assets were acquired in a business combination (Note 21) and met the criteria for separate recognition outlined in SFAS No. 141. They were recorded under provisions of SFAS No. 141 at fair values at the date of acquisition, based on their appraisal.

	<b>Amortization expense</b>
<b>Aggregate amortization expense</b>	
For the year ended December 31, 2005	(4,087)
<b>Estimated amortization expense</b>	
For the year ended December 31, 2006	(4,164)
For the year ended December 31, 2007	(4,164)
For the year ended December 31, 2008	(4,164)
For the year ended December 31, 2009	(4,164)

## 12 ACCOUNTS PAYABLE AND OTHER LIABILITIES

	<b>As at December 31, 2005</b>	<b>As at December 31, 2004</b>	<b>As at December 31, 2003</b>
Trade accounts payable	90,637	78,651	65,606
Advances received	130,347	127,776	81,447
Customers' deposits and accounts in the subsidiary bank	188,265	156,176	55,704
Taxes payable other than income tax	18,209	19,044	6,166
Accounts payable and accrued liabilities to employees	55,945	51,628	33,356
Dividends payable	2,572	6,332	-
Notes payable	5,282	5,312	2,803
Other accounts payable	16,380	10,123	6,605
	<b>507,637</b>	<b>455,042</b>	<b>251,687</b>

## 13 OTHER LONG-TERM LIABILITIES

	<b>As at December 31, 2005</b>	<b>As at December 31, 2004</b>	<b>As at December 31, 2003</b>
Customers' deposits in the subsidiary bank	45,377	16,150	4,855
Notes payable	16,298	3,796	1,738
	<b>61,675</b>	<b>19,946</b>	<b>6,593</b>



## 14 MINORITY INTEREST

<b>Balance as at December 31, 2002</b>	<b>12,891</b>
Minority's share in subsidiaries' income from continuing operations	2,243
Issuance of additional stock by subsidiaries to minority stockholders	388
Cumulative translation adjustment (Note 2(b))	1,130
<b>Balance as at December 31, 2003</b>	<b>16,652</b>
Minority's share in subsidiaries' income from continuing operations	19,280
Acquisitions of new subsidiaries (Note 21)	49,147
Purchase of the minority interest in existing subsidiaries	(2,289)
Cumulative translation adjustment (Note 2(b))	2,997
<b>Balance as at December 31, 2004</b>	<b>85,787</b>
Minority's share in subsidiaries' income from continuing operations	28,925
Disposal of a stake in a non-wholly owned subsidiary (Note 6(c))	(19,147)
Cumulative translation adjustment (Note 2(b))	(2,989)
<b>Balance as at December 31, 2005</b>	<b>92,576</b>

## 15 STOCKHOLDERS' EQUITY

### (a) Stock

In May 2004, the Parent Company made a stock split through an additional issue of 5,987,240,000 common stock with a par value of 1 Russian ruble each. These shares were distributed to all existing shareholders of the Parent Company in proportion to their interest held at the date of additional shares distribution. Shareholders are eligible for 1,000 additional shares per share held. In accordance with legal requirements the stock split was followed by a transfer from cumulative retained earnings to capital stock at par value totaling to \$206,733.

As at December 31, 2005, 2004 and 2003, the Parent Company's share capital consisted of 5,993,227,240, 5,993,227,240 and 5,987,240 issued common shares (5,993,227,240 at all the dates given the retrospective effect of the stock split), respectively, with a par value of 1 Russian ruble each. For each common share held, the stockholder has the right to one vote at the annual stockholders' meeting.

In August 2004 the Group increased the statutory reserve of the Parent Company up to the amount of \$10,267 following the change in common stock value.

### (b) Dividends

Dividends are paid on common stock at the recommendation of the Board of Directors and approval at the annual Stockholders' Meeting, subject to certain limitations as determined by Russian legislation. Profits available for distribution to stockholders in respect of any reporting period are determined by reference to the statutory financial statements of the Parent Company. At December 31, 2005, 2004 and 2003 the retained earnings of the Parent Company, in accordance with the legislative requirements of the Russian Federation, available for distribution amounted to \$4,137,791, \$3,411,114 and \$1,855,959, respectively, converted into US dollars using exchange rates at December 31, 2005, 2004 and 2003, respectively.

The dividend policy, which was approved by a General Shareholders' Meeting on June 25, 2004, provides for a minimum annual dividend payment of at least 15% of annual net income and sets an objective of making dividend payments of 25% of annual net income, as determined in accordance with US GAAP.

## **15 STOCKHOLDERS' EQUITY (continued)**

In May 2005 the Parent Company declared dividends for the year ended December 31, 2004 of 1.8 Russian ruble per share for the total of \$385,556, including interim dividends for the nine months ended September 30, 2004 of 1 Russian ruble per share (\$214,081). In September 2005 the Parent Company declared interim dividends for the six months ended June 30, 2005 of 1 Russian ruble per share for the total of \$210,792. Dividends payable amount to \$2,572 at December 31, 2005 (Note 12).

In 2004 and 2003 the Parent Company declared dividends of 0.6 and 312.5 Russian rubles per share based on the results of 2003 and 2002, respectively, for a total of \$124,834 and \$61,675.

At the dates dividends were declared, owners of 5,993,227,240 shares were eligible to receive dividends for all periods mentioned, except the results of year 2002, where owners of 5,987,240 shares were eligible (Note 15(a)).

## **16 INCOME TAX**

	<u>For the year ended December 31, 2005</u>	<u>For the year ended December 31, 2004</u>	<u>For the year ended December 31, 2003</u>
Current tax expense	495,521	608,166	236,533
Deferred tax (benefit) / expense: origination and reversal of temporary differences	<u>162</u>	<u>(35,945)</u>	<u>(13,498)</u>
<b>Total income tax expense</b>	<b><u>495,683</u></b>	<b><u>572,221</u></b>	<b><u>223,035</u></b>

The corporate income tax rate in Russia applicable to the Group was 24% in 2005, 2004 and 2003.

Income before income tax is reconciled to the income tax expense as follows:

	<u>For the year ended December 31, 2005</u>	<u>For the year ended December 31, 2004</u>	<u>For the year ended December 31, 2003</u>
Income before tax	1,876,063	2,364,002	881,734
Income tax at applicable tax rate	450,255	567,360	211,616
Increase in income tax resulting from: non-deductible expenses	<u>45,428</u>	<u>4,861</u>	<u>11,419</u>
<b>Total income tax expense</b>	<b><u>495,683</u></b>	<b><u>572,221</u></b>	<b><u>223,035</u></b>



## 16 INCOME TAX (continued)

The tax effects of temporary differences that give rise to the deferred tax assets and deferred tax liabilities are presented below:

	<u>As at December 31, 2005</u>	<u>As at December 31, 2004</u>	<u>As at December 31, 2003</u>
<i>Deferred tax assets</i>			
Accounts payable and other liabilities	8,486	6,948	8,659
Non-current liabilities	88	222	2,455
Accounts receivable	1,066	1,129	1,572
Other	381	-	-
Allowance	-	(28)	-
	<u>10,021</u>	<u>8,271</u>	<u>12,686</u>
<i>Deferred tax liabilities</i>			
Property, plant and equipment	(272,202)	(302,529)	(160,021)
Intangible assets	(4,156)	(5,183)	-
Inventories	(12,906)	(6,031)	(11,145)
Other	(15,094)	-	(1,236)
	<u>(304,358)</u>	<u>(313,743)</u>	<u>(172,402)</u>
<b>Total deferred tax liability</b>	<b><u>(294,337)</u></b>	<b><u>(305,472)</u></b>	<b><u>(159,716)</u></b>

An allowance for deferred tax assets is recognized in respect of the temporary differences, where it is not probable that future taxable profit will be available and therefore realization of these tax assets is doubtful.

The deferred tax effect of establishing a new functional currency basis at January 1, 2003 (Note 2(b)) was recorded within the cumulative translation adjustment directly in other comprehensive income within stockholders' equity.

At December 31, 2005, \$130,253 (December 31, 2004: \$155,663) of the deferred tax liability on property, plant and equipment relate to differences between the US GAAP and tax carrying values of property, plant and equipment of the acquired subsidiaries. As noted in Note 21(c), the US GAAP carrying value was recorded at fair value on acquisition.

## 17 EARNINGS PER SHARE

	<u>Year ended December 31, 2005</u>	<u>Year ended December 31, 2004</u>	<u>Year ended December 31, 2003</u>
Average number of shares			
before restatement	5,993,227,240	3,948,404,836	5,987,240
after restatement	5,993,227,240	5,993,227,240	5,993,227,240
Net income (thousands of US dollars)	<u>1,385,336</u>	<u>1,772,501</u>	<u>656,456</u>
<b>Basic and diluted net income per share (US dollars)</b>	<b><u>0.2312</u></b>	<b><u>0.2958</u></b>	<b><u>0.1095</u></b>

Basic net income per share of common stock is calculated by dividing net income by the weighted average number of shares of common stock outstanding during the reporting period, after giving retroactive effect to any stock splits.

In May 2004, the Parent Company made a stock split through an additional issue of 5,987,240,000 common stock with a par value of 1 Russian ruble each (Note 15(a)). Earnings per share data for 2004 and 2003 have been restated to reflect this share distribution.

The average shares outstanding for purposes of basic and diluted earnings per share information were 5,993,227,240 for the years ended December 31, 2005, 2004 and 2003.

The Parent Company does not have potentially dilutive shares outstanding.

## 18 NON-CASH TRANSACTIONS

Approximately \$7,300, \$4,400 and \$3,000 of the Group's 2005, 2004 and 2003 revenues, respectively, were settled in the form of mutual offset against the liability to pay for raw materials supplied.

Prices for goods sold and purchased through non-cash settlement arrangements are fixed in the respective contracts and generally reflect current market prices.

In 2004 and 2003, the Group acquired equipment and vehicles under capital lease arrangements with the right to buy out leased assets upon completion of the underlying agreements. The amount of capital lease liabilities incurred during the years ended December 31, 2004 and 2003, was \$19,920 and \$17,059, respectively. In 2004 the majority of capital lease liabilities were settled (Note 20).

In 2004 the Group acquired assets and liabilities as a result of acquisitions of new subsidiaries (Note 21).

## 19 FAIR VALUE OF FINANCIAL INSTRUMENTS

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties.

Management believes, that the carrying amounts of financial assets and liabilities approximate to a reasonable estimate of their fair value.

The fair values of available-for-sale securities are based on quoted market prices for these or similar instruments.

## 20 CAPITAL AND OPERATIONAL LEASES

At December 31, 2004 and 2003, net book value of the machinery, equipment and vehicles held under the capital lease arrangements with a related party was:

	<u>As at December 31, 2005</u>	<u>As at December 31, 2004</u>	<u>As at December 31, 2003</u>
Machinery and equipment	-	198	4,620
Vehicles	-	664	17,199
	-	862	21,819
Accumulated depreciation	-	(87)	(1,067)
<b>Net value of property, plant and equipment obtained under capital lease arrangements</b>	<b>-</b>	<b>775</b>	<b>20,752</b>

In September 2004, the Group cancelled the majority of its capital lease arrangements and bought out leased assets. The capital lease liability in the amount of \$30,625 at the date of cancellation was settled. The difference of \$6,656 between the carrying amount of the capital lease liability settled and purchase price was accounted as an adjustment of the carrying value of the assets.

The discount rates used for the calculation of the present value of net minimum lease payments was 14%. Capital lease charges of \$3,155 and \$3,405 were recorded in the consolidated statements of income for the years ended December 31, 2004 and 2003, respectively.

The Group incurred expenses in respect of operational leases of \$7,347, \$6,595 and \$5,584 in 2005, 2004 and 2003, respectively.

## **21 BUSINESS COMBINATIONS**

### **(a) OJSC Stoilensky GOK**

In March 2004 the companies under common control of the controlling shareholders of the Parent Company (“the Companies under common control”) transferred to the Parent Company 59.8% and in November 2004 – 31.1% of the outstanding common shares of OJSC Stoilensky GOK. In these consolidated financial statements, the Group accounted for these transfers retrospectively, in a manner similar to pooling by reflecting the controlling shareholders’ book value of their acquisition cost in such transfers of \$598,735 as capital contributions. The Group transferred cash consideration to such control parties of \$636,453 which is reflected as distributions to controlling shareholders.

A part of the primary acquisition cost in the amount of \$60,761 represents transaction related fees paid for by the Companies under common control. The acquisition agreements contain no material future contingent payments or commitments. The acquisitions resulted in the Group’s ownership of 91.4% of the voting shares of the company. Prior to March 2004 the Group’s 0.5% interest in OJSC Stoilensky GOK was accounted for at cost.

This transaction was consummated to acquire one of the largest iron-ore concentrate and agglomerated ore producers in Russia in order to secure long-term supplies of raw materials for the Group.

The acquisition of OJSC Stoilensky GOK by the control party was accounted for using the purchase method of accounting. The entity was consolidated by the Group for the first time as at the effective date of obtaining control by the control party which management considers to be March 31, 2004. The results of operations of the acquired entity were included in the consolidated statement of income starting from April 1, 2004.

In October and November 2004 the Group acquired, at an auction for sale of a state-owned shareholding and from other minority shareholders, an additional 5.6% of the common stock of OJSC Stoilensky GOK for a consideration of \$22,793 paid in cash.

The Group generated positive goodwill of \$95,501 on acquisition of the controlling stock (59.8%) and negative goodwill \$110,837 on subsequent acquisitions. Negative goodwill was allocated to the acquired assets other than current assets in accordance with SFAS No. 141.

### **(b) OJSC TMTP**

In June 2004 the Group acquired 69.4% of the common stock of OJSC TMTP for a consideration of \$189,172 paid in cash to unrelated parties. The Group also obtained control over its subsidiaries OJSC Tuapse Dockyard, OJSC Tuapsegrazhdanstroi, LLC Nafta-T and LLC Karavella. The agreement contains no future contingent payments or commitments.

This transaction was consummated to provide smooth transportation of the Group’s products within the respective area of export sales.

The acquisition of OJSC TMTP and its subsidiaries was accounted for using the purchase method of accounting. OJSC TMTP and its subsidiaries were consolidated for the first time as of the effective date of obtaining control which management considers to be June 30, 2004. The results of operations of the acquired entities were included in the consolidated statement of income starting from July 1, 2004.

**21 BUSINESS COMBINATIONS (continued)**

**(c) Fair values of the assets acquired and liabilities assumed**

The following table summarizes the fair values of the assets acquired and liabilities assumed in the business combinations, determined in accordance with SFAS No. 141 provisions. The fair values of property, plant and equipment, including mineral extraction rights, and intangible assets were established by independent appraisers:

	<b>OJSC Stoilensky GOK</b>	<b>OJSC TMTP and its subsidiaries</b>	<b>Total acquisitions</b>
Current assets	29,197	56,270	85,467
Mineral rights	486,880	-	486,880
Other property, plant and equipment	223,307	95,545	318,852
Intangible assets	-	22,712	22,712
Other non-current assets	616	1,000	1,616
Goodwill (Note 11(a))	95,501	78,176	173,677
<b>Total assets acquired</b>	<b>835,501</b>	<b>253,703</b>	<b>1,089,204</b>
Current liabilities	(49,577)	(5,969)	(55,546)
Non-current liabilities	(4,139)	(1,208)	(5,347)
Deferred income tax liability	(154,280)	(14,184)	(168,464)
<b>Total liabilities assumed</b>	<b>(207,996)</b>	<b>(21,361)</b>	<b>(229,357)</b>
Minority interest	(5,977)	(43,170)	(49,147)
<b>Fair value of net assets acquired</b>	<b>621,528</b>	<b>189,172</b>	<b>810,700</b>
Less: cash acquired	(1,070)	(38,109)	(39,179)
<b>Fair value of net assets acquired, net of cash acquired</b>	<b>620,458</b>	<b>151,063</b>	<b>771,521</b>
Transfers of subsidiary interests from common control parties reflected as capital contribution, net of cash received of \$1,070	597,665	-	597,665
Fair value of net assets acquired from third parties, net of cash acquired of \$38,109 at OJSC TMTP and its subsidiaries	22,793	151,063	173,856
<b>Fair value of net assets acquired, net of cash acquired</b>	<b>620,458</b>	<b>151,063</b>	<b>771,521</b>

The transfers of subsidiary interests were recorded in the statement of stockholders' equity as capital contributions of \$598,735, comprising \$597,665 of non-cash contributions and \$1,070 of cash owned by the subsidiary at the dates of contributions. The payments to the common control parties for the transfer of the shares in OJSC Stoilensky GOK of \$636,453 were recorded as a reduction in stockholders' equity.

**(d) Other acquisitions**

In 2004 the Group made a number of immaterial acquisitions of stock in other Group's subsidiaries and an immaterial acquisition of the controlling stock in LLC Independent Transport Company from related parties for the total consideration of \$2,617 (Note 24).



**21 BUSINESS COMBINATIONS (continued)**

**(e) Pro forma financial statements**

The following unaudited pro forma statements of income are presented relating to the acquisitions by the Group of OJSC Stoilensky GOK and OJSC TMTP and its subsidiaries (together – “TMTP Group”) in the transactions accounted for as purchases. The unaudited pro forma statements of income are based on the consolidated statements of income of the Group and TMTP Group and individual statements of income of OJSC Stoilensky GOK.

The unaudited pro forma statements of income combine the results of operations of the Group, OJSC Stoilensky GOK (acquired by the Group as of March 31, 2004) and TMTP Group (acquired by the Group as of June 30, 2004) for the years ended December 31, 2004 and 2003 as if the acquisitions occurred on January 1, 2004 and 2003, respectively. These unaudited pro forma statements of income should be read in conjunction with the consolidated financial statements of the Group.

Unaudited proforma income statement data for the year ended December 31, 2004 and 2003 are as follows:

	<b><u>For the year ended December 31, 2004</u></b>	<b><u>For the year ended December 31, 2003</u></b>
Sales revenue	4,620,124	2,720,714
Operating income	2,217,107	841,781
Income before income tax and minority interest	2,354,558	815,623
Income before minority interest	1,781,686	605,035
Net income	1,760,792	602,621
Net income per share (US dollars)	<u>0.2938</u>	<u>0.1006</u>

The above statements give effect to the following pro forma adjustments necessary to reflect the acquisitions:

- (a) A depreciation charge and respective deferred tax effect for the periods preceding business combinations was calculated on the basis of appraised fair value of property and equipment, including mineral rights, acquired in new subsidiaries.
- (b) An amortization charge and respective deferred tax effect for the periods preceding business combination was calculated on the basis of appraised fair value of intangible assets identified and separated from goodwill in the process of TMTP Group’s purchase price allocation.
- (c) Minority interest in net income of acquired subsidiaries for the periods preceding business combinations was calculated on the basis of interest owned by the Group at December 31, 2004.

The unaudited proforma amounts are provided for informational purposes only and do not purport to present the results of operations of the Group had the transactions assumed therein occurred on or as of the date indicated, nor is it necessarily indicative of the results of operations which may be achieved in the future.

## 22 SEGMENTAL INFORMATION

The Group has two reportable business segments: steel and mining. These segments are combinations of subsidiaries, have separate management teams and offer different products and services. The above two segments meet criteria for reportable segments. Subsidiaries are consolidated by the segment to which they belong based on their products and management.

Revenue from segments that does not exceed the quantitative thresholds is primarily attributable to the two operating segments of the Group. Those segments include the trade seaport services business, represented by OJSC TMTP and its subsidiaries, and finance business, comprising banking and insurance services to commercial and retail customers. None of these segments has met any of the quantitative thresholds for determining reportable segments.

The Group accounts for intersegmental sales and transfers as if the sales or transfers were to third parties.

The Group's management evaluates performance of the segments based on segment revenues, gross profit, operating income and income before minority interest.

Segmental information for the year ended December 31, 2005 is as follows:

	Steel	Mining	All other	Totals	Intersegmental operations and balances	Consolidated
Revenue from external customers	4,174,715	119,496	174,515	4,468,726	-	4,468,726
Intersegment revenue	4,402	460,579	5,154	470,135	(470,135)	-
Depreciation and amortization	(197,110)	(69,354)	(17,158)	(283,622)	-	(283,622)
<b>Gross profit</b>	<b>1,667,880</b>	<b>318,227</b>	<b>65,939</b>	<b>2,052,046</b>	<b>14,947</b>	<b>2,066,993</b>
<b>Operating income</b>	<b>1,518,890</b>	<b>290,904</b>	<b>39,712</b>	<b>1,849,506</b>	<b>10,533</b>	<b>1,860,039</b>
Interest income	58,741	10,736	30,249	99,726	(854)	98,872
Interest expense	(1)	(28)	(15,916)	(15,945)	854	(15,091)
Income tax	(394,344)	(68,093)	(14,541)	(476,978)	(18,705)	(495,683)
<b>Income before minority interest</b>	<b>1,165,120</b>	<b>224,778</b>	<b>44,524</b>	<b>1,434,422</b>	<b>(23,862)</b>	<b>1,410,560</b>
Segment assets, including goodwill	4,422,873	1,071,717	706,761	6,201,351	(150,283)	6,051,068
Capital expenditures	(492,984)	(67,467)	(12,769)	(573,220)	-	(573,220)

Segmental information for the year ended December 31, 2004 is as follows:

	Steel	Mining	All other	Totals	Intersegmental operations and balances	Consolidated
Revenue from external customers	4,399,606	74,965	64,115	4,538,686	-	4,538,686
Intersegment revenue	3,365	337,344	204	340,913	(340,913)	-
Depreciation and amortization	(174,646)	(59,972)	(9,038)	(243,656)	-	(243,656)
<b>Gross profit</b>	<b>2,182,293</b>	<b>207,805</b>	<b>20,873</b>	<b>2,410,971</b>	<b>(4,643)</b>	<b>2,406,328</b>
<b>Operating income</b>	<b>2,037,325</b>	<b>186,105</b>	<b>18,084</b>	<b>2,241,514</b>	<b>(18,650)</b>	<b>2,222,864</b>
Interest income	31,110	2,382	17,236	50,728	(659)	50,069
Interest expense	(3,326)	(443)	(9,186)	(12,955)	659	(12,296)
Income tax	(530,694)	(40,818)	(4,238)	(575,750)	3,529	(572,221)
<b>Income before minority interest</b>	<b>1,639,276</b>	<b>140,813</b>	<b>17,322</b>	<b>1,797,411</b>	<b>(5,630)</b>	<b>1,791,781</b>
Segment assets, including goodwill	3,767,196	984,495	654,131	5,405,822	(239,901)	5,165,921
Capital expenditures	(219,673)	(44,541)	(5,245)	(269,459)	-	(269,459)

**22 SEGMENTAL INFORMATION (continued)**

Segmental information for the year ended December 31, 2003 is as follows:

	<u>Steel</u>	<u>Mining</u>	<u>All other</u>	<u>Totals</u>	<u>Intersegmental operations and balances</u>	<u>Consolidated</u>
Revenue from external customers	2,450,193	17,179	650	2,468,022	-	2,468,022
Intersegment revenue	1,017	23,099	-	24,116	(24,116)	-
Depreciation and amortization	(155,439)	(2,054)	(316)	(157,809)	-	(157,809)
<b>Gross profit / (loss)</b>	<b>1,004,013</b>	<b>4,973</b>	<b>(55)</b>	<b>1,008,931</b>	<b>7,952</b>	<b>1,016,883</b>
<b>Operating income / (loss)</b>	<b>884,209</b>	<b>2,598</b>	<b>(289)</b>	<b>886,518</b>	<b>(4,244)</b>	<b>882,274</b>
Interest income	23,820	-	10,394	34,214	(581)	33,633
Interest expense	(3,151)	(691)	(4,083)	(7,925)	581	(7,344)
Income tax	(221,372)	(435)	(1,228)	(223,035)	-	(223,035)
<b>Income before minority interest</b>	<b>653,775</b>	<b>2,193</b>	<b>3,504</b>	<b>659,472</b>	<b>(773)</b>	<b>658,699</b>
Segment assets	3,022,399	19,431	125,427	3,167,257	(81,992)	3,085,265
Capital expenditures	(232,955)	(2,803)	(3,521)	(239,279)	-	(239,279)

The allocation of total revenue by territory is based on the location of end customers who purchased the Group's products from international traders (Note 23(c)) and the Group. It does not reflect the geographical location of the international traders. The Group's total revenue from external customers by geographical area for the years ended December 31, 2005, 2004 and 2003, was as follows:

	<u>For the year ended December 31, 2005</u>	<u>For the year ended December 31, 2004</u>	<u>For the year ended December 31, 2003</u>
Russia	1,882,839	1,628,242	1,043,880
Asia and Oceania	847,605	628,238	533,987
European Union	626,332	783,014	384,139
Middle East, including Turkey	571,331	636,044	348,743
North America	306,996	657,427	46,354
Other regions	233,623	205,721	110,919
	<b>4,468,726</b>	<b>4,538,686</b>	<b>2,468,022</b>

Geographically, all assets, production and administrative facilities of the Group are located in Russia.

As disclosed in Note 23(c), the Group sells to three international traders that accounted for a majority of the Group's export sales in 2005, 2004 and 2003. LLC Insaur-Stal accounted for in excess of 10% of the Group's 2004 and 2003 domestic sales.

## **23 RISKS AND UNCERTAINTIES**

### **(a) Operating environment of the Group**

The Russian Federation economy continues to display some characteristics of an emerging market. These characteristics include, but are not limited to, the existence of a currency that is not freely convertible in most countries outside of the Russian Federation, restrictive currency controls, and relatively high inflation. The tax, currency and customs legislation within the Russian Federation is subject to varying interpretations, and changes, which can occur frequently.

Whilst there have been improvements in the economic trends, the future economic direction of the Russian Federation is largely dependent upon the effectiveness of economic, financial and monetary measures undertaken by the Government, together with tax, legal and political developments.

### **(b) Convertibility of Russian ruble**

Exchange restrictions and controls exist relating to converting Russian rubles into other currencies. At present, the Russian ruble is not a convertible currency outside of the Russian Federation and, further, the Group is required to convert 10% of its foreign currency earnings into Russian rubles starting 2005 (25% before 2005). Future movements in the exchange rate between the Russian ruble and the US dollar will affect the reported US dollar amounts related to the Russian ruble carrying values of the Group's assets and liabilities. Such movements may also affect the Group's ability to realize assets presented in US dollars in these consolidated financial statements. Accordingly, any translation of ruble amounts to US dollars should not be construed as a representation that such ruble amounts have been, could be, or will in the future be converted into US dollars at the exchange rate shown or at any other exchange rate.

### **(c) Commercial risks**

The Group minimizes its sales risks by having a wide range of geographical zones for sales, which allows the Group to respond quickly to unexpected changes in the situation on one or more sales markets on the basis of an analysis of the existing and prospective markets.

The Group's exports in monetary terms in 2005 were 58% (2004: 64%, 2003: 58%) of the total sales.

The Group relies on export sales to generate foreign currency earnings. As the Group exports a significant portion of its production, it is exposed to foreign currency risk as well as global economic and political risks.

Due to its foreign currency denominated assets and liabilities, the Group is subject to the risk arising from foreign exchange rate fluctuations. The Group's objective in managing its exposure to foreign currency fluctuations is to minimize earnings and cash flow volatility associated with foreign exchange rate changes. The net foreign currency position as at December 31, 2005 is as follows:

	<u>US Dollar</u>	<u>EURO</u>	<u>Other currencies</u>
Cash and cash equivalents	960,508	487,582	-
Accounts receivable	286,855	205,741	1,197
Other current assets	14,446	-	-
Investments and long-term deposit	1,559	-	-
Other non-current assets	27,223	4,465	-
Accounts payable and other liabilities	(26,863)	(15,215)	(389)
Other long-term liabilities	(8,500)	-	-

## **23 RISKS AND UNCERTAINTIES (continued)**

The Group sells to three international traders that account for the majority of its export sales. In 2005, Steelco Mediterranean Trading Ltd., Cyprus, Tuscany Intertrade (UK), and Moorfield Commodities Company, UK, purchased 41%, 26% and 17% of the Group's export sales, respectively (2004: 43%, 30% and 17%; 2003: 45%, 33% and 9%). These companies were indirect shareholders of the Parent Company during 2003. The maximum shareholdings during 2003 were 7.59%, 9.99% and 7.59%, and at December 31, 2003 were 4.16%, 4.11% and 4.16%, respectively. In 2004 these companies ceased to be indirect shareholders of the Parent Company. Price fluctuations of sales to these companies are in line with general trends in global price fluctuations. The Group's export prices are comparable to the prices of Russian competitors. In August 2005, 1.199% of the share capital of the Parent Company was acquired by a company beneficially owned by the shareholders of these traders.

The Group's future profitability and overall performance is strongly affected by the prices of ferrous metal products set in the international metal trading market that are subject to significant fluctuations.

## **24 RELATED PARTY TRANSACTIONS**

Related parties relationships are determined with reference to SFAS No. 57, *Related Party Disclosures*. Balances as at December 31, 2005, 2004 and 2003 and transactions for the years ended December 31, 2005, 2004 and 2003 with related parties of the Group consist of the following:

### **(a) Sales to and purchases from related parties**

#### ***Sales***

Sales to related parties, either the Companies under common control or companies under control or significant influence of the Group's management, were \$38,436, \$45,715 and \$24,502 for the years ended December 31, 2005, 2004 and 2003, respectively, which accounts for 0.9%, 1% and 1% of the total sales revenue. Related accounts receivable equaled \$33,178, \$6,501 and \$7,397 as at December 31, 2005, 2004 and 2003, respectively.

#### ***Purchases and services***

Purchases of raw materials, technological equipment and management services from the Companies under common control, were \$22,247, \$114,255 and \$77,216 for the years ended December 31, 2005, 2004 and 2003, respectively. Purchases of energy from the companies under significant influence of the Group's management (OJSC Lipetsk energy sales company and other companies, which originated from reorganization of OJSC Lipetskenergo (Note 6(d)), in 2005, and OJSC Lipetskenergo in 2004 and 2003), were \$140,005, \$106,377 and \$85,735 for the years ended December 31, 2005, 2004 and 2003, respectively.

In 2004 and 2003, the Group made payments to one of the Companies under common control, acting as an agent between the Group and railroad companies, for the transportation of raw materials and the Group's products. The payments include both railroad tariff (transferred to railroad companies), and agent fee, retained by the agent. The agent fee and purchases of other materials from this Company under common control amounted to \$8,452 and \$2,979 for the years ended December 31, 2004 and 2003, respectively.

Accounts payable to the related parties were \$4,152, \$2,044 and \$7,689 as at December 31, 2005, 2004 and 2003, respectively.

## **24 RELATED PARTY TRANSACTIONS (continued)**

### **(b) Financial transactions**

The subsidiary bank of the Group had loans receivable from related parties, either associates or companies under control or significant influence of the Group's management, of \$10,633, \$7,538 and \$9,221 as at December 31, 2005, 2004 and 2003, respectively.

Deposits and current accounts of related parties, either the Companies under common control or companies under control or significant influence of the Group's management, in the subsidiary bank amounted to \$88,090, \$28,642 and \$8,217 as at December 31, 2005, 2004 and 2003, respectively.

Deposits and current accounts of Group companies in a bank under significant influence of the Group's management (OJSC Bank Zenit) amounted to \$70,967 as at December 31, 2005 (nil at December 31, 2004 and 2003). Related interest income from these deposits and current accounts for the year ended December 31, 2005 amounted to \$10,235.

The Group leased property, plant and equipment under capital lease arrangements with one of the Companies under common control. The amount of capital lease liabilities incurred during the years ended December 31, 2004 and 2003, was \$19,920 and \$17,059, respectively. The capital lease liabilities to this related party as at December 31, 2004 and 2003 amounted to \$545 and \$17,677, respectively.

The Group granted interest free loans to management in the total amount of \$817, \$71 and \$40 for the years ended December 31, 2005, 2004 and 2003, respectively. The aggregate amount of such loans outstanding as at December 31, 2005, 2004 and 2003 was \$514, \$60 and \$38, respectively.

As at December 31, 2003, the Group had issued guarantees to the Companies under common control amounting to \$38,980 in respect of borrowings from non-group companies (Note 25(h)). There were no guarantees issued to related parties as at December 31, 2005 and 2004.

In 2003 the Parent Company's shareholders repaid remaining portion of the long-term interest free loan in the amount of \$71,415. A gain on the early repayment of the loan in the amount of \$20,984 was recognized in the consolidated statement of income for the year ended December 31, 2003.

### **(c) Acquisitions and investments**

In 2004 the Companies under common control transferred to the Parent Company 91.4% of the outstanding common shares of OJSC Stoilensky GOK. Such transfers of \$598,735 were recorded as capital contributions. The Group transferred cash consideration to such control parties of \$636,453 which is reflected as distributions to controlling shareholders (Note 21(a)).

In the second half of 2004 the Group made a number of immaterial acquisitions of stock in the Group's companies OJSC Dolomit, OJSC StAGDoK, and an immaterial acquisition of the controlling stock in LLC Independent Transport Company from the Companies under common control in the total amount of \$2,617 (Note 21(d)); acquired non-marketable securities, shares in OJSC Lipetskenergo, for \$944 from one of the Companies under common control, and sold non-marketable securities, shares in OJSC Moscow Pipe Plant Filit, OJSC Almeteyevsky Pipe Plant and CJSC Engels Pipe Plant, for the total consideration of \$2,430 to the Companies under common control (Note 6(d)). The Group sold an investment in associate CJSC Korpus to one of the Companies under common control for the consideration of \$3,124 (Note 6(c)). In 2003 the Group sold its share in OJSC Coal Mining Company Kuzbassugol for the consideration of \$38,104 to one of the Companies under common control.

### **(d) Contributions to non-governmental pension fund and charity fund**

Total contributions to a non-governmental pension fund amounted to \$2,729, \$2,607 and \$2,216 in 2005, 2004 and 2003, respectively. The Group has the right to appoint and dismiss top management of the fund as the major contributor to its capital. The Group has no long-term commitments to provide funding, guarantees, or other support to the fund.

Contributions to the charity fund controlled by the Parent Company's management were \$6,941 in 2004. There were no such contributions in 2005 and 2003.

## **24 RELATED PARTY TRANSACTIONS (continued)**

### **(e) Stock-based compensation**

In August 2005, the controlling shareholder of the Parent Company effectively sold 200,100,000 of NLMK shares to companies beneficially owned by certain members of its Board of Directors and management of the Group. The purchase price of these shares was based on the Russian Trade System (“RTS”) trading price at the date of the transaction. This purchase price is payable by December 31, 2006 with no interest charged on the outstanding debt. The respective shares were pledged to secure the payment. There were no shares under such arrangements as at and for the years ended December 31, 2004 and 2003. The only movements which took place in the year ended December 31, 2005 were as described above.

This transaction was achieved through contractual arrangements between companies owned by the controlling shareholder of the Parent Company and companies beneficially owned by certain members of NLMK’s Board of Directors and management of the Group, and therefore there was no cash outflow to the Group as a result of this transaction.

The Group applied SFAS No. 123, *Accounting for Stock-Based Compensation*, (“SFAS No. 123”) for the purposes of accounting for this transaction, and estimated the fair value of the options at \$31,463. Management of the Group estimated that \$1,132 of this value related to the services provided by the individuals to the Group, and accordingly recorded an expense in general and administrative expenses in the year ended December 31, 2005, with a corresponding increase in stockholders’ equity. The arrangement effectively represents the granting of options, at zero consideration, to buy shares at the RTS trading price of the shares on the grant date (in August 2005), the option expiring on December 31, 2006.

The following assumptions were made in applying the Black-Scholes model in estimating the fair values of the options for the purposes of applying SFAS No. 123: risk-free interest rate on Russian dollar-denominated bonds of 4.5%, expected life of 1.33 years, expected volatility of 25.91%, and expected dividend yield of 4.24%.

## **25 COMMITMENTS AND CONTINGENCIES**

### **(a) Anti-dumping investigations**

The Group’s export trading activities are subject to from time to time compliance reviews of importers’ regulatory authorities. The Group’s export sales were considered within several anti-dumping investigation frameworks. The Group takes steps to address negative effects of the current and potential anti-dumping investigations and participates in the settlement efforts coordinated through the Russian authorities. No provision arising from any possible agreements as a result of anti-dumping investigations has been made in the accompanying consolidated financial statements.

### **(b) Litigation**

The Group, in the ordinary course of business, is the subject of, or party to, various pending or threatened legal actions. The management of the Group believes that any ultimate liability resulting from these legal actions will not significantly affect its financial position or results of operations, and no amount has been accrued in the consolidated financial statements.

### **(c) Environmental matters**

The enforcement of environmental regulation in Russian Federation is evolving and the enforcement posture of government authorities is continually being reconsidered. The Group periodically evaluates its obligations under environmental regulations. As obligations are determined, they are recognised immediately. Potential liabilities, which might arise as a result of changes in existing regulations, civil litigation or legislation, cannot be estimated but could be material. In the current enforcement climate under existing legislation, management believes that the Group has met the Government’s federal and regional requirements concerning environmental matters, therefore there are no significant liabilities for environmental damage or remediation.

## **25 COMMITMENTS AND CONTINGENCIES (continued)**

### **(d) Insurance**

The Russian insurance market is in a developing stage and some forms of insurance protection common in other parts of the world are not yet generally available in the Russian Federation.

The Group has entered into insurance contracts to insure property, plant and equipment, land transport, an aircraft and purchased accident and health insurance, inter-city motor vehicle passenger insurance and medical insurance for employees. Furthermore, the Group has purchased operating entities civil liability coverage for dangerous production units.

### **(e) Capital commitments**

Management estimates the outstanding agreements in connection with equipment supply and construction works amounted to \$264,903, \$52,230 and \$6,000 as at December 31, 2005, 2004 and 2003, respectively.

### **(f) Social commitments**

The Group makes contributions to mandatory and voluntary social programs. The Group's social assets, as well as local social programs, benefit the community at large and are not normally restricted to the Group's employees. The Group has transferred certain social operations and assets to local authorities, however, management expects that the Group will continue to fund certain social programs through the foreseeable future. These costs are recorded in the year they are incurred.

### **(g) Tax contingencies**

Russian tax, currency and customs legislation is subject to varying interpretations, and changes, which can occur frequently. Management's interpretation of such legislation as applied to the transactions and activity of the Group may be challenged by the relevant regional and federal authorities. Recent events within the Russian Federation suggest that the tax authorities may be taking a more assertive position in their interpretation of the legislation and assessments, and it is possible that transactions and activities that have not been challenged in the past may be challenged. As a result, significant additional taxes, penalties and interest may be assessed. Fiscal periods remain open to review by the authorities in respect of taxes for three calendar years preceding the year of review. Under certain circumstances reviews may cover longer periods.

As at December 31, 2005 management believes that its interpretation of the relevant legislation is appropriate and the Group's tax, currency and customs positions will be sustained. Where management believes it is probable that a position cannot be sustained, an appropriate amount has been accrued for in these consolidated financial statements.

### **(h) Financial guarantees issued**

As at December 31, 2005 and 2004, the Group has issued guarantees to third parties amounting to \$540 and \$1,365. As at December 31, 2003 the Group had issued guarantees to related parties amounting to \$38,980 in respect of borrowings from non-group companies (Note 24(b)). No amount has been accrued in the consolidated financial statements for the Group's obligation under these guarantees as the projected outflows from such guarantees are immaterial.

## **26 SUBSEQUENT EVENTS**

### **(a) Acquisition of DanSteel A/S shares**

In January 2006, a company under common control outside of the Group transferred to the Parent Company 100% of the outstanding common shares of DanSteel A/S, a steel-rolling company acquired by the common control party in November 2005. The Group transferred cash consideration of \$104,000 to such control party. The transaction value was determined based on an independent appraisal.

The consideration paid will be reflected as distribution to controlling shareholders in the consolidated financial statements for the year ending December 31, 2006. Carrying values of the assets and liabilities contributed will be reflected in the consolidated financial statements for the year ending December 31, 2006 as capital contribution from controlling shareholders:

**26 SUBSEQUENT EVENTS (continued)**

Current assets	138,257
Property, plant and equipment	14,471
Intangible assets	2,567
Other non-current assets	4,904
	<hr/>
<b>Total assets</b>	<b>160,199</b>
	<hr/>
Current liabilities	(50,300)
Non-current liabilities	(35,753)
Deferred income tax liability	(10,164)
	<hr/>
<b>Total liabilities</b>	<b>(96,217)</b>
	<hr/>
<b>Carrying value of net assets contributed</b>	<b>63,982</b>

In the consolidated financial statements for the three years ending December 31, 2006, this business combination will be accounted for retrospectively, as if this transaction had taken place in November 2005 (the date of purchase by the controlling shareholder).

**(b) Acquisition of OJSC Combinat KMAruda shares**

In February-March 2006, the Parent Company purchased from third parties 43.37% of the outstanding common shares of OJSC Combinat KMAruda, and iron ore producer, for consideration of \$60,597. The acquisition resulted in the Group's ownership of 76.26%. These transactions were consummated to improve the upstream integration of the Group.

The following table summarizes the preliminary fair values of the assets acquired and liabilities assumed in this business combination, determined in accordance with SFAS No. 141 provisions. The fair values of property, plant and equipment, including mineral extraction rights, and intangible assets were based on estimates of independent appraisers (in relation to the 43.37% stake acquired):

Current assets	7,873
Mineral rights	18,926
Other property, plant and equipment	15,687
Other non-current assets	8,849
Goodwill	16,836
	<hr/>
<b>Total assets acquired</b>	<b>68,171</b>
	<hr/>
Current liabilities	(1,432)
Deferred income tax liability	(6,142)
	<hr/>
<b>Total liabilities assumed</b>	<b>(7,574)</b>
	<hr/>
<b>Fair value of net assets acquired</b>	<b>60,597</b>

**26 SUBSEQUENT EVENTS (continued)**

**(c) Disposal of OJSC Lebedinsky GOK shares**

In January 2006, the Parent Company sold to third parties 11.96% of the outstanding common shares of OJSC Lebedinsky GOK for consideration of \$400 million; carrying value of these shares at December 31, 2005 was \$9,456 (Note 6(d)). This transaction was consummated in line with Group's strategy for investment management.

**(d) Acquisition of coal mines and coke plants**

In March 2006, the Parent Company signed agreements to acquire from third parties 82% of the outstanding common shares of OJSC Altai-koks, coke-chemical plant, and 100% of the outstanding common shares of holding company Kuzbass Asset Holdings Limited, Gibraltar, which owns 100% of Prokopievskugol Coal Company for a consideration of approximately USD 750 million.

OJSC Altai-koks is among leading coke-chemical plants in Russia. It produces high-quality coke and chemical products. In January – April 2006, the Parent Company acquired additional 6.18% in OJSC Altai-koks from other minority shareholders. The acquisitions resulted in the Group's ownership of more than 88% of the voting shares of the company.

Prokopievskugol Coal Company is the leader in high-grade coking coal production and processing in the Kemerovo region of Russia. It owns seven mines and three processing plants.

These acquisitions were made in line with Group's vertical integration strategy, aiming on additional competitive advantages through the stable supply of key raw materials. The acquired companies will be consolidated by the Group for the first time as at the effective date of obtaining control which management considers to be April 2006.

Management considers disclosure of fair values of assets acquired and liabilities assumed in this business combination to be not practicable, given the effective date of obtaining control.