

# **OJSC COMSTAR UTS AND SUBSIDIARIES**

**Independent Auditors' Report**

**Financial Statements**

Years ended December 31, 2007 and 2006

# COMSTAR UTS AND SUBSIDIARIES

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## INDEPENDENT AUDITORS' REPORT

To the Shareholders of Comstar UTS:

We have audited the accompanying consolidated balance sheets of OJSC "COMSTAR – United TeleSystems" and its subsidiaries (the "Group") as of December 31, 2007 and 2006 and the related consolidated statements of operations and comprehensive income, changes in shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Group as of December 31, 2007 and 2006, 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.

As described in Note 2 to the financial statements, the Group changed the manner in which it accounts for uncertain income tax positions effective January 1, 2007, following the adoption of Statement of Financial Accounting Standards Interpretation No 48, "Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109".



April 30, 2008

# COMSTAR UTS AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2007 AND 2006 (Amounts in thousands of US dollars)

	Note	December 31,	
		2007	2006
<b>Assets</b>			
Current assets:			
Cash and cash equivalents.....	4	\$ 179,794	\$ 136,621
Short-term investments .....	5	425,929	67,662
Trade receivables, net .....	6	163,028	95,868
Other receivables and prepaid expenses.....	7	101,668	87,654
Inventories and spare parts.....	8	41,328	33,740
Deferred tax assets, current portion.....	21	29,910	23,545
Total current assets .....		941,657	445,090
Property, plant and equipment, net .....	9	1,907,112	1,477,329
Intangible assets, net.....	10	191,006	91,835
Investments in shares of Svyazinvest .....	3	1,485,378	1,390,302
Other long-term investments .....	11	99,731	118,488
Restricted cash.....	13	2,447	4,008
Deferred tax assets, long-term portion.....	21	1,631	6,725
Deferred finance charges .....	13	1,375	3,808
<b>Total assets</b> .....		<b>\$ 4,630,337</b>	<b>\$ 3,537,585</b>
<b>Liabilities and shareholders' equity</b>			
Current liabilities:			
Trade accounts payable, accrued expenses and other current liabilities ...	12	\$ 178,954	\$ 113,653
Deferred connection fees, current portion .....		35,787	39,812
Subscriber prepayments .....		48,767	45,540
Debt, current portion .....	13	103,476	777,837
Capital lease obligations, current portion.....	14	10,360	14,107
Derivative financial instruments .....	15	88,000	150,000
Total current liabilities .....		465,344	1,140,949
Long-term liabilities:			
Deferred connection fees, net of current portion.....		117,884	109,040
Debt, net of current portion.....	13	891,321	33,529
Capital lease obligations, net of current portion.....	14	6,150	17,467
Retirement and post-retirement obligations .....	16	35,817	10,182
Property, plant and equipment contributions.....	17	112,779	103,793
Deferred tax liabilities, long-term portion.....	21	114,123	47,619
Other long-term liabilities .....	23	31,009	8,066
Total long-term liabilities.....		1,309,083	329,696
Total liabilities.....		1,774,427	1,470,645
Commitments and contingencies .....	24		
Minority interests.....		765,005	496,745
Shareholders' equity: <b>18, 24</b>			
Common stock (par value of 1 Ruble, 417,940,860 shares authorized and issued).....	25	23,900	23,900
Treasury stock (13,484,004 and 59,712,504 shares as of December 31, 2007 and 2006, respectively).....		(857)	(4,004)
Additional paid-in capital.....		1,425,044	1,064,225
Retained earnings.....		472,431	433,145
Accumulated other comprehensive income.....		170,387	52,929
Total shareholders' equity .....		2,090,905	1,570,195
<b>Total liabilities and shareholders' equity</b> .....		<b>\$ 4,630,337</b>	<b>\$ 3,537,585</b>

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

## COMSTAR UTS AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006

(Amounts in thousands of US dollars, except for share and per share amounts)

	Note	Years ended December 31,	
		2007	2006
Operating revenues.....	19	\$ 1,562,385	\$ 1,120,247
Operating expenses, excluding depreciation and amortization and stock-based compensation, net .....	20	(888,858)	(690,969)
Depreciation and amortization .....	9, 10, 17	(177,907)	(130,939)
Stock-based compensation .....	25	(10,287)	(62,800)
<b>Operating income</b> .....		<b>485,333</b>	<b>235,539</b>
Other income and expenses:			
Interest income.....		15,680	43,537
Interest expense, net of interest capitalized.....		(53,613)	(22,145)
Change in fair value of derivative financial instruments.....	15	(145,859)	(60,000)
Impairment of long-term investments .....	11	(22,691)	–
Foreign currency transactions gain/(loss), net.....		(4,528)	19,938
Gain from disposal of an affiliate.....	3	3,216	–
<b>Income before income tax, income from affiliates and minority interests</b> .....		<b>277,538</b>	<b>216,869</b>
Income tax expense .....	21	(118,368)	(72,422)
Income from affiliates and other investees.....		2,703	3,292
Minority interests .....		(118,060)	(65,243)
<b>Net income</b> .....		<b>\$ 43,813</b>	<b>\$ 82,496</b>
Other comprehensive income/(loss):			
Unrecognized actuarial losses, net of minority interest of \$7,219 and income tax of \$nil .....	16	(9,089)	–
Translation adjustment, net of minority interest of \$36,360 and \$39,111, respectively, and income tax of \$14,513 and \$nil, respectively .....		126,547	41,309
<b>Comprehensive income</b> .....		<b>\$ 161,271</b>	<b>\$ 123,805</b>
Weighted average number of common shares outstanding:			
Basic.....	2	361,394,049	345,805,894
Diluted.....	2	373,488,887	346,083,856
Earnings per common share:			
basic .....	2	\$ 0.12	\$ 0.24
diluted .....	2	\$ 0.12	\$ 0.24

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

## COMSTAR UTS AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars)

	Years ended December 31,	
	2007	2006
<b>Cash flows from operating activities:</b>		
Net income .....	\$ 43,813	\$ 82,496
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization .....	177,907	130,939
Change in fair value of derivative financial instruments .....	145,859	60,000
Pre-acquisition operating cash flows of the acquired subsidiaries .....	(30,844)	-
Impairment of long-term investments .....	22,691	-
Stock-based compensation .....	10,287	2,746
Gain on compensation of losses from third parties .....	(10,778)	(9,217)
Loss/(gain) from disposal of fixed assets and assets held for sale and other non-cash items, net .....	1,484	(2,812)
Gain from disposal of an affiliate .....	(3,216)	-
Amortization of deferred finance charges .....	4,019	301
Deferred taxes .....	10,734	(653)
Income from affiliates and other investees, net of dividends received .....	(620)	(3,292)
Foreign currency transactions (gain)/loss on non-operating activities, net	(1,093)	(5,172)
Postretirement benefits .....	7,572	(7,125)
Minority interests .....	118,060	65,243
Bad debt expense .....	5,394	11,717
Inventory obsolescence charge and other provisions .....	4,932	2,735
Changes in operating assets and liabilities:		
Trade receivables .....	(51,541)	(46,938)
Other receivables and prepaid expenses .....	9,852	(6,276)
Inventories and spare parts .....	(8,784)	(6,710)
Trade accounts payable, accrued expenses and other current liabilities	37,609	25,608
Deferred connection fees .....	(3,964)	(7,445)
Subscriber prepayments .....	(1,017)	2,574
<b>Net cash provided by operating activities .....</b>	<b>488,356</b>	<b>288,719</b>
<b>Cash flows from investing activities:</b>		
Purchases of property, plant and equipment .....	(303,416)	(280,298)
Proceeds from sale of property, plant and equipment .....	4,690	29,661
Purchases of intangible assets .....	(42,013)	(26,160)
Acquisition of subsidiaries, net of cash acquired .....	(183,162)	(20,050)
Acquisition of minority interests in existing subsidiaries .....	(1,832)	(184,052)
Purchases of long-term investments .....	(21,382)	(1,300,000)
Proceeds from sale of long-term investments .....	36,780	-
Purchases of short-term investments .....	(447,707)	(586,614)
Proceeds from sale of short-term investments .....	96,575	602,249
Decrease/(increase) in restricted cash .....	1,561	(1,736)
<b>Net cash used in investing activities .....</b>	<b>(859,906)</b>	<b>(1,767,000)</b>

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

## COMSTAR UTS AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF CASH FLOWS (continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US Dollars)

	Years ended December 31,	
	2007	2006
<b>Cash flows from financing activities:</b>		
Proceeds from exercise of the call option.....	322,237	–
Proceeds from issuance of common stock, net of issuance costs .....	–	975,519
Acquisition of treasury stock, net of stock bonus granted.....	(32)	(13,810)
Contributions from minority shareholders of subsidiaries .....	–	510
Proceeds from borrowings.....	849,530	1,503,995
Principal payments on borrowings .....	(712,461)	(896,155)
Principal payments on capital lease obligations .....	(17,194)	(13,455)
Deferred finance charges.....	(1,492)	(4,050)
Dividends and other distributions to shareholders .....	(37,031)	(1,662)
<b>Net cash provided by financing activities .....</b>	<b>403,557</b>	<b>1,550,892</b>
Effects of foreign currency translation on cash and cash equivalents.....	11,166	2,049
<b>Net increase in cash and cash equivalents .....</b>	<b>43,173</b>	<b>74,660</b>
Cash and cash equivalents, beginning of the year .....	136,621	61,961
<b>Cash and cash equivalents, end of the year .....</b>	<b>\$ 179,794</b>	<b>\$ 136,621</b>
<b>Supplemental cash flows information:</b>		
Cash paid for interest, net of amounts capitalized.....	\$ 48,057	\$ 22,278
Income taxes paid.....	98,801	88,312
Non-cash investing and financing activities:		
Contributed property, plant and equipment .....	6,299	5,387
Cost of construction incurred in transactions with Sistema Hals, a subsidiary of Sistema (see Notes 23 and 24) .....	17,621	6,836
(Decrease)/increase in accounts payable for the acquisition of property, plant and equipment.....	(4 813)	525
Equipment acquired through vendor financing .....	2,770	4,287
Building contributed in the share capital of Sistema Mass Media (see Note 11).....	4,751	–

In addition, non-cash investing activities during the years ended December 31, 2007 and 2006 included acquisitions and disposals of subsidiaries and affiliates as described in Note 3.

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

## COMSTAR UTS AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006

(Amounts in thousands of US dollars)

	Common stock	Treasury stock	Additional paid-in capital	Retained earnings	Accumulat ed other compre- hensive income	Total
<b>Balances at</b>						
<b>January 1, 2006</b> .....\$	18,982 \$	(3,929)\$	100,051 \$	352,647 \$	11,620 \$	479,371
Common stock issuance in the course of IPO, net of issuance costs (see Note 1)....	4,918	-	969,316	-	-	974,234
Acquisition of own stock (see Note 25).....	-	(404)	(73,460)	-	-	(73,864)
Stock-based compensation (see Note 25)...	-	329	62,471	-	-	62,800
Minorities' share in fair value of the call and put option at the grant date (see Note 3).....	-	-	27,606	-	-	27,606
Revaluation of treasury stock in connection with acquisition of a minority interest in MGTS (see Note 3) ..	-	-	(21,759)	-	-	(21,759)
Dividends declared.....	-	-	-	(1,998)	-	(1,998)
Net income .....	-	-	-	82,496	-	82,496
Translation adjustment, net of minority interest of \$39,111 and tax of \$nil .....	-	-	-	-	41,309	41,309
<b>Balances at</b>						
<b>December 31, 2006</b> .....\$	<u>23,900 \$</u>	<u>(4,004)\$</u>	<u>1,064,225 \$</u>	<u>433,145 \$</u>	<u>52,929 \$</u>	<u>1,570,195</u>
Effect of adoption of FIN No. 48, net of minority interest of \$1,061 (see Note 2) ..	-	-	-	(2,415)	-	(2,415)
Stock-based compensation (see Note 25)...	-	-	(651)	-	-	(651)
Exercise of the call option, net of minority interest of \$183,821 (see Note 15).....	-	3,147	358,713	-	-	361,860
Acquisition of minority interest in Golden Line, net of tax of \$2,032 (see Note 3) ....	-	-	2,789	-	-	2,789
Acquisition of own stock.....	-	-	(32)	-	-	(32)
Dividends declared.....	-	-	-	(2,112)	-	(2,112)
Net income .....	-	-	-	43,813	-	43,813
Unrecognized actuarial losses (see Note 16), net of minority interest of \$7,219 and tax of \$nil .....	-	-	-	-	(9,089)	(9,089)
Translation adjustment, net of minority interest of \$36,360 and tax of \$14,513 ....	-	-	-	-	126,547	126,547
<b>Balances at</b>						
<b>December 31, 2007</b> .....\$	<u>23,900 \$</u>	<u>(857) \$</u>	<u>1,425,044 \$</u>	<u>472,431 \$</u>	<u>170,387 \$</u>	<u>2,090,905</u>

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

# COMSTAR UTS AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 *(Amounts in thousands of US dollars, unless otherwise stated)*

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### 1. DESCRIPTION OF THE BUSINESS

#### *Nature of the Business*

Open Joint-Stock Company “COMSTAR–United TeleSystems” (“Comstar UTS”) and subsidiaries (together referred to as “the Company”, or “the Group”) is a provider of fixed line communications services, including voice, broadband and dial-up Internet access, pay TV and various value added services, to commercial and residential customers throughout the Moscow metropolitan area and in several other regions in Russia, Ukraine and Armenia. The controlling shareholder of Comstar UTS is JSFC AFK Sistema (“Sistema”). Primary operating entities of the Group are incorporated in the Russian Federation (“the RF”), Ukraine and Armenia.

#### *The Group’s Restructuring and the Initial Public Offering (IPO)*

The Group was formed in the fourth quarter of 2005 through the consolidation by Sistema of its fixed line communications businesses under Comstar UTS. In November 2005, Comstar UTS issued 255,919,860 common shares to acquire Sistema’s stakes in MGTS, MTU-Inform, Telmos and MTU-Intel and MGTS’ stakes in MTU-Inform, Telmos and MTU-Intel. This merger was accounted for at cost as a transaction between entities under common control.

In December 2005, Sistema Multimedia, a subsidiary of Sistema, was merged into MTU-Intel, which was then renamed to Comstar-Direct in November 2006.

In February 2006, Comstar UTS completed an initial public offering of 146,500,000 common shares, including 139,000,000 newly issued shares and 7,500,000 shares sold by the shareholders. The shares (in the form of global depositary receipts (“GDRs”), with one GDR representing one share) were admitted to trade on the London Stock Exchange. The Group’s net proceeds from the offering approximated \$975.5 million.

During the year ended December 31, 2007, Comstar UTS’ wholly-owned subsidiaries Telmos, MTU-Inform and Contrast-Telecom were legally merged into Comstar UTS. These mergers were executed to streamline the decision-making process within the Group. The transactions had no material impact on the Company’s financial statements.

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### *Basis of Presentation*

The Group’s operating entities maintain accounting records and prepare their financial statements in local currency in accordance with the requirements of accounting and tax legislation in the countries of their incorporation. These financial statements have been prepared in conformity with the accounting principles generally accepted in the United States of America (“US GAAP”) and are expressed in terms of US dollars (see “Foreign Currency Translation Methodology” below). The accompanying consolidated financial statements differ from the financial statements prepared for statutory purposes because they reflect certain adjustments, which are appropriate to present the financial position, results of operations and cash flows in accordance with US GAAP.

## COMSTAR UTS AND SUBSIDIARIES

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006**  
*(Amounts in thousands of US dollars, unless otherwise stated)*

The principal adjustments are related to revenue recognition, foreign currency translation, accounting for derivative financial instruments, deferred taxation, consolidation, and valuation and depreciation of property, plant and equipment and intangible assets.

### *Principles of Consolidation*

The assets and liabilities of the entities transferred to the Group by Sistema following the Group's restructuring in November 2005 (see Note 1) were recorded in these financial statements at the historical cost of their acquisition by Sistema.

All significant intercompany transactions, balances and unrealized gains (losses) have been eliminated.

The ownership interest of Comstar UTS and proportion of its voting power in its major operating subsidiaries as of December 31, 2007 and 2006 were as follows:

Operating entities	December 31, 2007		December 31, 2006	
	Ownership interest	Proportion of voting power	Ownership interest	Proportion of voting power
MGTS.....	56%	67% (*)	56%	56% (*)
MTU-Inform (**)	—	—	100%	100%
Telmos (**)	—	—	100%	100%
Porttelecom.....	100%	100%	100%	100%
Comstar-Direct (***)	52%	52%	52%	52%
Golden Line (****)	100%	100%	52%	52%
Digital Telephone Networks – South (DTN).....	100%	100%	—	—
Regional Technical Centre (RTC) .....	88%	88%	—	—
Tyumenneftegazsvyaz (TNGS)	75%	89%	75%	89%
TK Overta.....	100%	100%	100%	100%
Conversiya-Svyaz.....	100%	100%	100%	100%
CTK Contrast-Telecom (**)	—	—	100%	100%
Unitel.....	100%	100%	100%	100%
AMT .....	56%	67% (*)	56%	56% (*)
Astelit .....	100%	100%	100%	100%
Comstar Ukraine.....	100%	100%	75%	75%
Technological Systems .....	100%	100%	75%	75%
TC Digital Global Telecommunications .....	100%	100%	75%	75%
Degre .....	100%	100%	75%	75%
Neophone.....	100%	100%	74%	74%
Callnet .....	75%	75%	75%	75%
Cornet.....	75%	75%	75%	75%

(\*) As of December 31, 2007 and 2006, Comstar UTS owned 67% of MGTS' common stock. MGTS decided not to pay dividend on preferred stock in 2006. Accordingly, in 2006 preferred stock received voting rights at par with common stock (see also Notes 18 and 24). In 2007, MGTS paid dividend on preferred stock, and preferred stockholders have lost their voting rights.

(\*\*) Legally merged with Comstar UTS in 2007.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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(\*\*\*) MTU-Intel prior to November 2006.

(\*\*\*\*) In April 2007, Comstar UTS acquired 100% of shares of Golden Line from Comstar-Direct.

The ownership interest of Comstar UTS in its subsidiaries is determined by taking into account both the common and preferred (non-voting) shares (see also Note 18).

Accounts of newly acquired subsidiaries have been consolidated in the Group's financial statements from the beginning of the year when control was acquired, with pre-acquisition earnings included in minority interests in the statements of operations.

#### *Use of Estimates*

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, amounts of revenues and expenses and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Examples of significant estimates include the allowance for doubtful accounts, the useful lives and recoverability of long-lived tangible and intangible assets, average subscriber lives, fair value of financial instruments and valuation allowances on deferred tax assets.

#### *Concentration of Business Risk*

The Group's principal business activities are within the RF. Laws and regulations affecting businesses operating in the RF are subject to rapid changes, and the Group's assets and operations could be at risk due to negative changes in the political and business environment.

#### *Foreign Currency Translation Methodology*

Management has determined that in 2006 the functional currency of all the Group entities except for MGTS, Conversiya-Svyaz, TK Overta, CTK Contrast Telecom and TNGS, and Golden Line (until August 1, 2006) had been the US dollar ("USD"), because the majority of their revenues, costs, capital expenditures and debt were either priced, incurred, payable or otherwise measured in USD.

Accordingly, transactions and balances not already measured in USD (primarily transactions involving Russian Rubles and Euros) have been re-measured into USD in accordance with the relevant provisions of Statement of Financial Accounting Standards ("SFAS") No. 52, "Foreign Currency Translation". The objective of this re-measurement process is to produce the same results that would have been reported if the accounting records had been maintained in USD.

Cash, receivables, payables and loans are considered monetary assets and liabilities and have been translated using the exchange rate as of the balance sheet dates. Non-monetary assets and liabilities and shareholders' equity are stated at their actual USD cost or have been restated from their historic cost by applying the historical exchange rate as at the dates of the original transactions or approximations to these rates. Income, expenses and items in the statement of cash flows are restated by applying the actual exchange rates to underlying transactions or approximations to these rates.

Exchange gains and losses arising from the use of these different rates are credited or charged to the statement of operations.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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Effective August 1, 2006, in connection with change of all tariffs previously denominated in or linked to the US dollar to the Russian Ruble, Golden Line has changed its functional currency to the Russian Ruble. The effect of this change has not been material to the financial statements and has been reflected as part of the translation adjustment in the statement of changes in shareholders' equity as part of other comprehensive income.

In January and February 2007, Comstar UTS, Telmos and MTU-Inform, for the purpose of subscriber billing, fixed the US dollar exchange rate at 28.70 Rubles for 1 US dollar for a significant majority of the subscribers. Further, in June 2007 Comstar UTS re-financed its \$675.0 million USD-denominated loan with a ruble-denominated credit facility (see Note 13). Accordingly, management has reevaluated the functional currency criteria under SFAS No. 52 and determined that effective from June 30, 2007, Comstar UTS (including Telmos and MTU-Inform which were legally merged into Comstar UTS in April 2007 as discussed in Note 1) has changed its functional currency to the Russian Ruble. The change in functional currency resulted in approximately \$12.2 million, net of income taxes of \$14.5 million, of the translation adjustment recorded in the statement of changes in shareholders' equity as part of other comprehensive income as of the date of the change.

Effective July 1, 2007, in connection with change of all tariffs previously denominated in or linked to the US dollar to the Russian Ruble, Comstar-Direct has changed its functional currency to the Russian Ruble. The effect of this change has not been material to the financial statements and has been reflected as part of the credit translation adjustment in the statement of changes in shareholders' equity as part of other comprehensive income.

Management has determined that the functional currency of MGTS, Conversiya-Svyaz, TK Overta, Contrast-Telecom and TNGS is the Russian Ruble ("RUR").

The Group has selected the USD as the reporting currency and translates the financial statements of the Group into USD in accordance with provisions of SFAS No. 52. All assets and liabilities are translated at the exchange rates current at the balance sheet date. Shareholders' equity is translated at the applicable historical rates. Income and expenses are translated at average rates of exchange prevailing during the year. Translation gains and losses resulting from the use of such rates are reported in the statement of changes in shareholders' equity as part of other comprehensive income.

The official rate of exchange, as determined by the Central Bank of the RF ("CBR"), between the RUR and the USD at December 31, 2007 was 24.55 Rubles to 1 US dollar (December 31, 2006: 26.33).

The translation of Ruble-denominated assets and liabilities into US dollars for the purpose of these financial statements does not indicate that the Group could realize or settle in US dollars the reported values of the assets and liabilities. Likewise, it does not indicate that the Group could return or distribute the reported US dollar values of capital and retained earnings to its shareholders.

#### ***Revenue Recognition***

The Group's revenues are principally derived from the provision of telecommunication services which primarily consist of (i) monthly subscription fees, (ii) traffic charges, (iii) connection fees, (iv) revenues from data transmission services, (v) revenues from value-added and additional telecommunication services, and (vi) revenues from services to other operators, including commission for provision of domestic and international long-distance ("DLD/ILD") services through the Group's network to the Group's subscribers, servicing the connection points, interconnection and rent of technological resources. The Group records revenues over the periods they are earned as follows:

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

- (i) Monthly subscription fees are recognized in the month during which the services are provided to the subscribers;
- (ii) Traffic charges are recognized as the services are provided;
- (iii) Upfront fees received for the connection of new subscribers are deferred and recognized over the expected subscriber relationship period, which varies between 1 and 15 years, depending on the type of the subscriber and the region of operations;
- (iv) Revenues from the provision of data transmission services are recognized when the services are provided to the subscribers;
- (v) Revenues derived from value-added and additional telecommunication services are recognized when the services are provided to the subscribers; and
- (vi) Revenues from services to other operators are recognized when the services are provided to the operators.

The Company reports revenue net of value-added tax (“VAT”) and other taxes included in the sales price. In accordance with the Emergency Issue Task Force Consensus No. 99-19, “Reporting Revenue Gross as a Principal versus Net as an Agent”, the Group reports as revenue gross amounts billed to a customer when it has earned revenue from the sale of services or goods, or the net amount retained (that is, the amount billed to a customer less the amount paid to supplier) when it has earned a commission or a fee.

Local telephone services provided by MGTS are regulated tariff services, and changes in rate structure are subject to the Federal Tariff’s Service (“FTS”) approval. Further, effective July 1, 2006, the majority of MGTS’ and Comstar UTS’ services to operators, including interconnection and line rental became regulated. See Note 19 for the amounts the Group earned for such services during the years ended December 31, 2007 and 2006.

Fixed monthly fees approved by FTS for MGTS and effective during 2006 were RUR 200 (including value-added tax, approximately USD 7.60 as of December 31, 2006) for residential subscribers, RUR 200 (excluding VAT) for state-financed institutions and RUR 210 (excluding VAT, approximately USD 7.98 as of December 31, 2006) for other companies (“corporate entities”). In addition to a fixed monthly fee, corporate entities and state-financed institutions had been charged for local traffic.

In December 2006, regulatory bodies approved new tariffs for MGTS, which came in effect from February 1, 2007 (USD amounts represent translation of the RUR-denominated tariff plans using December 31, 2007 CBR rate):

Tariff	Tariff elements	State-financed institutions	Corporate subscribers	Individual subscribers (*)
Per-minute plan	monthly fee	RUR 136 (USD 5.54)	RUR 160 (USD 6.52)	RUR 125 (USD 5.09)
	per-minute charges	RUR 0.28 (USD 0.01)	RUR 0.28 (USD 0.01)	RUR 0.28 (USD 0.01)
Combined plan	monthly fee	RUR 240 (USD 9.78)	RUR 264 (USD 10.76)	RUR 229 (USD 9.33)
	prepaid minutes included in monthly fee	370	370	370
	per-minute charges for each additional minute	RUR 0.23 (USD 0.01)	RUR 0.23 (USD 0.01)	RUR 0.23 (USD 0.01)
Unlimited plan	monthly fee	RUR 438 (USD 17.84)	RUR 502 (USD 20.45)	RUR 380 (USD 15.48)

(\*) tariffs for individual subscribers include VAT. VAT rate prevailing in 2007 and 2006 was 18%.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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Effective December 1, 2007, the number of prepaid minutes included in the combined plan was increased from 370 to 450. Furthermore, effective February 1, 2008, combined plan per-minute charges for additional minutes were increased from RUR 0.23 to RUR 0.24 for all categories of subscribers, and the unlimited plan monthly fee decreased from RUR 380 to RUR 345 for individual subscribers.

Before January 1, 2005, MGTS was required to grant discounts ranging from 20% to 100% on installation and monthly fees to certain categories of residential subscribers, such as pensioners, military veterans and disabled individuals, and was entitled to reimbursement from the federal budget for these discounts. Due to the lack of certainty of reimbursement, MGTS accounted for such revenues upon collection. During the years ended December 31, 2007 and 2006, MGTS received compensation from the federal budget in the amount of approximately \$36.6 million and \$25.8 million, respectively, which has been included in revenues for the respective years. As of December 31, 2007, MGTS' claims to the federal budget in respect of aforementioned reimbursements were fully satisfied.

In accordance with the legislation effective January 1, 2005, substantially all MGTS' subscribers are required to pay the full price for residential service, and those entitled to discounts are to receive reimbursement from the government rather than discounts from MGTS.

Historically, the Group has entered into interconnect agreements, under which the Group provides services to, and receives services from, other operators for a fixed periodic fee, regardless of the volume of the outgoing or incoming traffic. Revenues and expenses under these agreements are recognized in the amount of the net fixed fee receivable or payable by the Group. Following the introduction of the new interconnect rules in 2006, these arrangements are being phased out and replaced with agreements under which the Group bills its counterparties for the use of its network and pays other operators for the calls of its subscribers to other operators' customers. Revenues under these arrangements are recognized in the amounts receivable by the Group and expenses are recorded for charges payable by the Group.

#### ***Cash and Cash Equivalents***

Cash and cash equivalents include cash on hand, amounts on deposit in banks and cash invested temporarily in various highly liquid instruments with original maturities of three months or less.

#### ***Fair Value of Financial Instruments***

Financial instruments carried on the balance sheet include cash and bank balances, receivables, investments, accounts payable, capital lease obligations, debt and a liability under a call and put option granted in connection with acquisition of Svyazinvest shares (see Note 15). The particular recognition methods adopted are disclosed in the individual policy statements associated with each item.

Short-term financial instruments consist primarily of cash and bank balances, receivables, short-term investments, payables, short-term debt and a call and put option. The estimated fair value of such financial instruments as of December 31, 2007 approximated their carrying value.

Long-term financial instruments consist primarily of long-term investments and long-term debt. It is not practicable for the Group to estimate the fair values of all of its long-term investments, as quoted market prices are not readily available and, due to nature of the investments, valuations are not being completed or obtained.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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Fair values of corporate bonds issued by MGTS are disclosed in Note 13. As of December 31, 2007, the fair value of other fixed rate debt, including capital lease obligations and variable rate debt approximated carrying value.

The Group does not discount promissory notes of and loans granted to related parties, interest rates on which are different from market rates. Accordingly, fair value of such notes and loans may be different from their carrying value. The estimation of Group's fair value of financial instruments with related parties is not practicable based on the nature of underlying transactions.

#### *Short-Term Investments*

Short-term investments represent investments in promissory notes, loans and time deposits, which have original maturities in excess of three months and mature within twelve months from the balance sheet date. These investments are being accounted for at amortized cost. Management periodically assesses the recoverability of the carrying values of the investments and, if necessary, records impairment losses to write the investment down to fair value. For the years ended December 31, 2007 and 2006, no such impairments have occurred.

#### *Accounts Receivable*

Accounts receivable are stated net of allowance for doubtful accounts. Such allowance reflects either specific cases or estimates based on evidence of collectibility.

Concentrations of credit risk with respect to trade receivables are limited due to a highly diversified customer base, which includes a large number of individuals, private businesses and state-financed institutions.

#### *Prepaid Expenses*

Prepaid expenses are primarily comprised of advance payments for inventories, spare parts and services to vendors.

#### *Value-Added Taxes*

VAT related to sales are payable to the tax authorities upon provision of services and issuance of an invoice to the customer. VAT incurred for purchases ("VAT recoverable") may be reclaimed, subject to certain restrictions, against VAT related to sales. Management periodically reviews the recoverability of the balance of VAT recoverable and believes that the amounts reflected in the financial statements are fully recoverable within one year.

#### *Inventories and Spare Parts*

Inventories and spare parts are primarily comprised of goods for resale, cables and spare parts and are stated at the lower of cost or market value. Cost is computed on a weighted average basis. The management periodically assesses inventories and spare parts for obsolete or slow moving stock and writes down such inventories and spare parts to their market value.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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#### *Property, Plant & Equipment*

For the entities acquired by the Group in the course of merger described in Note 1, property, plant and equipment ("PP&E") were assigned their fair values at the date of acquisition by Sistema. For the entities acquired by the Group subsequent to the merger described in Note 1, PP&E were assigned their fair values at the date of acquisition by the Group. If fair values of the identifiable net assets of the acquired entities exceeded acquisition cost, the fair values of non-current assets held by the acquired entities at the acquisition date, including PP&E, were reduced by such excess. All subsequent purchases of PP&E have been recorded at cost.

Cost includes all costs directly attributable to bringing the asset to working condition for its intended use, except for rental costs, as well as major expenditures for improvements and replacements which extend useful lives of the assets or increase their value or revenue generating capacity. Repairs and maintenance are charged to the statements of operations as incurred. Interest expense incurred during the period of construction of the qualifying assets is capitalized as part of property, plant and equipment until the project is completed and the asset is placed into service. Interest expense capitalized for the years ended December 31, 2007 and 2006 amounted to \$15.7 million and \$0.9 million, respectively.

Property, plant and equipment items transferred to MGTS free of charge (Note 17) are capitalized at their fair value at the date of transfer and deferred revenue is recorded and amortized to the consolidated statements of operations over the contributed asset's useful life.

The Group accounts for leases based on the requirements of SFAS No. 13, "Accounting for Leases". Leases are classified as capital leases whenever terms of the lease transfer substantially all of the benefits and rewards incident to the ownership. All other leases are classified as operating leases. Capital leases are recorded at the fair market value of the asset or the present value of future minimum lease payments, whichever is lower. The discount rate used in determining the present value of the minimum lease payments is the Group's incremental borrowing rate, unless (1) it is practicable to obtain the implicit rate computed by the lessor and (2) the implicit rate is less than the Group's incremental borrowing rate. If both of those conditions are met, the interest rate implicit in the lease is used.

Items of property, plant and equipment that are retired or otherwise disposed of are eliminated from the balance sheet along with the corresponding accumulated depreciation. Any gain or loss resulting from such retirement or disposal is included in the consolidated statement of operations.

Property, plant and equipment are depreciated on a straight-line method over the estimated useful lives of the assets as follows:

Buildings and constructions.....	20-47 years
Cables and transmission devices.....	10-31 years
Other telecommunication equipment (*) .....	7-17 years
Office equipment and other .....	3-25 years

(\*) Analogue switching equipment of MGTS is depreciated over the remaining useful lives ranging from 1 to 5 years.

Leasehold improvements are depreciated on a straight-line basis over the shorter of their useful life or lease term. The lease term includes renewals when such renewals are reasonably assured.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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Construction in-progress and equipment for installation are not depreciated until an asset is placed into service.

#### *Asset Retirement Obligations*

In accordance with SFAS No. 143, "Accounting for Asset Retirement Obligations", the Group calculates an asset retirement obligation and an associated asset retirement cost when the Group has a legal or contractual obligation in connection with the retirement of tangible long-lived assets. The Group's obligations under SFAS No. 143 arise from certain of its leases and relate primarily to the cost of removing equipment from such lease sites. As of December 31, 2007 and 2006, the estimated assets retirement obligations were not significant to the Group's consolidated financial position and results of operations.

#### *Intangible Assets and Goodwill*

For the entities acquired by the Group in the course of merger described in Note 1, intangible assets were assigned their fair values at the date of acquisition by Sistema. For the entities acquired by the Group subsequent to the merger described in Note 1, intangible assets were assigned their fair values at the date of acquisition by the Group. If fair values of the identifiable net assets of the acquired entities exceeded acquisition cost, the fair values of non-current assets held by the acquired entities at the acquisition date, including intangible assets, were reduced by such excess. All subsequent purchases of intangible assets have been recorded at cost.

Current operating licenses of the Group do not provide for automatic renewal upon expiration. As the Group and the industry do not have sufficient experience with the renewal of licenses, license costs are being amortized during the initial license period without consideration of possible future renewals, subject to periodic review for impairment, on a straight-line basis over the license period starting from the date network in such license area becomes commercially operational. Amortization of other finite-life intangible assets, comprised mostly of billing systems and other software, is computed on a straight-line basis over their estimated useful lives, generally five years.

The goodwill recorded in connection with the acquisition of subsidiaries is not amortized but tested for impairment at least annually.

#### *Impairment of Long-Lived Assets*

The Company periodically evaluates the recoverability of the carrying amount of its long-lived assets in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". Whenever events or changes in circumstances indicate that the carrying amounts of those assets may not be recoverable, the Company compares the undiscounted net cash flows estimated to be generated by those assets to the carrying amount of those assets.

When these undiscounted cash flows are less than the carrying amounts of the assets, the Company records impairment losses to write the asset down to fair value, measured by the discounted estimated net future cash flows expected to be generated from the assets.

#### *Investments*

Investments in businesses in which the Group does not have control, but exercises significant influence over operating and financial policies ("affiliates"), are accounted for using the equity method.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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Investments in corporate shares where the Group does not have the ability or intent to control or exercise significant influence over operating and financial policies are accounted for at cost of acquisition. Management periodically assesses the ability to recover the carrying values of such investments and records an impairment loss if, based upon the expected undiscounted cash flows, such investment's carrying value will not be recovered. Any such impairment loss is based upon recording as a new carrying amount of the investment, the lesser of the historical carrying amount and the expected discounted future cash flows.

The promissory notes purchased and loans granted by the Group are carried at cost and a discount against the nominal value is accrued over the period to maturity, if it exceeds one year. A provision is made, based on management's assessment, for notes and loans that are considered uncollectible.

#### *Deferred Finance Charges*

Arrangement, commission, commitment and related legal fees paid to secure a firm commitment from lenders and other direct debt issuance costs incurred in connection with new borrowings are deferred and amortized over the expected terms of the related loans using the effective-interest method.

#### *Income Taxes*

Income taxes have been computed in accordance with the laws of the country of incorporation of respective companies included in the Group. Statutory income tax rates in the RF, Ukraine and Republic of Armenia equal 24%, 25% and 10%, respectively. Income tax rate on dividends paid within Russia is 9%.

Deferred income taxes are accounted for under the liability method and reflect the tax effect of all significant temporary differences between the tax basis of assets and liabilities and their reported amounts in the consolidated financial statements. A valuation allowance is provided for deferred tax assets if it is more likely than not that some portion or all of the deferred tax assets will not be realized.

On January 1, 2007, the Group adopted the provisions of the FASB Interpretation No. 48 ("FIN No. 48"), "Accounting for Uncertainty in Income Taxes" — an interpretation of FASB Statement No. 109. FIN No. 48 removes income taxes from the scope of SFAS No. 5, "Accounting for Contingencies", creates a single model to address uncertainty in tax positions and prescribes the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN No. 48 also provides guidance on de-recognition, measurement and classification of tax positions, accounting for interest and penalties, disclosure and transition. The adoption of FIN No. 48 resulted in the cumulative effect debit adjustment to the retained earnings as of January 1, 2007 of approximately \$2.4 million. Included in trade accounts payable, accrued expenses and other current liabilities as of December 31, 2007 is a total of approximately \$4.7 million of unrecognized income tax benefits. The management considers it reasonably possible that approximately \$0.8 million of the unrecognized income tax benefit will be reversed within the next twelve months due to expiration of the statute of limitations.

The Company classifies accrued penalties and interest related to unrecognized tax benefits as a component of income tax expense.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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#### *Retirement Benefit and Social Security Costs*

In Russia, all social contributions, including contributions to the pension fund, are included in the unified social tax (“UST”) calculated by the application of a regressive rate from 26% to 2% of the annual gross remuneration of each employee. UST is allocated to three social funds, including the Pension Fund of the Russian Federation, where the rate of contributions vary from 20% to 2%, depending on the annual gross salary of each employee. UST contributions are expensed as incurred.

MGTS has historically offered its employees certain benefits upon and after retirement. The cost of such benefits is recognized during an employee’s years of active service (see Note 16). The Group accounts for pension plans in accordance with the requirements of SFAS No. 87, “Employers’ Accounting for Pensions”, SFAS No. 132R, “Employers’ Disclosure about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88 and 106” and SFAS No. 158, “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans”, an amendment of FASB Statements No. 87, 88, 106, and 132(R).

#### *Advertising Costs*

Advertising costs are expensed as incurred and are reflected as a component of operating expenses in the statements of operations (see Note 20).

#### *Subscriber Acquisition Costs*

Subscriber acquisition costs represent the direct costs incurred to connect each new subscriber including dealer’s commissions. The Group expenses these costs as incurred.

#### *Distributions to Shareholders*

Dividends are recognized at the date they are declared. Distributable retained earnings of the Group are based on amounts extracted from statutory accounts of Comstar UTS and may differ from amounts calculated on the basis of US GAAP (see Note 18).

#### *Earnings Per Share (EPS)*

Basic earnings per share is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share is computed on the basis of the weighted average number of common shares outstanding plus the effect of the call and put option using the treasury stock method. Net income available to Comstar UTS’s shareholders for each period is divided by the weighted average number of common shares outstanding during the respective period.

The following table reconciles numerator (income) and denominator (shares) of the EPS calculation for the year ended December 31, 2006:

	<b>Income</b> <b>(‘000 USD)</b>	<b>Shares</b> <b>(units)</b>	<b>EPS</b> <b>(USD)</b>
EPS – basic .....	\$ 82,496	345,805,894 \$	0.24
Effect of call and put option (Note 15) .....	–	277,962	(0.00)
EPS – diluted .....	82,496	346,083,856	0.24

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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The following table reconciles numerator (income) and denominator (shares) of the EPS calculation for the year ended December 31, 2007:

	<u>Income</u> <u>('000 USD)</u>	<u>Shares</u> <u>(units)</u>	<u>EPS</u> <u>(USD)</u>
EPS – basic .....	\$ 43,813	361,394,049 \$	0.12
Effect of call and put option (Note 15).....	–	12,094,838	(0.00)
EPS – diluted .....	43,813	373,488,887	0.12

Employee stock options (see Note 25) were outstanding for the period from November 15, 2006 until December 31, 2006 and during the year ended December 31, 2007 but were not included in the computation of diluted EPS because the effect of these options is anti-dilutive.

#### ***Comprehensive Income***

Comprehensive income is defined as net income plus all other changes in net assets from non-owner sources.

#### ***Stock-Based Compensation***

The Group accounts for stock-based compensation in accordance with provisions of SFAS No. 123R (revised 2004), “Share-Based Payment”. Under SFAS No. 123R, companies must calculate and record the cost of equity instruments, such as stock options or restricted stock, awarded to employees for services received in the income statement. The cost of the equity instruments is measured based on the fair value of the instruments on the date they are granted using a Black-Scholes option pricing model and is recognized over the period during which the employees are required to provide services in exchange for the equity instruments. The Company adopted SFAS No. 123R effective January 1, 2006 in connection with the stock-based compensation plan approved in 2006 (see Note 25).

#### ***Derivative Financial Instruments (Call and Put Option)***

The Company accounts for the call and put option granted in connection with acquisition of 25% plus one share stake in Svyazinvest (see Note 15) in accordance with SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities”, as amended, and SFAS No. 150, “Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity”.

#### ***Comparative Information***

Certain prior year amounts and disclosures have been reclassified to conform to the 2007 presentation.

#### ***New Accounting Pronouncements***

In September 2006, the FASB issued FASB Statement No. 157 (“SFAS No. 157”), “Fair Value Measurements”. The standard provides guidance for using fair value to measure assets and liabilities and applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. Management believes that the adoption of SFAS No. 157 will not have a material effect on the Company’s financial statements.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 *(Amounts in thousands of US dollars, unless otherwise stated)*

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In September 2006, the FASB issued FASB Statement No. 158 (“SFAS No. 158”), “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans”, an amendment of FASB Statements No. 87, 88, 106, and 132(R). SFAS No. 158 requires companies with publicly traded equity securities that sponsor a postretirement benefit plan to fully recognize, as an asset or liability, the overfunded or underfunded status of their benefit plan(s). The funded status is measured as the difference between the fair value of the plan’s assets and its benefit obligation. SFAS No. 158 also requires companies to measure their plan assets and benefit obligations as of year-end balance sheet date. SFAS No. 158 is becoming effective for fiscal years ending after December 15, 2006; the provision to require measurement at the entity’s year-end balance sheet date will be effective for fiscal years ending after December 15, 2008. The adoption of SFAS No. 158 did not have a material effect on the Company’s financial statements.

In February 2007, the FASB issued FASB Statement No. 159 (“SFAS No. 159”), “The Fair Value Option for Financial Assets and Financial Liabilities” – including an amendment of FASB Statement No. 115, which permits an entity to measure certain financial assets and financial liabilities at fair value. SFAS No. 159 offers an irrevocable option to carry the vast majority of financial assets and liabilities at fair value, with changes in fair value recorded in earnings (the fair value option, or FVO). The Statement’s objective is to improve financial reporting by allowing entities to mitigate volatility in reported earnings caused by the measurement of related assets and liabilities using different attributes, without having to apply complex hedge accounting provisions. SFAS No. 159 is effective as of the beginning of an entity’s first fiscal year beginning after November 15, 2007. Early adoption is permitted as of the beginning of the previous fiscal year provided that the entity (1) makes that choice in the first 120 days of that fiscal year, (2) has not yet issued financial statements, and (3) elects to apply the provisions of FASB Statement No. 157, “Fair Value Measurements”. The Group adopted the provisions of SFAS No. 159 effective January 1, 2008. Management has decided not to designate any additional financial instruments to be accounted for at the fair value effective January 1, 2008 and therefore believes that the adoption will not have a material impact on the Company’s financial statements.

In December 2007, the FASB issued FASB Statement No. 141 (Revised 2007) (“SFAS No. 141R”), “Business Combinations”, which significantly changes the accounting for business combinations. Under SFAS No. 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS No. 141R will change the accounting treatment for certain specific acquisition related items including: (1) expensing acquisition related costs as incurred; (2) valuing noncontrolling (minority) interests at fair value at the acquisition date; and (3) expensing restructuring costs associated with an acquired business. SFAS No. 141R also includes a substantial number of new disclosure requirements. SFAS No. 141R is to be applied prospectively to business combinations for which the acquisition date is on or after January 1, 2009. Retrospective application and early adoption of SFAS No. 141R is prohibited. Management believes that SFAS No. 141R will have an impact on the accounting for future business combinations once adopted but the effect cannot be quantified at the moment.

In December 2007, the FASB issued FASB Statement No. 160 (“SFAS No. 160”), “Noncontrolling Interests in Consolidated Financial Statements”, which establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 requires that a noncontrolling interest in a subsidiary (minority interest) should be reported as equity in the consolidated financial statements separately from the parent company’s equity. Among other requirements, this statement requires consolidated net income to include the amounts attributable to both the parent and the noncontrolling interest. This statement is effective on January 1, 2009. Management is currently evaluating the provisions of SFAS No. 160 to determine the potential impact, if any, the adoption will have on the Company’s financial statements.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

In March 2008, the FASB issued FASB Statement No. 161 (“SFAS No. 161”), “Disclosures about Derivative Instruments and Hedging Activities”. The new standard requires enhanced disclosures about derivative instruments and hedging activities to enable investors to better understand their effects on an entity’s financial statements. SFAS No. 161 becomes effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Management is currently evaluating the potential impact, if any, of the adoption of SFAS No. 161 on the Company’s financial statements.

### 3. ACQUISITIONS AND DISPOSALS OF SUBSIDIARIES AND AFFILIATES

#### *Acquisitions of controlling interests in regional fixed line operators*

In 2007 and 2006, as a part of its program of regional expansion, the Group has acquired controlling interests in a number of alternative fixed-line operators in certain regions of Russia, Republic of Armenia and Ukraine. The acquisitions were accounted for using the purchase method of accounting.

The following table summarizes the purchase price allocation of the companies acquired during the year ended December 31, 2007:

	<b>Sochitelecom service</b>	<b>DTN (*)</b>	<b>RTC (*)</b>	<b>Comstar Ukraine (**)</b>	<b>Total</b>
Month of acquisition.....	August	November	December	May	
Ownership interest acquired .....	100%	100%	88%	25%	
Region of operations.....	Krasnodar region	Rostov region	Khanty Mansiisk and Orenburg Regions	Ukraine	
Current assets.....	\$ 51	\$ 11,377	\$ 13,492	\$ –	\$ 24,920
Property, plant and equipment.....	114	121,856	6,854	–	128,824
Subscriber base .....	232	74,493	15,155	–	89,880
Goodwill .....	451	–	–	543	994
Current liabilities .....	(98)	(6,431)	(3,615)	–	(10,144)
Non-current liabilities .....	–	(34,139)	(3,637)	–	(37,776)
Minority interests.....	–	–	(2,123)	424	(1,699)
<b>Purchase price.....</b>	<b>\$ 750</b>	<b>\$ 167,156</b>	<b>\$ 26,126</b>	<b>\$ 967</b>	<b>\$ 194,999</b>

(\*) The purchase price allocation of DTN and RTC has not been finalized as of the date of these financial statements.

(\*\*) Acquisition of a minority interest in the existing subsidiary, Comstar Ukraine.

## COMSTAR UTS AND SUBSIDIARIES

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006**  
*(Amounts in thousands of US dollars, unless otherwise stated)*

The following table summarizes the purchase price allocation of the companies acquired during the year ended December 31, 2006:

	M-Telecom Holding (*)	Callnet and Cornet	DG Tel, Technologic Systems, Degre, Neophone	MTU-Inform	MGTS	Total
Month of acquisition.....	June	October	October	February	various	
Ownership interest acquired ....	100%	75%	100% (**)	1% (***)	11.26% voting and 9.39% total shares (***)	
Region of operations.....	Moscow region	Republic of Armenia	Ukraine	Moscow	Moscow	
Current assets.....	\$ 754	\$ 1,080	\$ 514	\$ -	\$ (903)	\$ 1,445
Property, plant and equipment .	2,900	407	2,409	-	49,229	54,945
Subscriber base .....	-	-	-	375	6,080	6,455
Licenses .....	-	5,252	3,179	-	-	8,431
Other intangible assets .....	-	-	1,457	-	6,713	8,170
Goodwill .....	4,353	-	-	-	-	4,353
Other non-current assets .....	335	-	-	-	-	335
Current liabilities .....	(530)	(963)	(852)	-	2,859	514
Non-current liabilities.....	-	(1,196)	(2,897)	-	123	(3,970)
Treasury stock.....	-	-	-	-	21,759	21,759
Minority interests.....	-	(133)	(430)	2,277	95,498	97,212
<b>Purchase price.....</b>	<b>\$ 7,812</b>	<b>\$ 4,447</b>	<b>\$ 3,380</b>	<b>\$ 2,652</b>	<b>\$ 181,358</b>	<b>\$ 199,649</b>

(\*) A company holding a 100% stake in Astelit, an alternative fixed line operator based in the Moscow Region.

(\*\*) The shares were acquired through a 75%-owned subsidiary Comstar-Ukraine.

(\*\*\*) Acquisition of minority interests in the existing subsidiaries. Acquisition of a 1% minority interest in MTU-Inform was executed to streamline the legal merger of MTU-Inform and Comstar-UTS (see Note 1). Acquisition of a minority stake in MGTS was executed as a part of Comstar's strategy to maximize control over its key subsidiaries.

The Company's financial statements reflect the allocation of the purchase price based on a fair value assessment of the assets acquired and liabilities assumed. The excess purchase price over the fair value of the net assets acquired of approximately \$4.4 million has been assigned to goodwill which is not deductible for tax purposes. Licenses and subscriber base are amortized over 10-year and up to 31-year periods, respectively. Other intangible assets primarily represent non-amortizable numbering capacity and a trademark.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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#### *Acquisition of a 25% stake plus one share in Svyazinvest*

In December 2006, as a part of its program of regional expansion, the Group acquired a 25% stake plus one share in Telecommunication Investment Joint Stock Company (“Svyazinvest”) from Mustcom Limited for a total consideration of approximately \$1,390.0 million, including cash of \$1,300.0 million and the fair value of the call and put option of \$90.0 million (see Note 15). In a series of transactions, Comstar UTS and MGTS Finance S.A., a subsidiary of MGTS, have acquired 4,879,584,306 ordinary shares of Svyazinvest, with Comstar UTS buying 3,378,173,750 shares, which represent 17.3% of total outstanding shares of Svyazinvest, and MGTS Finance S.A. buying 1,501,410,556 shares, representing 7.7% of total outstanding shares of Svyazinvest.

Based on the analysis of all relevant factors, the management has determined that the acquisition of 25% plus one share of Svyazinvest does not allow the Group to exercise significant influence over this entity. Accordingly, the Group accounts for its investment in Svyazinvest under the cost method. Due to lack of consolidated financial statements of Svyazinvest prepared in accordance with US GAAP as of December 31, 2007 or earlier date, the Group is unable to present summarized information as to assets, liabilities and results of operations of Svyazinvest.

#### *Disposal of shares in Metrocom*

In March 2007, Comstar UTS sold its 45% stake in Metrocom (see Note 11) to a third party for a total cash consideration of \$20.0 million.

#### *Acquisition of minority interest in Golden Line*

In April 2007, as a part of reorganization of Moscow and the Moscow Region operations of the Group, Comstar UTS has acquired 100% shares in Golden Line from Comstar-Direct, a 52%-owned subsidiary of the Group, thus increasing its effective shareholding in Golden Line to 100%. The acquisition has been accounted for at cost with excess of the book value of the net assets acquired over the purchase price, net of income taxes, recorded as an increase in the additional paid-in capital of the Group.

#### *Pro-forma results of operations (unaudited)*

The following pro-forma financial data for the years ended December 31, 2007 and 2006 give effect to the acquisition of subsidiaries and minority interests discussed above as if they had occurred as of January 1, 2006:

	<u>2007</u>		<u>2006</u>
Operating revenues .....	\$ 1,562,385	\$	1,174,061
Operating income.....	485,333		254,891
Net income.....	66,211		127,984

The pro-forma information is based on various assumptions and estimates and is not necessarily indicative of the operating results that would have occurred if the Group’s acquisitions had been consummated at the beginning of the respective period, nor is it necessarily indicative of future operating results. The pro-forma information does not give effect to any potential revenue enhancements or cost synergies or other operating efficiencies that could result from the acquisitions.

## COMSTAR UTS AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006  
(Amounts in thousands of US dollars, unless otherwise stated)

### 4. CASH AND CASH EQUIVALENTS

Cash and cash equivalents as of December 31, 2007 and 2006 consisted of the following:

	<u>2007</u>	<u>2006</u>
Cash .....	\$ 82,992	\$ 48,816
Cash equivalents:		
Promissory notes of MBRD .....	32,592	–
Deposits .....	63,964	87,579
Other .....	<u>246</u>	<u>226</u>
<b>Total .....</b>	<b>\$ <u>179,794</u></b>	<b>\$ <u>136,621</u></b>

Cash and cash equivalents with the Moscow Bank of Reconstruction and Development (“MBRD”), a subsidiary of Sistema, as of December 31, 2007 and 2006 amounted to \$66.8 million and \$87.5 million, respectively. Interest income earned on cash and cash equivalents and short-term investments in MBRD is disclosed in Note 23.

### 5. SHORT-TERM INVESTMENTS

Short-term investments as of December 31, 2007 and 2006 consisted of the following:

	<b>Interest rate at December 31, 2007</b>	<u>2007</u>	<u>2006</u>
RUR-denominated time deposits in MBRD .....		\$ –	\$ 8,888
USD-denominated time deposits in MBRD .....		–	7,940
RUR-denominated time deposits in other banks ..	7%	414	26,123
USD-denominated time deposits in other banks...	7%	10,005	–
RUR-denominated promissory notes of other banks .....	5-8%	40,129	–
Funds transferred to the investment broker .....		95,821	–
Loan to Remstroytrest .....	10%	37,196	–
Promissory notes of and loans to other subsidiaries and affiliates of Sistema:			
Sky Link (see Note 11) .....	11%	12,741	–
Sistema Hals .....	9%	19,975	–
MBRD .....	7-9%	<u>209,648</u>	<u>24,711</u>
<b>Total .....</b>		<b>\$ <u>425,929</u></b>	<b>\$ <u>67,662</u></b>

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

Interest income earned on cash and cash equivalents and short-term investments in MBRD and other related parties is disclosed in Note 23.

In 2007, the Group has transferred cash to the investment broker as part of a planned acquisition of a telecommunication company. Due to the changes in market conditions, as of December 31, 2007 and the date of the financial statements, the transaction has not been completed. Management believes that possibility that the transaction will be successfully closed is remote and expects that the deposit will be returned in cash in 2008.

The loan to Remstroytrest is guaranteed by Sistema Hals, a subsidiary of Sistema.

#### 6. TRADE RECEIVABLES, NET

Trade receivables, net of provision for doubtful debts, as of December 31, 2007 and 2006 consisted of the following:

	<u>2007</u>	<u>2006</u>
Receivables from individuals..... \$	55,677 \$	20,839
Receivables from legal entities .....	130,768	95,168
Provision for doubtful receivables.....	<u>(23,417)</u>	<u>(20,139)</u>
<b>Total .....</b> \$	<b><u>163,028</u></b> \$	<b><u>95,868</u></b>

Trade receivables as of December 31, 2007 and 2006 include receivables from subsidiaries and affiliates of Sistema of \$18.8 million and \$7.1 million, respectively.

#### 7. OTHER RECEIVABLES AND PREPAID EXPENSES

Other receivables and prepaid expenses as of December 31, 2007 and 2006 consisted of the following:

	<u>2007</u>	<u>2006</u>
VAT recoverable .....	\$ 28,124	\$ 28,048
Prepaid taxes .....	23,769	23,913
Prepayments.....	16,301	9,967
Other receivables .....	<u>33,474</u>	<u>25,726</u>
<b>Total .....</b> \$	<b><u>101,668</u></b> \$	<b><u>87,654</u></b>

Included in other receivables as of December 31, 2007 is \$17.4 million of receivables from Sistema Mass Media, a subsidiary of Sistema (see Note 23).

## COMSTAR UTS AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006  
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### 8. INVENTORIES AND SPARE PARTS

Inventories and spare parts as of December 31, 2007 and 2006 consisted of the following:

	<u>2007</u>	<u>2006</u>
Equipment for resale.....	\$ 16,978	\$ 9,988
Spare parts and other materials.....	<u>24,350</u>	<u>23,752</u>
<b>Total .....</b>	<b>\$ <u>41,328</u></b>	<b>\$ <u>33,740</u></b>

### 9. PROPERTY, PLANT AND EQUIPMENT, NET

Property, plant and equipment, net of accumulated depreciation, as of December 31, 2007 and 2006 consisted of the following:

	<u>2007</u>	<u>2006</u>
Buildings and constructions.....	\$ 384,990	\$ 335,493
Telecommunications equipment and cable .....	1,468,033	1,110,934
Other fixed assets.....	303,071	267,857
Construction in-progress and equipment for installation.....	<u>365,080</u>	<u>251,979</u>
Property, plant and equipment, at cost, total.....	<u>2,521,174</u>	<u>1,966,263</u>
Less: accumulated depreciation .....	<u>(614,062)</u>	<u>(488,934)</u>
<b>Property, plant and equipment, net .....</b>	<b>\$ <u>1,907,112</u></b>	<b>\$ <u>1,477,329</u></b>

The depreciation charge for the years ended December 31, 2007 and 2006, net of amortization of property, plant and equipment contributions (see Note 17), amounted to \$145.5 million and \$110.6 million, respectively.

## COMSTAR UTS AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
 FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006  
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### 10. INTANGIBLE ASSETS, NET

Intangible assets, net of accumulated amortization, as of December 31, 2007 and 2006 consisted of the following:

	Weighted average amorti- zation period, years	2007			2006		
		Gross carrying value	Accu- mulated amorti- zation	Net carrying value	Gross carrying value	Accu- mulated amorti- zation	Net carrying value
Billing systems and other software .....	4	\$ 124,702	\$ (62,717)	\$ 61,985	\$ 84,171	\$ (38,772)	\$ 45,399
Customer base.....	12	106,751	(6,467)	100,284	15,524	(1,222)	14,302
Licenses .....	3	13,128	(4,180)	8,948	11,566	(169)	11,397
TV content .....	6	1,420	(543)	877	8,272	(2,820)	5,452
Goodwill .....	–	4,209	–	4,209	3,459	–	3,459
Other .....	4	23,042	(8,339)	14,703	16,276	(4,450)	11,826
<b>Total intangible assets .....</b>	<b>7</b>	<b>\$ 273,252</b>	<b>\$ (82,246)</b>	<b>\$ 191,006</b>	<b>\$ 139,268</b>	<b>\$ (47,433)</b>	<b>\$ 91,835</b>

Amortization expense recorded on intangible assets for the years ended December 31, 2007 and 2006 amounted to \$32.4 million and \$20.3 million, respectively. Based on the intangible assets existing at December 31, 2007, the estimated amortization expense for each of the five succeeding years is as follows: 2008 – \$37.5 million; 2009 – \$26.6 million; 2010 – \$24.3 million; 2011 – \$23.3 million and 2012 – \$18.6 million.

Actual amortization expense to be reported in future periods could differ from these estimates as a result of new intangible assets acquisitions, changes in useful lives and other relevant factors.

During the year ended December 31, 2007, the Group has sold to Sistema Mass Media, a subsidiary of Sistema, certain TV content (see Note 23).

## COMSTAR UTS AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006  
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### 11. OTHER LONG-TERM INVESTMENTS

Other long-term investments as of December 31, 2007 and 2006 consisted of the following:

	2007		2006	
	Ownership, %	Investment	Ownership, %	Investment
<b>Investments in shares</b>				
MBRD .....	4.56%	\$ 6,466	5.35%	\$ 6,028
Metrocom (see Note 3) .....	–	–	45%	16,164
Sistema Mass Media .....	3%	4,751	–	–
TS-Retail.....	15%	2,105	–	–
Coral-Sistema Strategic Fund .....	10%	860	–	–
Other .....	various	1,127	various	1,418
Total investments in shares		<u>15,309</u>		<u>23,610</u>
<b>Other investments</b>				
Promissory notes of Sistema Telecom..		58,319		55,296
Loans to and notes of Sky Link and subsidiaries, related parties (see also Note 5) .....		–		27,222
Advance to the Moscow City Government .....		11,203		10,400
Loan to Intellect Telecom .....		6,355		–
Advance to investment broker for acquisitions of subsidiaries .....		3,598		–
Other .....		4,947		1,960
Total other investments		<u>84,422</u>		<u>94,878</u>
<b>Grand total</b> .....		<u><b>\$ 99,731</b></u>		<u><b>\$ 118,488</b></u>

In 2007, MBRD issued additional stock. The Group did not acquire any stocks issued. Accordingly, its ownership interest in MBRD was diluted from 5.35% to 4.56%.

In October 2007, Golden Line contributed an office building with net book value of \$4.8 million in the charter capital of Sistema Mass Media, a subsidiary of Sistema.

In September 2007, Comstar invested \$2.1 million in cash in TS-Retail, a retail start-up jointly owned by several subsidiaries of Sistema. The Group plans to use TS-Retail as one of the distribution channels.

In September 2007, Comstar invested \$0.9 million in cash in Coral-Sistema Strategic Fund (CSSF), a limited liability partnership owned by Sistema and several of its subsidiaries which is managed by Coral Capital Management. Comstar committed to invest a further \$6.6 million in CSSF. CSSF will be investing in companies with strategic value to Comstar and other subsidiaries of Sistema.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

Promissory notes of Sistema Telecom, a subsidiary of Sistema, include \$36.7 million of RUR-denominated notes, which bear interest of 4.4% per annum, and \$21.6 million of USD-denominated notes, which bear interest of 3.0% per annum. Interest income earned on investments in Sistema Telecom's promissory notes is disclosed in Note 23.

In 2006, the management of Sky Link, an affiliate of Sistema, started negotiations to extend the term of the repayment of certain receivables, loans and notes, the majority of which were overdue as of December 31, 2006. In 2007, the agreement has been reached in respect of such receivables, loans and notes totalling \$29.5 million as of December 31, 2007, which will be repaid by Sky Link, together with interest charged at 10% and 11% p.a., depending on instrument, on various dates in 2008 and 2009. The negotiations in respect of the remaining portion of Skylink promissory notes and loans have not yet resulted in a firm repayment schedule. Due to historically experienced delays in payments as they become due and requests to extend maturity of the amounts owed made by Sky Link over the last several years, management believes that recoverability of the long-term portion of Sky Link debt is doubtful in the foreseeable future. Accordingly, in 2007 management has recorded a provision for impairment of the long-term portion of Sky Link debt for the amount of \$21.1 million.

In connection with the long-term program of digitalization of MGTS' network (see Note 24) and planned renovation and disposal of certain MGTS' buildings, during the fourth quarter of 2005, MGTS has made an advance payment to the Moscow City Government, which will be offset against the future liability of MGTS to provide the Moscow City Government with its share in the buildings when their reconstruction is complete and the sales commence.

In July 2007, MGTS granted a 156.0 million ruble (\$6.4 million as of December 31, 2007) loan to Intellect Telecom, a subsidiary of Sistema. The loan bears interest at 7% per annum and is repayable in 2012.

#### 12. TRADE ACCOUNTS PAYABLE, ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Trade accounts payable, accrued expenses and other current liabilities as of December 31, 2007 and 2006 consisted of the following:

	<u>2007</u>	<u>2006</u>
Trade accounts payable.....	\$ 56,580	\$ 51,023
Accrued payroll .....	48,068	24,034
Taxes payable .....	26,772	12,999
Accounts payable for the acquisition of property, plant and equipment.....	20,830	5,975
Liability under employee stock option program (see Note 25) .....	10,948	-
Accrued interest .....	1,775	2,542
Dividends payable .....	893	368
Other current liabilities .....	13,088	16,712
<b>Total .....</b>	<b>\$ <u>178,954</u></b>	<b>\$ <u>113,653</u></b>

Trade accounts payable, accrued expenses and other current liabilities as of December 31, 2007 and 2006 include payables from subsidiaries and affiliates of Sistema of \$16.5 million and \$14.0 million, respectively.

## COMSTAR UTS AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006  
(Amounts in thousands of US dollars, unless otherwise stated)

### 13. DEBT OBLIGATIONS

The Group's debt obligations as of December 31, 2007 and 2006 consisted of the following:

	Currency	Annual interest rate (actual at December 31, 2007)	2007	2006
MGTS Bonds 5 <sup>th</sup> issue .....	RUR	7.1%	\$ 29,338	\$ 55,842
MGTS Bonds 4 <sup>th</sup> issue .....	RUR	7.1%	59,903	27,533
Total corporate bonds .....			<u>89,241</u>	<u>83,375</u>
Sberbank credit line facility .....	RUR	7.6%	877,689	—
ABN Amro and Morgan Stanley .....	USD	LIBOR+1.2%	—	675,000
		LIBOR +		
Citibank .....	USD	1.6%	—	17,117
		EURIBOR +		
		2.75%		
MBRD .....	Euro	(7.46%)	2,183	2,526
VTB .....	Euro	various	18,984	21,428
Commerzbank .....	Euro	4.0%	2,247	2,337
Vendor financing .....	various	various	3,158	6,001
Other .....	various	various	<u>1,295</u>	<u>3,582</u>
Total debt .....			<u>994,797</u>	<u>811,366</u>
Less: amounts maturing within one year .....			<u>(103,476)</u>	<u>(777,837)</u>
<b>Debt, net of current portion .....</b>			<b>\$ <u>891,321</u></b>	<b>\$ <u>33,529</u></b>

#### *Corporate bonds*

In April 2004, MGTS issued 5-year RUR-denominated bonds (fourth issue) with the face value of RUR 1,500 million (equivalent to \$61.1 million as of December 31, 2007). The bonds carried a coupon of 10.0% per annum, which was decreased to 7.1% per annum in April 2006. MGTS made unconditional offers to repurchase the bonds at par value in April 2006 and April 2007, which were exercised in the amounts of approximately \$30.1 million and \$0.2 million, respectively. The interest rate will be re-set, at management discretion, in April 2009.

In May 2005, MGTS issued 5-year RUR-denominated bonds (fifth issue) with a face value of RUR 1,500 million (equivalent to \$61.1 million as of December 31, 2007). The bonds carried a coupon of 8.3% per annum during the two years ending April 2007, and carries a coupon of 7.1% per annum further until May 2008, when the interest rate will be re-set at management discretion. In June 2006, the Group repurchased the bonds at par value for the amount of \$0.6 million.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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Currently, MGTS has an unconditional outstanding offer to repurchase the fourth and the fifth issues of the bonds at par in April and May 2008, respectively. Accordingly, both issues are classified as current liabilities in the accompanying consolidated balance sheet as of December 31, 2007.

As of December 31, 2007, the total fair value of the bonds was approximately \$89.2 million.

#### *Sberbank Credit Line Facility*

In June 2007, Comstar UTS entered into a non-revolving credit line facility with Sberbank for the amount of RUR 26.0 billion (equivalent of \$1,059.2 million as of December 31, 2007). In June 2007, Comstar UTS has drawn down approximately RUR 17.4 billion (equivalent of \$675.0 million as of the date of the drawdown) under this facility and used the proceeds to repay a \$675.0 million loan from ABN Amro and Morgan Stanley. In November 2007, Comstar UTS has drawn additional RUR 4.1 billion (equivalent of \$167.4 million as of the date of the drawdown) under this facility to finance the acquisition of a 100% stake in DTN (see Note 3). The facility bears interest at 7.6% per annum and is repayable in equal quarterly installments from September 2009 until June 2012 and is secured by a pledge of a 25% plus one share stake in Svyazinvest (see Note 3). Deferred financing costs of approximately \$1.5 million were capitalized in connection with this facility. As of December 31, 2007, approximately RUR 4.5 billion (equivalent of approximately \$181.5 million) under the facility remains undrawn.

#### *ABN Amro and Morgan Stanley*

In December 2006, to finance the acquisition of a 25% plus one share stake in Svyazinvest (see Note 3), Comstar UTS entered into a credit facility with ABN Amro Bank and Morgan Stanley for the amount of \$675.0 million. The facility bore interest at LIBOR+1.2% per annum (6.56% as of December 31, 2006) and was repaid in June 2007. Deferred financing costs of approximately \$4.1 million were capitalized in connection with this facility.

#### *Citibank*

In 2003-2006, MGTS entered into four credit facilities with Citibank for a total amount of \$25.1 million. These credit facilities were opened to finance the acquisitions of equipment from STROM Telecom, a subsidiary of Sistema. All facilities bore interest of LIBOR+1.6% per annum and were repaid by MGTS ahead of schedule.

#### *MBRD*

In July 2006, MGTS entered into a credit agreement with MBRD for an amount of Euro 2.1 million (equivalent of \$3.1 million as of December 31, 2007) to finance the acquisition of equipment. The loan is repayable in equal semi-annual installments in 2006-2011 and bears interest at EURIBOR+2.75% per annum (7.46% as of December 31, 2007).

#### *VTB*

In January 2006, MGTS entered into a credit agreement with VTB bank (formerly known as Vneshtorgbank) for an amount of Euro 7.7 million (equivalent of \$11.3 million as of December 31, 2007) to finance the acquisition of equipment. The loan matures in January 2012 and bears interest at EURIBOR+5.0% per annum (9.71% as of December 31, 2007). As of December 31, 2007, the amount outstanding under the agreement was \$10.2 million.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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In March 2005, MGTS entered into a credit agreement with VTB for an amount of Euro 5.3 million (equivalent of \$7.8 million as of December 31, 2007) to finance the acquisition of equipment. The loan matures in September 2010 and bears interest at EURIBOR+5.0% per annum (9.71% as of December 31, 2007). As of December 31, 2007, the amount outstanding under the agreement was \$4.6 million.

In July 2004, MGTS entered into two credit agreements for a total amount of Euro 7.3 million (equivalent of \$10.7 million as of December 31, 2007) to finance the acquisition of equipment. The loans mature in January 2010 and bear interest at the highest of EURIBOR+5.35% (10.1% as of December 31, 2007) or 7.5% per annum. As of December 31, 2007, the amount outstanding under the agreements totalled \$4.3 million. In 2008, MGTS fully repaid these loans ahead of schedule.

In December 2007, MGTS and VTB dissolved the agreements under which the acquired equipment financed by these loans was pledged to collateralize the outstanding balances under the credit agreements. Accordingly, as of December 31, 2007, VTB loans are not secured.

#### *Commerzbank*

In December 2004, Sistema Multimedia (subsequently merged into MTU-Intel which was then renamed to Comstar-Direct, see Note 1) entered into a credit facility agreement with Commerzbank for Euro 5.5 million (equivalent of \$8.1 million as of December 31, 2007). The loan bears interest at 4.0% per annum and matures in 2010.

#### *Vendor financing*

Suppliers of telecommunications equipment provide uncollateralized commercial credit to the Group denominated in various currencies on the short-term and long-term basis.

#### *Debt Repayments Schedule*

The debt repayments over future periods are as follows:

Year ended December 31,		
2008 .....	\$	103,476
2009 .....		151,138
2010 .....		296,629
2011 .....		295,131
2012 .....		<u>148,423</u>
<b>Total .....</b>	<b>\$</b>	<b><u><u>994,797</u></u></b>

#### *Compliance with Covenants and Other Restrictive Provisions*

Loans from Sberbank effective as of December 31, 2007 impose certain covenants and restrictions on the Company, including but not limited to restrictions on Debt to Operating Income before Depreciation and Amortization ("OIBDA") ratio. Management believes that as of December 31, 2007, the Group is in compliance with all existing restrictive provisions and covenants of its debt obligations which could cause the technical default on the Group's obligations in case of non-compliance.

## COMSTAR UTS AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006  
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### 14. CAPITAL LEASE OBLIGATIONS

MGTS entered into several agreements for the lease of telecommunication equipment with InvestSvyazHolding, a subsidiary of Sistema. The agreements expire on various dates in 2008-2009 and provide for transfer of ownership of the equipment to the Group after the last lease payment is made.

In February 2005, Sistema Multimedia entered into an agreement for the lease of equipment with BSGV Leasing. After the legal merger with MTU-Intel in December 2005, the rights and obligations under the agreement were transferred to MTU-Intel (renamed Comstar-Direct in November 2006). In 2007, the Group made an early repayment of the lease and obtained the title to this equipment.

The net book value of leased assets approximated \$55.8 million and \$56.7 million as of December 31, 2007 and 2006, respectively. Interest expense accrued on capital lease obligations for the years ended December 31, 2007 and 2006 amounted to \$2.4 million and \$3.8 million, respectively.

The following table presents future minimum lease payments under capital leases together with the present value of the net minimum lease payments as of December 31, 2007:

Year ended December 31,		
2008 .....	\$	11,443
2009 .....		5,501
2010 .....		<u>952</u>
Total minimum lease payments (undiscounted) .....		17,896
Less: amount representing interest .....		<u>(1,386)</u>
<b>Total present value of net minimum lease payments.....</b>	<b>\$</b>	<b><u><u>16,510</u></u></b>

### 15. DERIVATIVE FINANCIAL INSTRUMENTS

Simultaneously with the acquisition of the 25% stake plus one share in Svyazinvest (see Note 3), MGTS Finance S.A. and “2711 Centerville Cooperatief U.A.” (“2711 UA”), an affiliate of Mustcom Limited, signed a call and put option agreement, which gives 2711 UA a right to purchase 46,232,000 shares of Comstar UTS, representing 11.06% of total issued shares, from MGTS Finance S.A. and sell them back to MGTS Finance S.A. The call option acquired by 2711 UA could be exercised at a strike price of USD 6.97 per share at any time following the signing of the agreement with respect to 10.5% of Comstar UTS’ shares. The call option for the remaining 0.56% stake could be exercised at any time beginning from April 1, 2007. The call option was to expire in one year from the date of signing of the agreement. 2711 UA may exercise its put option at any time within two years from the date of exercising the call option at a strike price, which will be calculated based on a weighted average price of Comstar UTS’ GDRs during the 90 trading days period preceding the exercise of the put.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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Fair value of the call and put option as of December 11, 2006, the grant date, was estimated at \$90.0 million and included in cost of investment in Svyazinvest. The Group estimates the fair value of the respective liability using an option pricing model and re-measures it as of each balance sheet date. Respective gains and losses are included in the statement of operations for the period and amounted to \$60.0 million loss for the year ended December 31, 2006.

On December 7, 2007, Access Telecommunications Cooperatief U.A. (previously known as 2711 UA) has exercised the call option for 46,232,000 shares and paid \$322.2 million in cash to the Group. Fair value of the put option outstanding as of December 31, 2007 amounted to \$88.0 million. Loss from revaluation of the call and put option for the period from January 1, 2007 till December 7, 2007 and the remaining put option for the period from December 7 till December 31, 2007 totalled \$145.9 million and was included in the statement of operations for the year ended December 31, 2007.

#### 16. RETIREMENT AND POST-RETIREMENT OBLIGATIONS

MGTS has historically provided certain benefits to employees upon their retirement and afterwards, which include monthly regular pension, death-in-service payments, lump-sum upon retirement payments, death-while-pensioner payments and 50% monthly telephone subsidy for the pensioners who served more than 30 years at MGTS. As of December 31, 2007, there were 13,828 active employees eligible to the program. The pension plan is terminally funded, i.e., upon retirement MGTS transfers all its obligations to a pension fund (NPF "Sistema"), a subsidiary of Sistema, and from that moment onwards has no more obligations towards the pensioner regarding the pension plan. All other program benefits are financed on a pay-as-you-go basis.

MGTS' pension obligations are measured as of December 31. The following are the key assumptions used in determining the projected benefit obligation and net periodic pension expense:

Discount rate .....	6.50% p.a.
Expected return on plan assets.....	7.11% p.a.
Increase in unit pensions and other benefits .....	9.20% p.a.
Discount rate used for annuity contracts calculation .....	7.00% p.a.
Rate at which pension payment are assumed to be indexed .....	0.00% p.a.
Long-term inflation.....	5.00% p.a.
Staff turnover (for ages below 50).....	10.00% p.a.

## COMSTAR UTS AND SUBSIDIARIES

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
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The change in the projected benefit obligation and the change in plan assets for the years ended December 31, 2007 and 2006 are presented in the following table:

	<u>2007</u>	<u>2006</u>
<b>Change in projected benefit obligation</b>		
Projected benefit obligation, beginning of the year.....	\$ 15,942	\$ 18,868
Service cost.....	1,556	(8,538)
Interest cost.....	970	1,232
Plan amendments.....	(746)	-
Actuarial losses.....	18,155	6,352
Benefit payment.....	(1,395)	(365)
Settlement and curtailment gain.....	(2,676)	-
Termination benefits.....	4,471	-
Foreign currency translation effect.....	2,013	(1,607)
Projected benefit obligation, end of the year.....	<u>38,290</u>	<u>15,942</u>
<b>Change in fair value of plan asset</b>		
Fair value of plan assets, beginning of the year.....	5,760	2,651
Actual return on plan assets.....	103	337
Employer contributions.....	2,760	3,137
Benefits paid.....	(1,395)	(365)
Settlement.....	(1,575)	-
Foreign currency translation effect.....	270	-
Other.....	(3,450)	-
Fair value of plan assets, end of the year.....	<u>2,473</u>	<u>5,760</u>
<b>Unfunded status of the plan, end of the year, net.....</b>	<u><b>(35,817)</b></u>	<u><b>(10,182)</b></u>

The changes in the projected benefit obligation due to actuarial losses for the years ended December 31, 2007 and 2006 relate primarily to the changes in the discount rate and employees turnover assumptions.

Reconciliations of the unfunded status of the plan for the years ended December 31, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
Unfunded status of the plan, beginning of the year.....	\$ 10,182	\$ 16,217
Net periodic benefit cost.....	6,894	(7,643)
Contributions made.....	(2,760)	(3,137)
Charge to other comprehensive income, net.....	16,308	-
Foreign currency translation effect.....	1,743	(1,607)
Other.....	3,450	6,352
<b>Unfunded status of the plan, end of the year.....</b>	<u><b>\$ 35,817</b></u>	<u><b>\$ 10,182</b></u>

The components of the net periodic benefit costs for the years ended December 31, 2007 and 2006 are as follows:

## COMSTAR UTS AND SUBSIDIARIES

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
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	<u>2007</u>	<u>2006</u>
Service cost.....	\$ 1,556	\$ (8,538)
Interest cost.....	970	1,232
Return on assets .....	(103)	(337)
Immediate recognition of prior service cost .....	<u>4,471</u>	<u>—</u>
<b>Net periodic benefit cost.....</b>	<b><u>\$ 6,894</u></b>	<b><u>\$ (7,643)</u></b>

Service cost in the year ended December 31, 2006 represents benefit and relates primarily to decrease in the number of employees and reduction of average age of MGTS' employees.

Amounts recognized in other comprehensive income for the years ended December 31, 2007 and 2006 are as follows:

	<u>2007</u>	<u>2006</u>
Unrecognized losses .....	\$ 17,072	\$ —
Unrecognized prior service credit.....	<u>(764)</u>	<u>—</u>
<b>Total recognized in other comprehensive income.....</b>	<b><u>\$ 16,308</u></b>	<b><u>\$ —</u></b>

The estimated net loss and prior service credit for the defined benefit pension plans that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the year ending December 31, 2008 are \$1.6 million and \$0.1 million, respectively.

The Group's management expects contributions to the plan during the year ended December 31, 2008 to amount to \$5.9 million.

The future benefit payments to retirees under the defined benefit plan are expected to be as follows: 2008 – \$5.9 million; 2009 – \$1.8 million; 2010 – \$1.9 million; 2011 – \$2.5 million, 2012 – \$2.9 million, and \$25.0 million thereafter.

In connection with reorganization and headcount reduction program adopted in 2007, management has estimated an additional liability in respect to lump-sum payments upon retirement in the projected benefit obligation ("PBO"), which resulted in an increase in PBO of approximately \$9.7 million as of December 31, 2007, and revised estimated staff turnover rate, which was increased to 10% per annum. In addition, due to adoption of new motivation scheme at MGTS, estimated future increase in unit pension and other benefits was increased to 9.2% per annum, which resulted in a difference of approximately \$14.3 million between PBO and accumulated benefit obligation (ABO) as of December 31, 2007. Accumulated benefit obligation as of December 31, 2007 and 2006 amounted to \$24.0 million and \$15.9 million, respectively.

NPF "Sistema" does not allocate any separately identifiable assets to its clients such as MGTS. Instead, it operates a pool of investments where it invests the funds from the pension solidarity and individual accounts. The pool of investments includes primarily investments in Russian corporate bonds, Russian governmental bonds and shares of Russian issuers.

### 17. PROPERTY, PLANT AND EQUIPMENT CONTRIBUTIONS

## COMSTAR UTS AND SUBSIDIARIES

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
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MGTS receives telecommunication infrastructure which is intended to operate as an integral part of the Moscow city wire line network from the real estate constructors free of charge as provided by the regulations of the city government. Property, plant and equipment contributions received by MGTS during the years ended December 31, 2007 and 2006 were as follows:

	<u>2007</u>	<u>2006</u>
Unamortized property, plant and equipment contributions, beginning of the year .....	\$ 103,793	\$ 102,746
Contributions received during the year.....	6,299	5,387
Change in the fair value of property, plant and equipment contributions in the course of allocation of purchase price of MGTS shares (Note 3) .....	–	(9,561)
Currency translation effect .....	6,815	9,217
Amortization for the year.....	<u>(4,128)</u>	<u>(3,996)</u>
<b>Unamortized property, plant and equipment contributions, end of the year .....</b>	<b><u>\$ 112,779</u></b>	<b><u>\$ 103,793</u></b>

### 18. SHAREHOLDERS' EQUITY

As of December 31, 2007 and 2006, Comstar UTS' share capital comprised of 417,940,860 authorized and issued common shares with par value of 1 Russian Ruble, and amounted to \$23,900. As a result of the Group's reorganization, as of December 31, 2006 MGTS and its subsidiaries owned 57,742,500 shares, or approximately 13.8% of total issued shares of Comstar UTS. In addition, as a result of shares buy-back in October-December 2006 and stock bonus granted in November 2006 (see Note 25), as of December 31, 2006 the Group owned 1,970,004 own shares in the form of GDRs, or approximately 0.5% of total issued shares. All shares of Comstar UTS owned by the Group are accounted for as treasury stock and are recorded at par value in the accompanying consolidated financial statements with the difference between par value and the cost of acquisition accounted for as a reduction to additional paid-in capital in the statement of changes in shareholders' equity.

In December 2007, under the exercise of the call option, MGTS Finance S.A. has sold 46,232,000 shares of Comstar UTS, representing 11.06% of total issued shares, to Access Telecommunications Cooperatief U.A. (see Note 15). Further, in 2007 Comstar UTS has acquired 3,500 of own shares from a shareholder who voted against the legal merger of certain subsidiaries with Comstar UTS.

As a result, as of December 31, 2007 the Group owned 13,484,004 shares (including 1,970,004 shares in the form of GDRs) of Comstar UTS.

MGTS' preferred shares carry guaranteed non-cumulative dividend rights amounting to the higher of (a) 10% of MGTS' net profit as determined under Russian accounting regulations and (b) the dividends paid on common shares. No dividends may be declared on common shares before dividends on preferred shares are declared. If the preferred dividend is not paid in full in any year the preferred shares also obtain voting rights, which will lapse after the first payment of the dividend in full. Otherwise, preferred shares carry no voting rights except on resolutions regarding liquidation or reorganization of MGTS and changes/amendments to MGTS' charter restricting the rights of holders of preferred shares. Such resolutions require the approval of 75% of the preferred shareholders. In the event of liquidation, dividends to preferred shareholders that have been declared but not paid have priority over ordinary shareholders.

## COMSTAR UTS AND SUBSIDIARIES

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In accordance with Russian legislation, dividends may only be declared to the shareholders of the Company from accumulated undistributed and unreserved earnings as reported in the Company's Russian statutory financial statements, subject to certain restrictions. Comstar UTS had approximately \$564.4 million of undistributed and unreserved earnings as at December 31, 2007.

### 19. OPERATING REVENUES

Operating revenues for the years ended December 31, 2007 and 2006 consisted of the following:

	<u>2007</u>	<u>2006</u>
<b>Traditional Segment in Moscow</b>		
Residential subscribers		
Voice.....	\$ 516,370	\$ 317,167
Value-added services .....	11,601	10,588
Other .....	3,845	4,605
Total residential subscribers .....	<u>531,816</u>	<u>332,330</u>
Corporate subscribers		
Voice.....	167,585	142,752
Access node/Trunk rental .....	67,884	61,327
Value-added services .....	15,724	14,412
Other .....	15,584	11,348
Total corporate subscribers.....	<u>266,777</u>	<u>229,839</u>
Operators		
Rent of access nodes .....	188,537	130,750
Rent of data transmission ports.....	65,145	51,721
Initiation and termination of DLD/ILD traffic.....	35,037	36,685
Other .....	25,174	19,900
Total operators .....	<u>313,893</u>	<u>239,056</u>
Inter-segment revenue .....	<u>(127,033)</u>	<u>(106,145)</u>
<b>Total revenue of the Traditional Segment in Moscow, net .....</b>	<b>\$ <u>985,453</u></b>	<b>\$ <u>695,080</u></b>

## COMSTAR UTS AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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	<u>2007</u>	<u>2006</u>
<b>Alternative Segment in Moscow</b>		
Residential subscribers		
Broadband Internet access and pay-TV .....	\$ 104,237	\$ 77,644
Dial-up Internet access.....	4,650	10,325
Voice and other .....	11,454	12,130
Total residential subscribers .....	<u>120,341</u>	<u>100,099</u>
Corporate subscribers		
Voice.....	66,686	72,639
Data and Internet.....	93,852	76,586
Value-added services .....	19,150	11,945
Other .....	10,244	8,015
Total corporate subscribers.....	<u>189,932</u>	<u>169,185</u>
Operators .....	142,230	119,137
Inter-segment revenue .....	<u>(3,286)</u>	<u>(2,489)</u>
<b>Total revenue of the Alternative Segment in Moscow, net.....</b>	<b>\$ <u>449,217</u></b>	<b>\$ <u>385,932</u></b>
<b>Alternative Segment in Regions and the CIS</b>		
Corporate subscribers .....	\$ 52,878	\$ 19,910
Residential subscribers .....	38,857	9,700
Operators .....	35,080	9,333
Other .....	<u>900</u>	<u>292</u>
<b>Total revenue of Alternative Segment in Regions and the CIS, net .....</b>	<b>\$ <u>127,715</u></b>	<b>\$ <u>39,235</u></b>
<b>Total revenue of the Group, net .....</b>	<b>\$ <u><u>1,562,385</u></u></b>	<b>\$ <u><u>1,120,247</u></u></b>

To comply with the new long-distance traffic routing rules which came into effect starting January 1, 2006, the companies comprising Alternative Segment in Moscow and Alternative Segment in Regions and the CIS entered into agent agreements with authorized DLD/ILD providers and started migration of its end-user customer base to the agent contracts in June 2006. As of December 31, 2006, the migration has been substantially completed. Under the agent agreements, the Group re-sells the services of authorized DLD/ILD operators, receiving a share in long-distance revenues generated by the end users from authorized operators in the form of commission. Under the old arrangements, the Group had been providing services as a principal under its own operating licenses and, accordingly, reported all DLD/ILD revenues on a gross basis, i.e. full amount earned from subscriber was shown as revenue and corresponding traffic cost was included in operating expenses. Under the new rules, the DLD/ILD revenues generated by the customers are reported on a net basis, i.e. only the commission is shown as revenue from a DLD/ILD operator with no corresponding traffic cost. The long-distance revenues from subscribers that were not yet transferred in 2006 to the agent scheme were reported on a gross basis and approximated \$22.0 million for the year ended December 31, 2006.

MGTS comprising the Traditional Segment in Moscow historically has been providing DLD/ILD services to its subscribers under the agent agreement with authorized DLD/ILD operators, reporting in revenues only a commission received from authorized DLD/ILD operators. Accordingly, new long-distance traffic routing rules had no impact on the revenues of the Traditional Segment in Moscow.

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Effective July 1, 2006, the Calling Party Pays rule (“the CPP rule”) was introduced in Russia, under which the subscribers are to pay for outgoing calls, and all incoming calls are free of charge. Accordingly, the Group started to charge its subscribers for calls to mobile operators; respective revenue for the years ended December 31, 2007 and 2006 totalled \$118.8 million and \$36.3 million, respectively.

Included in residential voice revenue of the Traditional Segment in Moscow for years ended December 31, 2007 and 2006 are approximately \$36.6 million and \$25.8 million of cash received as compensation from the federal budget of the discounts on installation and monthly fees to certain categories of residential subscribers, such as pensioners and military veterans, granted according to the applicable legislation prior to January 1, 2005 (see Note 2).

### 20. OPERATING EXPENSES, EXCLUDING DEPRECIATION AND AMORTIZATION AND STOCK-BASED COMPENSATION, NET

Operating expenses, excluding depreciation and amortization and stock-based compensation for the years ended December 31, 2007 and 2006 consisted of the following:

	<u>2007</u>	<u>2006</u>
Employee costs, net of stock-based compensation .....	\$ 353,810	\$ 280,766
Interconnection and line rental .....	175,631	104,237
Repairs and maintenance .....	70,757	72,251
Advertising, selling and marketing .....	48,675	35,664
Taxes other than income taxes .....	43,232	37,813
Utilities and energy .....	38,746	26,598
Rent .....	34,482	23,013
Security services .....	21,417	19,418
Bank charges .....	18,453	12,710
Consulting .....	16,327	14,733
Transportation .....	12,016	8,767
Cost of equipment sold .....	9,227	11,583
IT maintenance .....	7,854	5,942
Insurance .....	7,293	6,541
Bad debt expense .....	5,394	11,717
Compensation of losses from the third parties .....	(10,778)	(9,217)
Other operating expenses, net .....	<u>36,322</u>	<u>28,433</u>
<b>Total .....</b>	<b><u>\$ 888,858</u></b>	<b><u>\$ 690,969</u></b>

Included in interconnection and line rental expenses for the years ended December 31, 2007 and 2006 are approximately \$92.5 million and \$28.7 million of costs incurred by the Group in connection with introduction of the CPP Rule (see also Note 19).

During the years ended December 31, 2007 and 2006 MGTS has received in-kind compensation from the third parties for the cable and other fixed assets damaged in the course of construction works in Moscow in the amount of \$10.8 million and \$9.2 million, respectively, which have been capitalized in the cost of property, plant and equipment.

## COMSTAR UTS AND SUBSIDIARIES

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
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During the year ended December 31, 2006, MGTS sold a building renovated in cooperation with the co-investor for cash consideration of approximately \$22.9 million, which resulted in a gain of \$7.6 million included in other operating expenses.

### 21. INCOME TAXES

The Group's provision for income taxes for the years ended December 31, 2007 and 2006 was as follows:

	<b>Year ended December 31,</b>	
	<b>2007</b>	<b>2006</b>
Current income tax .....	\$ 107,634	\$ 73,075
Deferred income tax (benefit).....	10,734	(653)
<b>Total</b> .....	<b>\$ 118,368</b>	<b>\$ 72,422</b>

The provision for income taxes is different from that which would be obtained by applying the statutory income tax rate to net income before income tax, income from affiliates and minority interests. The items causing this difference are as follows:

	<b>Year ended December 31,</b>	
	<b>2007</b>	<b>2006</b>
Income tax charge computed on income before income taxes, income from affiliates and minority interests at standard rate applicable to the Group of 24% .....	\$ 66,609	\$ 52,049
Change in valuation allowance .....	(6,953)	(4,328)
Stock-based compensation (Note 25) .....	2,469	15,072
Decrease in deferred tax liability on property subject to registration.....	(10,018)	-
Change in fair value of derivative financial instruments (call and put option) (Note 15).....	35,006	14,400
Impairment of long-term investments (Note 11) .....	5,446	-
Foreign currency transactions differences, net .....	1,884	(14,481)
Non-deductible expenses and other, net .....	23,925	9,710
<b>Provision for income taxes</b> .....	<b>\$ 118,368</b>	<b>\$ 72,422</b>

In November 2007, management has taken a decision to register certain property with the state authorities. Such registration will enable the Group to make the depreciation of respective property tax deductible. As a result, the Group has decreased its deferred tax liabilities as of December 31, 2007 and provision for income taxes for the year then ended by \$10.0 million, which resulted in an increase in basic and diluted EPS for the year ended December 31, 2007 by USD 0.03.

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Temporary differences between the tax and accounting bases of assets and liabilities give rise to the following deferred tax assets and liabilities at December 31, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
<b>Deferred tax assets</b>		
Deferred connection fees .....	\$ 36,881	\$ 35,725
Property, plant and equipment contributions .....	27,067	24,910
Valuation of property, plant and equipment .....	27,005	30,781
Provision for doubtful accounts .....	824	469
Accrued operating expenses .....	13,290	9,435
Tax losses carry-forward .....	650	4,314
Other .....	11,754	15,731
Less: valuation allowance .....	<u>(26,183)</u>	<u>(25,816)</u>
<b>Total .....</b>	<b><u>91,288</u></b>	<b><u>95,549</u></b>
<b>Deferred tax liabilities</b>		
Property, plant and equipment .....	\$ (117,590)	\$ (93,320)
Assets recognized in purchase price allocations .....	(50,433)	(17,725)
Other .....	<u>(5,847)</u>	<u>(1,853)</u>
<b>Total .....</b>	<b><u>\$(173,870)</u></b>	<b><u>\$(112,898)</u></b>

Deferred tax assets relating to tax losses carried forward attributable to Comstar UTS in amount of \$0.7 million as of December 31, 2007 expire in 2016.

## 22. SEGMENT INFORMATION

Prior to 2007, the Group had reported its results by two business segments – the Traditional fixed line communications segment, comprised of MGTS and its subsidiaries, and the Alternative fixed line communications segment, comprised of all other entities of the Group. Following the Group’s reorganization at the end of 2006 and in the beginning of 2007, the Group operates in three business segments – Traditional segment in Moscow (comprised of MGTS and subsidiaries), Alternative segment in Moscow (comprised of Comstar UTS excluding regional branches, MTU-Inform, Telmos, Comstar-Direct, Golden Line, Contrast Telecom, Unitel, Porttelecom and Astelit) and Alternative segment in the regions and the CIS (comprised of all entities of the Group operating outside Moscow and the Moscow Region). The Group has presented its business segments consistent with the information used by the chief operating decision maker to manage the operations for purposes of making operating decisions and allocating resources. The Group’s management evaluates performance of the segments based on operating income and operating income before depreciation and amortization (“OIBDA”).

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An analysis and reconciliation of the Group's business segment information to the respective information in the financial statements and for the years ended December 31, 2007 and 2006 is as follows:

	<b>Year ended December 31, 2007</b>				
	<b>Traditional segment in Moscow</b>	<b>Alternative segment in Moscow</b>	<b>Alternative segment in the regions and the CIS</b>	<b>Elimina- tions and other</b>	<b>Total</b>
Operating revenues .. \$	1,112,486	\$ 452,503	\$ 127,715	\$ (130,319)	\$ 1,562,385
Depreciation and amortization .....	109,281	49,634	19,612	(620)	177,907
Operating income.....	438,639	29,743	20,581	(3,630)	485,333
OIBDA.....	547,920	79,377	40,193	(4,250)	663,240
Interest income.....	8,584	36,674	852	(30,430)	15,680
Interest expense .....	25,654	55,640	2,749	(30,430)	53,613
Income tax expense..	100,889	8,578	8,063	838	118,368
Change in fair value of derivative financial instruments .....	145,859	-	-	-	145,859
Impairment of long- term investments	5,860	16,831	-	-	22,691
Segment assets <sup>(a)</sup> .....	2,519,211	3,102,321	316,116	(1,307,311)	4,630,337
Cash and cash equivalents .....	93,624	72,799	13,371	-	179,794
Indebtedness <sup>(b)</sup> .....	227,781	879,935	29,092	(125,501)	1,011,307
Capital expenditures .....	246,191	86,110	13,128	-	345,429

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	Year ended December 31, 2006				
	Traditio- nal seg- ment in Moscow	Alternati- ve seg- ment in Moscow	Alternative segment in the regions and the CIS	Elimina- tions and other	Total
Operating revenues .....	\$ 801,225	\$ 388,421	\$ 39,235	\$ (108,634)	\$ 1,120,247
Depreciation and amortization .....	92,823	33,344	4,772	–	130,939
Operating income/(loss).	262,048	(20,853)	(701)	(4,955)	235,539
OIBDA.....	354,871	12,491	4,071	(4,955)	366,478
Interest income.....	6,312	38,160	145	(1,080)	43,537
Interest expense .....	16,073	6,612	540	(1,080)	22,145
Income tax expense.....	63,572	10,188	673	(2,011)	72,422
Change in fair value of derivative financial instruments .....	60,000	–	–	–	60,000
Segment assets <sup>(a)</sup> .....	2,063,257	2,728,253	62,197	(1,316,122)	3,537,585
Cash and cash equivalents .....	26,209	105,603	4,809	–	136,621
Indebtedness <sup>(b)</sup> .....	558,939	680,660	11,822	(408,481)	842,940
Capital expenditures .....	245,500	52,665	8,293	–	306,458

<sup>(a)</sup> – Included in “eliminations and other” are adjustments to eliminate investments of the Alternative segment in Moscow in other segments of the Group.

<sup>(b)</sup> – Represents the total of short-term and long-term debt and capital lease obligations.

The majority of the corporate costs are born by the Alternative segment in Moscow.

The reconciliation of segment OIBDA to the income before income tax, income from affiliates and minority interests for the years ended December 31, 2007 is as follows:

	Year ended December 31,	
	2007	2006
Total segment OIBDA.....	\$ 667,490	\$ 371,433
Inter-segment eliminations .....	(4,250)	(4,955)
OIBDA.....	663,240	366,478
Depreciation and amortization.....	(177,907)	(130,939)
Operating income.....	485,333	235,539
Interest income.....	15,680	43,537
Interest expense .....	(53,613)	(22,145)
Change in fair value of derivative financial instruments.....	(145,859)	(60,000)
Impairment of long-term investments.....	(22,691)	–
Foreign currency transactions gain/(loss), net .....	(4,528)	19,938
Gain from disposal of an affiliate .....	3,216	–
<b>Income before income tax, income from affiliates and minority interests .....</b>	<b>\$ 277,538</b>	<b>\$ 216,869</b>

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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For the years ended December 31, 2007 and 2006 the Group did not have revenues from transactions with a single external customer amounting to 10% or more of the Group's revenues.

#### 23. RELATED PARTY TRANSACTIONS

During the years ended December 31, 2007 and 2006, major transactions involving related parties were as follows:

##### Mobile Telesystems (MTS)

The Group has interconnection arrangements and line rental agreements with MTS, a subsidiary of Sistema. MTS also rents buildings for administrative, sales and marketing offices from the Group as well as premises for its switching and base station equipment, and pays Comstar UTS a fee for utilization of its numbering capacity by MTS' subscribers. Amounts received by the Group under these agreements during the years ended December 31, 2007 and 2006 were approximately \$63.1 million and \$45.9 million, respectively. Respective receivables as of December 31, 2007 and 2006 amounted to \$7.6 million and \$1.7 million, respectively.

In addition, during the years ended December 31, 2007 and 2006, the Group incurred costs, primarily interconnection, payable to MTS of approximately \$39.2 million and \$8.0 million, respectively. Respective payables as of December 31, 2007 and 2006 amounted to \$5.9 million and \$6.3 million, respectively.

##### Rosno

The Group purchases insurance services from Rosno, which had been a subsidiary of Sistema until February 2007. The insurance premiums paid to Rosno during the year ended December 31, 2006 amounted to \$6.9 million.

##### Sitronics

The Group purchases telecommunication equipment, software and consulting services from Sitronics, a subsidiary of Sistema. The cost of equipment, software and consulting services purchased from these entities during the years ended December 31, 2007 and 2006 was \$64.4 million and \$25.6 million, respectively. Related accounts payable as of December 31, 2007 and 2006 amounted to \$16.3 million and \$8.3 million, respectively. As of December 31, 2007, advances related to acquisition of equipment and software from Sitronics amounted to \$16.9 million.

##### MBRD

The Group has certain amounts of cash and cash equivalents and short-term investments in MBRD (see Notes 4 and 5). During the years ended December 31, 2007 and 2006, the Group has received interest income from MBRD of \$3.9 million and \$9.1 million, respectively.

##### Sistema Telecom, Sky Link

The Group provides financing in the form of loans and promissory notes to Sistema Telecom, a subsidiary of Sistema, and Sky Link, an affiliate of Sistema (see Notes 5 and 11). Interest income received by the Group on promissory notes of and loans to Sistema Telecom and Sky Link for the years ended December 31, 2007 and 2006 amounted to \$2.9 and \$1.7 million, respectively. In 2007, the Group recognized impairment of certain portion of loans receivable from Sky Link (see Note 11).

In addition, the Group provides interconnection and other services to Sky Link and subsidiaries. Respective revenues for the years ended December 31, 2007 and 2006 approximated \$9.8 million and

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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\$7.9 million, respectively. Related receivables as of December 31, 2007 and 2006 amounted to \$3.9 million and \$4.8 million, respectively.

#### RA Maxima

During the years ended December 31, 2007 and 2006 the Group purchased advertising from advertising agency RA Maxima, a subsidiary of Sistema, in the amounts of \$7.1 million and \$9.2 million, respectively.

#### InvestSvyazHolding

The Group entered into agreements with InvestSvyazHolding, a subsidiary of Sistema, for leasing of network equipment and billing systems, which have been recorded as capital leases as required by SFAS No. 13, "Accounting for Leases". The net book value of assets leased under the agreements with InvestSvyazHolding as of December 31, 2007 and 2006 was \$55.1 million and \$54.1 million, respectively. The interest rate implicit in the leases varies from 10% to 14%. Respective obligations are denominated in Euro.

The following table summarizes the future minimum lease payments under capital leases to InvestSvyazHolding together with the present value of the net minimum lease payments as of December 31, 2007:

Year ended December 31,		
2008 .....	\$	11,305
2009 .....		5,484
2010 .....		952
Total minimum lease payments (undiscounted) .....		<u>17,741</u>
Less: amount representing interest .....		<u>(1,374)</u>
Present value of net minimum lease payments .....		16,367
Less: current portion of lease obligations .....		<u>(10,231)</u>
<b>Non-current portion of lease obligations .....</b>	<b>\$</b>	<b><u><u>6,136</u></u></b>

#### Sistema Hals

As described in Note 24, MGTS entered into a series of agreements with Sistema Hals, a subsidiary of Sistema, on project development and reconstruction of buildings which house MGTS' automatic telephone exchanges. As of December 31, 2007 and December 31, 2006, as a result of the work performed by Sistema Hals under these contracts, MGTS recorded a liability of \$30.8 million and \$8.0 million, respectively, payable to Sistema Hals which was included in other long-term liabilities. In addition, as of December 31, 2007 and 2006, MGTS owed Sistema Hals \$0.6 million and \$0.4 million, respectively, for construction works performed.

In 2007, the Group provided Sistema Hals a loan (see Note 5). In addition, Sistema Hals guaranteed a loan provided by the Group to Remstroytrest, a subcontractor of Sistema Hals (see Note 5).

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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#### Svyazinvest and subsidiaries

Effective December 11, 2006, the Group owns 25% plus one share stake in Svyazinvest. Moreover, Svyazinvest owns approximately 28% voting shares in MGTS; accordingly, all transactions between MGTS and Svyazinvest are considered related party transactions. Entities of the Group enter in agent agreements with Rostelecom, a subsidiary of Svyazinvest, for provision of ILD/DLD services to the Group's subscribers and interconnection agreements with other subsidiaries of Svyazinvest. In December 2006 management recorded an allowance for receivable from Rostelecom in the amount of approximately \$5.5 million.

The Group's accounts payable to and accounts receivable from the subsidiaries of Svyazinvest as of December 31, 2007 amounted to \$7.5 million and \$16.0 million, respectively, including approximately \$5.0 million and \$14.2 million owed to and from Rostelecom, respectively. The Group's accounts payable to and accounts receivable from the subsidiaries of Svyazinvest as of December 31, 2006 amounted to \$2.2 million and \$12.2 million, respectively, including approximately \$1.0 million and \$11.2 million owed to and from Rostelecom, respectively.

MGTS' revenue from Rostelecom for the years ended December 31, 2007 and 2006, respectively, consisted of:

- (i) \$25.1 million and \$22.9 million earned under the agent agreement on provision of DLD/ILD services to MGTS' subscribers;
- (ii) \$2.7 million and \$2.5 million for rental of telecommunication equipment; and
- (iii) \$10.1 million and \$3.7 million, respectively, for interconnection and other services.

In addition, during the years ended December 31, 2007 and 2006, MGTS purchased services, including interconnection, from Rostelecom for the amounts of \$17.4 million and \$11.8 million, respectively.

During the years ended December 31, 2007 and 2006, in connection with new regulations on telecommunications which came in effect in 2006, MGTS' revenue from Central Telegraph, a subsidiary of Svyazinvest, for incoming traffic amounted to \$14.6 million and \$12.0 million, respectively, and MGTS' costs associated with outgoing traffic amounted to \$4.9 million and \$3.8 million, respectively.

Revenues and expenses of the Group from other transactions with Svyazinvest subsidiaries, primarily interconnection, in 2007 amounted to \$15.6 million and \$17.9 million, respectively.

In 2007, the Group paid dividends to Svyazinvest totaling \$7.6 million, and received dividends from Svyazinvest of \$1.9 million.

#### Mezhregion Tranzit Telecom

The Group entered into a series of agreements with Mezhregion Tranzit Telecom (MTT), an affiliate of Sistema, under which MTT provides DLD/ILD services to the Group's subscribers for a commission (see Note 19), which amounted to approximately \$36.4 million and \$4.6 million for the years ended December 31, 2007 and 2006, respectively. In addition, the Group's interconnection costs incurred under the agreements with MTT in 2007 and 2006 totalled approximately \$35.8 million and \$15.1 million, respectively.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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#### *Sistema Mass Media*

In 2007, Comstar-Direct has sold substantially all TV content and certain property, plant and equipment to Sistema Mass Media (SMM) for \$14.8 million (exclusive of VAT). Respective gains totalling \$2.7 million were included in accompanying consolidated statement of operations. As of December 31, 2007, SMM has not settled the Group's receivables under this transaction, which amounted to \$17.4 million (including VAT) and were included in other receivables and prepaid expenses (see Note 7).

## 24. COMMITMENTS AND CONTINGENCIES

#### *Capital Commitments*

In December 2003, MGTS announced its long-term investment program for the period from 2004 to 2012, providing for extensive capital expenditures, including expansion and full digitalization of the Moscow telephone network. The program was approved by the resolution of the Moscow City Government on December 16, 2003. At the inception of the investment program, capital expenditures were estimated to be approximately \$1,600.0 million and included reconstruction of 350 local telephone stations and installation of 4.3 million of new phone lines. As a result of implementation of the investment program, new digital equipment will be installed in the buildings housing the telephone nodes, and a substantial amount of floor space will become available after the replacement of analogue switching equipment. The additional free floor space after reconstruction is expected to be sold to third parties or rented out. There are 113 automatic telephone station buildings which are to be reconstructed or rebuilt in the course of the investment program. Currently, the management had not made a decision whether to sell the free floor space created in the course of the investment program or to rent it out.

In November 2006, MGTS signed an agreement with the Moscow City Government, under which MGTS' investment program was approved. Under the agreement, the Moscow City Government is entitled to receive not less than 30% of the market value of additional floor space constructed during the course of the investment program. The obligation arises at the time the reconstruction of specified properties is completed. In December 2003, MGTS made a prepayment to Moscow City Government under this program which will be offset against the future liability arising as a result of the investment program (see Note 11).

In the course of implementation of the investment program, MGTS entered into a series of agreements with Sistema Hals, a subsidiary of Sistema, related to project development and reconstruction of buildings housing the telephone stations. The main portion of the work under these contracts will be performed between 2008 and 2012. Under the agreements, Sistema Hals will prepare the project documentation and perform construction works on behalf of MGTS, and MGTS will reimburse all the expenses incurred in relation to the construction process with a margin of 4.75% on such expenses and will pay a fixed fee of \$0.04 million per one building. During 2007 and 2006, project development and site preparation works were performed by Sistema Hals on 98 sites, which resulted in \$17.6 million and \$6.8 million addition to construction in-progress in 2007 and 2006, respectively, and recognition of payable to Sistema Hals (see Note 23). No construction or other works were performed in relation to the other sites in 2006, as the business plans are still under development.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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In addition, MGTS has entered into joint venture agreements with ten project organizations affiliated with Sistema Hals. MGTS intends to engage these organizations in construction and reconstruction of certain sites and grant them the investor's rights to receive their share of property in new or reconstructed property.

#### *Licenses*

Substantially all of the Group's revenues are derived from operations conducted pursuant to licenses granted by the Russian Government. Most of these licenses expire in various years ranging from 2008 to 2017. The management has no reason to believe that the licenses will not be renewed or that any license will be suspended or terminated.

#### *Issued Guarantees*

MGTS is a guarantor under several credit facilities between Commerzbank (Eurasia) and InvestSvyazHolding, a subsidiary of Sistema. The credit facilities mature in 2008. The guarantees amounted to \$14.5 million as of December 31, 2007.

In 2006, MGTS became a guarantor under a credit facility provided to InvestSvyazHolding by Komerční banka, a.s., Prague. The credit line for the total amount of Euro 10.4 million matures in April 2011. MGTS' guarantee amounted to \$18.5 million as of December 31, 2007.

In 2006, MGTS became a guarantor under a credit facility provided to MBRD, a subsidiary of Sistema, by Bankgesellschaft Berlin AG, Berlin. The credit line for the total amount of Euro 2.1 million matures in June 2011. MGTS' guarantee amounted to \$2.2 million as of December 31, 2007.

Under these guarantees the Group could be potentially liable for a maximum amount of \$35.2 million in case of borrowers' default under the obligations. As of December 31, 2007, no event of default has occurred under any of the guarantees issued by the Group. The Group does not recognize a liability at inception for the fair value of the guarantor's obligation, as provisions of FIN No. 45 do not apply to the guarantees issued between corporations under common control.

#### *Operating Environment*

The Russian economy, while deemed to be of market status starting from 2002, continues to display certain traits consistent with that of an emerging market. These characteristics have in the past included higher than normal inflation, insufficient liquidity of the capital markets, and the existence of currency controls which cause the national currency to be illiquid outside of Russia. The continued success and stability of the Russian economy depends on the government's actions with regard to legal and economic reforms.

#### *Interest of the Moscow City Government in the Telecommunications Sector in the Moscow Metropolitan Area*

The operations of the telecommunications network in Moscow are of considerable interest to the city government. The city government has exercised and may be expected to continue to exercise influence over the Group's operations. In particular, the city government may influence setting of tariffs charged to customers to protect low income groups, such as pensioners.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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#### *Taxation Environment*

Russia currently has a number of laws related to various taxes imposed by both federal and regional governmental authorities. Applicable taxes include value added tax ("VAT"), corporate income tax and payroll (social) taxes, together with others. Laws related to these taxes have not been in force for significant periods, in contrast to more developed market economies; therefore, the government's implementation of these regulations is often inconsistent or nonexistent. Accordingly, few precedents with regard to tax rulings have been established. Tax declarations, together with other legal compliance areas (for example, customs and currency control matters), are subject to review and investigation by a number of authorities, which are enabled by law to impose extremely severe fines, penalties and interest charges. These facts create tax risks in Russia that are more significant than typically found in countries with more developed tax systems.

Generally, tax declarations remain open and subject to tax audits for a period of three years following the tax year. Tax declarations of Comstar UTS for 2005 were examined by the tax audit; tax declarations of Comstar UTS for 2006 and 2007 and of the other Group companies for 2005-2007 remain open for the audits.

Management believes that the Company is in compliance with the tax laws affecting its operations; however, the risk remains that governmental authorities could take differing positions with regard to interpretative issues.

Certain MGTS agreements with operators connected on the analogue segment of the network do not provide for per-minute settlements based on actual volumes of traffic as prescribed by changes in the legislation effective from July 1, 2006 due to lack of technical ability to execute per-minute settlements. Tax authorities may assess additional taxes on such agreements in the amount that cannot be estimated reliably. Any such assessment may be significant to the financial statements, however, management believes that they can sustain their position in the court.

#### *Legal Disputes*

In May 2007, certain minority shareholder won the case against MGTS in respect of non-payment of dividend on preferred shares for 2005 (see Note 18) in the court of first instance, which determined such decision of MGTS' general shareholders' meeting in respect of dividends for 2005 null and void. Such dividend, if declared and paid, may amount to 879.0 million Rubles (approximately \$35.8 million as of December 31, 2007). In February 2008, appeals to the court of the third instance ruled in favor of MGTS. Management believes that the likelihood of ruling against MGTS in case of appeal by the minority shareholders to the Supreme Arbitration Court is remote.

In the ordinary course of business, the Group is subjected to various proceedings, lawsuits, and other claims. While such matters are subject to many uncertainties, and outcomes are not predictable with assurance, management believes that any financial impact arising from these matters would not be material to the Group's financial position or annual operating results.

## COMSTAR UTS AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006 (Amounts in thousands of US dollars, unless otherwise stated)

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#### 25. STOCK-BASED COMPENSATION AND SHARE BUY-BACK

On September 15, 2006, the Extraordinary General Meeting of shareholders approved the stock option and stock bonus program (“the Program”) for the Board of Directors and senior management of Comstar UTS. The Program is being implemented based on separate decisions of the Board of Directors. In order to fund the Program, on September 25, 2006 the Board of Directors of Comstar UTS approved the share buyback of up to 4.5% of the total number of shares in the form of GDRs to be completed by the end of 2009.

During the year ended December 31, 2006, Comstar UTS acquired 10,746,761 shares in form of GDRs, or 2.6% of its total issued shares, for a total cash consideration of approximately \$73.9 million.

Within the framework of the Program, and in accordance with a separate decision of the Board of Directors, on November 15, 2006, Comstar UTS granted stock bonuses in the form of shares (GDRs) for the total of 8,776,757 (2.1% of total issued shares) to Mr. Schebetov, the Chairman of the Board of Directors, who received 2,507,645 shares in the forms of GDRs (0.6% of total issued shares), and Mr. Lagutin, a member of the Board of Directors, who received 6,269,112 shares in the form of GDRs (1.5% of total issued shares). Fair value of the awards as of the grant date approximated \$17.8 million and \$44.4 million, respectively.

In November 2006, the Company’s Board of Directors approved the grant of stock options to certain members of the Board of Directors and senior management of Comstar UTS. The exercise price for these options is 122.3 Rubles per one GDR (approximately USD 4.6 as of the grant date). These stock options vest in November 2008.

The following assumptions were used in the option-pricing model:

Risk-free interest rate.....	4.82%
Expected option life (years).....	2
Expected dividend yield .....	Nil
Expected volatility .....	38.1%
Grant date fair value of options (per share) .....	USD 3.16

Expected volatilities were based on historical volatility of the Company’s GDRs.

The following table summarizes information about non-vested common stock options during the year ended December 31, 2006:

	<u>Quantity</u>	<u>Exercise price, Rubles</u>
Non-vested as of January 1, 2006.....	–	–
Granted .....	3,343,525	122.3
Vested .....	–	–
Forfeited.....	–	–
Non-vested as of December 31, 2006.....	<u>3,343,525</u>	<u>122.3</u>

## COMSTAR UTS AND SUBSIDIARIES

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006**  
*(Amounts in thousands of US dollars, unless otherwise stated)*

The following table summarizes information about non-vested common stock options during the year ended December 31, 2007:

	<u>Quantity</u>	<u>Exercise price, Rubles</u>
Non-vested as of January 1, 2007 .....	3,343,525	122.3
Granted .....	—	—
Vested .....	—	—
Forfeited.....	<u>(940,366)</u>	<u>122.3</u>
Non-vested as of December 31, 2007 .....	<u>2,403,159</u>	<u>122.3</u>

During the year ended December 31, 2007, certain options have been forfeited, as employment of certain members of management and the Board of Directors has been terminated. Accordingly, \$0.1 million of costs under the cancelled options recorded during the year ended December 31, 2006 has been reversed in the accompanying consolidated statement of operations for the year ended December 31, 2007.

In connection with introduction of a repurchase feature of the option program (see Note 26), as of December 31, 2007 the Group re-classified the option program as liability (see Note 12), which resulted in a decrease in net income and basic and diluted earnings per share for the year ended December 31, 2007 by \$6.2 million, USD 0.02 and USD 0.02, respectively. The following assumptions were used in the option-pricing model as of December 31, 2007:

Risk-free interest rate.....	3.34%
Expected option life (months) .....	11
Expected dividend yield .....	Nil
Expected volatility .....	37.7%
Fair value of options (per share) as of December 31, 2007 .....	USD 7.76

The costs recognized in accordance with stock option plan for the years ended December 31, 2007 and 2006 approximated \$10.3 million and \$0.7 million, respectively. Total expected future compensation cost related to non-vested awards not yet recognized as of December 31, 2007 amounted to \$7.7 million. This cost will be recognized in 2008.

Intrinsic value of the employee stock options as of December 31, 2007 and 2006 was USD 7.6 and USD 3.8, respectively. Management expects that some of the option holders will use the repurchase feature. The source of shares for the rest of the holders will be the treasury stock.

## COMSTAR UTS AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
FOR THE YEARS ENDED DECEMBER 31, 2007 and 2006  
(Amounts in thousands of US dollars, unless otherwise stated)

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### 26. SUBSEQUENT EVENTS

#### *Abolishment of the Compensational Surcharge*

Effective January 2008, new agreements with Rostelecom was signed, under which compensational surcharge which in 2007 was included in the fees charged to Rostelecom for DLD/ILD calls made by MGTS subscribers and amounted to RUR 0.37 (approximately USD 0.02) per minute was cancelled. Compensational surcharge received by MGTS from Rostelecom in 2007 approximated \$13.1 million.

#### *Modification of Employee Stock Option Plan*

In March 2008, the Board of Directors of Comstar UTS has granted the participants of the existing employee stock option plan (see Note 25) the right to sell the GDRs purchased by the participants at the exercise of the options back to the Group at a price equal to an average price of one GDR for the 60 calendar days preceding the date of exercise weighted by trading volumes of Comstar UTS GDRs on the London Stock Exchange.

#### *Employee Phantom Option Program*

In March 2008, the Board of Directors of Comstar UTS approved the employee phantom option program, under which the Group's top and middle management were granted 12,965,882 phantom options effective April 1, 2008. In addition, 2,140,000 phantom options may be granted during the two years ending March 31, 2010. The phantom options vest on March 31, 2010. Upon vesting, the participants will be entitled to cash compensation equal to the difference between weighted average price of one GDR for the 60 calendar days preceding March 31, 2010 and April 1, 2008, respectively, timed by the number of phantom options granted. The compensation will be adjusted downwards should the return on Comstar UTS GDR be less than prescribed amount, and will not paid at all if the Group does not meet the benchmarks set for return on Comstar UTS GDR, revenue growth rate, OIBDA margin and market share.

#### *Legal Merger of Golden Line*

In April 2008, in line with the Group reorganization plan, Golden Line, a 100% subsidiary of the Group, has been legally merged into Comstar UTS.

#### *Repurchase of MGTS ruble bonds*

In April 2008, in accordance with the terms and conditions of the offer to the bondholders (see Note 13), MGTS has repurchased the ruble bonds for the total of 556.1 million rubles (equivalent of \$22.7 million as of December 31, 2007).