

# **OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES**

**Independent Auditors' Report**

**Consolidated Financial Statements**  
Years Ended December 31, 2008 and 2007

# OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

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## INDEPENDENT AUDITORS' REPORT

To the Shareholders of OJSC "Moscow City Telephone Network":

We have audited the accompanying consolidated balance sheets of OJSC "Moscow City Telephone Network" and its subsidiaries ("the Group") as of December 31, 2008 and 2007 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 presented fairly, in all material respects, the financial position of the Group as of December 31, 2008 and 2007, 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 9 to the financial statements, the Group has determined that its investment in the shares of OJSC "Telecommunication Investment Company" ("Svyazinvest"), amounted to \$382 million as of December 31, 2008 is not other than temporarily impaired. In the absence of readily ascertainable market information related to the fair value of the investment in Svyazinvest, management reached its conclusion based on the use of estimates incorporating various unobservable market inputs as discussed in Note 9. Because of the uncertainty inherent in such analysis, the value the Group could realize had a disposal of this investment been made between a willing buyer and seller may differ materially from its carrying amount.



April 24, 2009

# OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2008 AND 2007

(thousands of US dollars ("USD"), except for share amounts)

	2008	2007
<b>Assets</b>		
Current assets:		
Cash and cash equivalents (Note 4)	\$ 8,559	\$ 93,624
Short-term investments and loans (Note 5)	44,071	111,675
Accounts receivable, advances and taxes receivable, net (Note 6)	150,830	150,095
Inventories and spare parts	16,558	20,529
Deferred income taxes, net (Note 17)	6,208	18,835
Restricted cash	-	2,447
Total current assets	<u>226,226</u>	<u>397,205</u>
Non-current assets		
Property, plant and equipment, net (Note 7)	1,406,272	1,510,067
Advance payments for property, plant and equipment	2,069	19,781
Intangible assets, net (Note 8)	30,676	40,328
Long-term investments and loans (Note 9)	459,696	471,102
Long-term trade and other receivables (Note 10)	17,479	20,855
Total non-current assets	<u>1,916,192</u>	<u>2,062,133</u>
<b>Total assets</b>	<b><u>\$ 2,142,418</u></b>	<b><u>\$ 2,459,338</u></b>
<b>Liabilities and shareholders' equity</b>		
Current liabilities:		
Short-term debt (Note 11)	\$ 281,778	\$ 111,183
Accounts payable, taxes payable and accrued liabilities (Note 12)	136,911	100,857
Deferred revenue, current portion (Note 13)	39,423	50,580
Derivative financial instrument (Note 15)	-	88,000
Total current liabilities	<u>458,112</u>	<u>350,620</u>
Non-current liabilities		
Long-term debt (Note 11)	161,695	116,598
Deferred revenue (Note 13)	80,713	108,268
Retirement and post-retirement benefits (Note 14)	29,250	35,817
Property, plant and equipment contributions (Note 16)	101,326	123,209
Deferred income taxes, net (Note 17)	47,921	43,913
Payable to Sistema Hals, related party (Notes 2,23)	36,807	30,815
Other long-term liabilities	433	-
Total non-current liabilities	<u>458,145</u>	<u>458,620</u>
<b>Total liabilities</b>	<b><u>\$ 916,257</u></b>	<b><u>\$ 809,240</u></b>
Commitments and contingencies (Note 24)		
Shareholders' equity:		
Preferred stock, 15,965,850 shares authorized, issued and outstanding (Note 18)	\$ 22,538	\$ 22,538
Common stock, 79,829,200 shares authorized, issued and outstanding (Note 18)	112,462	112,462
Shares of Comstar UTS (Note 9), at cost (57,742,500 and 11,510,500 shares as of December 31, 2008 and 2007, respectively)	(381,277)	(34,537)
Additional paid-in capital	477,498	477,498
Retained earnings	1,104,638	903,148
Accumulated other comprehensive (loss)/income	(109,698)	168,989
Total shareholders' equity	<u>1,226,161</u>	<u>1,650,098</u>
<b>Total liabilities and shareholders' equity</b>	<b><u>\$ 2,142,418</u></b>	<b><u>\$ 2,459,338</u></b>

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

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (thousands of USD, except for share and per share amounts)

	<u>2008</u>	<u>2007</u>
Operating revenues (Note 19)	\$ 1,139,422	\$ 1,112,486
Operating expenses, net (Note 20)	<u>(750,415)</u>	<u>(681,423)</u>
<b>Operating income</b>	<b><u>389,007</u></b>	<b><u>431,063</u></b>
Interest and dividend income	18,603	9,703
Interest expense, net of amounts capitalized	(4,773)	(25,654)
Change in fair value of a derivative financial instrument (Note 15)	(27,940)	(145,859)
Impairment of long-term investments (Note 9)	(49)	(5,860)
Foreign currency transactions (loss)/gain, net	<u>(24,971)</u>	<u>18,170</u>
<b>Income before income tax expense and income from investments</b>	<b><u>349,877</u></b>	<b><u>281,563</u></b>
Income tax expense (Note 17)	<u>(100,553)</u>	<u>(103,303)</u>
<b>Net income</b>	<b>\$ <u><u>249,324</u></u></b>	<b>\$ <u><u>178,260</u></u></b>
Other comprehensive (loss)/income:		
Unrecognized actuarial income/(losses), net of income tax of \$nil	1,625	(16,308)
Translation adjustment	(280,312)	80,170
<b>Comprehensive (loss)/income</b>	<b>\$ <u><u>(29,363)</u></u></b>	<b>\$ <u><u>242,122</u></u></b>
Earnings per share ("EPS") (Note 22)		
Weighted average number of common shares outstanding	79,829,200	79,829,200
Earnings per common share – basic and diluted	<u>\$ 2.60</u>	<u>\$ 1.86</u>

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

# OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (thousands of USD, unless otherwise stated)

	<u>2008</u>	<u>2007</u>
<b>Cash flows from operating activities:</b>		
Net income	\$ 249,324	\$ 178,260
Adjustments to reconcile net income to net cash provided by operating activities:		
Bad debt expense	674	1,168
Depreciation and amortization	128,073	120,179
Foreign currency transactions gain/(loss) on non-operating activities, net	24,971	(18,170)
Stock-based compensation (Note 21)	559	207
Deferred taxes (Note 17)	23,930	17,403
Post-retirement benefits (Note 14)	860	7,572
Loss on disposal of property, plant and equipment, net	4,841	2,961
Impairment of long-term investments	49	5,860
Inventories' obsolescence charge	-	2,386
Change in fair value of a derivative financial instrument (Note 15)	27,940	145,859
In-kind compensation from third parties (Note 20)	(10,679)	(10,778)
Changes in operating assets and liabilities:		
Accounts receivable, advances and taxes receivable	(29,694)	(38,682)
Inventories and spare parts	700	(2,783)
Accounts payable, taxes payable and accrued liabilities	31,371	25,332
Deferred revenue	(14,865)	(17,373)
<b>Net cash provided by operating activities</b>	<b><u>438,054</u></b>	<b><u>419,401</u></b>
<b>Cash flows from investing activities:</b>		
Purchases of property, plant and equipment	(221,383)	(220,433)
Purchases of intangible assets	(10,956)	(16,719)
Proceeds from sale of property, plant and equipment	1,119	1,784
Purchases of short-term investments and disbursement of loans (Note 5)	(115,125)	(132,440)
Proceeds from sale of short-term investments and repayment of loans (Note 5)	175,295	84,415
Purchases of long-term investments and disbursement of loans (Note 9)	(68,030)	(6,100)
Decrease in restricted cash	2,357	1,561
<b>Net cash used in investing activities</b>	<b><u>(236,723)</u></b>	<b><u>(287,932)</u></b>

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED) FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (thousands of USD, unless otherwise stated)

	2008	2007
<b>Cash flows from financing activities:</b>		
Cash payments and proceeds from the exercise of put and call option (Note 15)	\$ (100,000)	\$ 322,237
Proceeds from the borrowings (Note 11)	177,410	-
Principal payments of borrowings (Note 11)	(292,644)	(325,874)
Principal payments on capital leases	(10,225)	(14,492)
Dividends paid	(48,049)	(51,674)
<b>Net cash used in financing activities</b>	<b>(273,508)</b>	<b>(69,803)</b>
Effects of foreign currency translation on cash and cash equivalents	(12,888)	5,749
<b>Net (decrease)/increase in cash and cash equivalents</b>	<b>(85,065)</b>	<b>67,415</b>
Cash and cash equivalents, beginning of the year	93,624	26,209
Cash and cash equivalents, end of the year	\$ 8,559	\$ 93,624
<b>Supplemental cash flows information:</b>		
Income taxes paid	\$ 77,741	\$ 80,228
Cash paid for interest, net of amounts capitalized	\$ -	\$ 18,298
<b>Non-cash investing and financing activities:</b>		
Property, plant and equipment contributions (Note 16)	\$ 2,939	\$ 6,299
Cost of construction incurred in transactions with Sistema Hals, a related party (Note 2)	\$ 13,077	\$ 17,621
Debt issued in the course of exercise of the put option (Note 15)	\$ 363,552	\$ -

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

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

(thousands of USD, except for share and per share amounts)

	Preferred stock		Common stock		Shares of Comstar UTS	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Total
	Shares	Amount	Shares	Amount					
<b>Balances at January 1, 2007</b>	<b>15,965,850</b>	<b>\$ 22,538</b>	<b>79,829,200</b>	<b>\$ 112,462</b>	<b>(173,441)</b>	<b>\$ 61,889</b>	<b>\$ 778,061</b>	<b>\$ 105,127</b>	<b>\$ 906,636</b>
Effect of adoption of FIN 48 (Note 3)	-	-	-	-	-	-	(1,481)	-	(1,481)
Net income	-	-	-	-	-	-	178,260	-	178,260
Translation adjustment, net of tax of \$nil	-	-	-	-	-	-	-	80,170	80,170
Unrecognized actuarial loss, net of tax of \$nil (Note 14)	-	-	-	-	-	-	-	(16,308)	(16,308)
Stock-based compensation granted by Comstar UTS to MGTS' employees, (Note 21)	-	-	-	-	-	207	-	-	207
Exercise of the call option (Note 15)	-	-	-	-	138,904	415,402	-	-	554,306
Dividends declared on preferred shares	-	-	-	-	-	-	(24,614)	-	(24,614)
Dividends declared on common shares	-	-	-	-	-	-	(27,078)	-	(27,078)
<b>Balances at December 31, 2007</b>	<b>15,965,850</b>	<b>\$ 22,538</b>	<b>79,829,200</b>	<b>\$ 112,462</b>	<b>(34,537)</b>	<b>\$ 477,498</b>	<b>\$ 903,148</b>	<b>\$ 168,989</b>	<b>\$ 1,650,098</b>
Net income	-	-	-	-	-	-	249,324	-	249,324
Translation adjustment, net of tax of \$nil	-	-	-	-	-	-	-	(280,312)	(280,312)
Unrecognized actuarial gain, net of tax of \$nil (Note 14)	-	-	-	-	-	-	-	1,625	1,625
Acquisition of shares of Comstar UTS (Note 15)	-	-	-	-	(346,740)	-	-	-	(346,740)
Dividends declared on preferred shares	-	-	-	-	-	-	(31,885)	-	(31,885)
Dividends declared on common shares	-	-	-	-	-	-	(15,949)	-	(15,949)
<b>Balances at December 31, 2008</b>	<b>15,965,850</b>	<b>\$ 22,538</b>	<b>79,829,200</b>	<b>\$ 112,462</b>	<b>(381,277)</b>	<b>\$ 477,498</b>	<b>\$ 1,104,638</b>	<b>\$ (109,698)</b>	<b>\$ 1,226,161</b>

Dividends declared in 2008 for the year ended December 31, 2007 were U.S. dollars 2.00 and 0.20 per preferred and common share, respectively. Dividends declared in 2007 for the year ended December 31, 2006 were U.S. dollars 1.62 and 0.36 per preferred and common share, respectively.

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

# OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

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### 1. DESCRIPTION OF THE BUSINESS

OJSC “Moscow City Telephone Network” (“MGTS”) and its subsidiaries (collectively, “the Group”) operates one of the largest metropolitan communication networks in the world. Founded in 1882 and nationalized in 1917, MGTS was privatized and became an open joint-stock company in 1994. MGTS provides telecommunication services to residential subscribers, state-financed institutions and businesses within the city of Moscow.

In November 2005, JSFC “Sistema” (“Sistema”), the Group’s ultimate controlling shareholder, performed corporate restructuring to consolidate its fixed line communications businesses under OJSC “Comstar-United TeleSystems” (“Comstar UTS”), the Group’s immediate parent effective November 2005. Upon completion of the restructuring, Comstar UTS owned 55.6% of MGTS’ common shares and MGTS owned 20.7% of Comstar UTS’ common shares.

Shares of Comstar UTS owned by the Group are accounted for as treasury stock and are recorded at cost of acquisition.

The principal activities of the Group’s major wholly-owned subsidiaries as of December 31, 2008 are as follows:

<b>Operating Entities</b>	<b>Short Name</b>	<b>Principal activity</b>
CJSC “AMT”	AMT	Fixed line and wireless telecommunication services to medium and small businesses
CJSC “Petrodvor”	Petrodvor	Providing rent and other services to the entities of the Group and Comstar UTS
MGTS Finance S.A.	MGTS Finance	Holding the Group’s shares in JSC Svyazinvest

### Operating Environment

During late 2008, major economies around the world experienced volatile capital and credit markets. A number of major global financial institutions have either been placed into bankruptcy, taken over by other financial institutions and/or supported by government funding. This has resulted in a significant worldwide economic downturn. The ongoing financial crisis has resulted in capital markets instability, significant deterioration of liquidity and tighter credit conditions within Russia. While the Russian Government has introduced a range of stabilization measures aimed at providing liquidity and supporting refinancing of foreign debt for Russian banks and companies, there continues to be uncertainty regarding the economy, general business conditions, access to capital and the marginal cost of such capital for the Group and its counterparties and as well as consumer purchase patterns, which could affect the Group’s financial position, results of operations and business prospects.

To date, the Group’s operations have not been directly impacted by the economic downturn and credit tightening.

# OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

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### Working Capital Deficit

As of December 31, 2008, the Group had a working capital deficit (i.e. excess of current liabilities, including nonmonetary, over current assets, including nonmonetary) of \$231.9 million, which was primarily attributable to \$263.6 million outstanding under the note payable to Access to fund the put option exercise (see Note 15). During 2009, management expects to finance this deficit using the Group's operating cash flows and by obtaining long-term borrowings from Comstar UTS and its subsidiaries and, to the extent necessary, third-party borrowings. In addition, capital expenditures, such as acquisition of property, plant and equipment or expenditures related to the upgrades or expansion of the Group's network, can be deferred to meet short-term liquidity requirements. Accordingly, management believes that cash flows from operating and financing activities, together with reductions in spending it is able to make, will be sufficient for the Group to meet its obligations as they become due.

## 2. INVESTMENT PROGRAM

In December 2003, the Group 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 a resolution of the Moscow City Government on December 16, 2003. At the inception of the investment program, capital expenditures were estimated to be approximately \$1.6 billion and included reconstruction of approximately 350 local telephone stations and installation of approximately 4.3 million of new phone lines numbers. As a result of the investment program, new digital equipment continues to be installed at telephone nodes buildings, and a substantial amount of floor space will become available after the replacement of analogue switching equipment. As a result of the investment program, additional floor space, constructed is expected to be sold to third parties or rented out. Currently MGTS is evaluating future uses of each of the building subject to the investment program. There are 113 automatic telephone station buildings which are to be reconstructed or rebuilt in the course of the implementation of the investment program.

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 reconstruction of each property is completed. In December 2005, MGTS made a prepayment of 275 million Russian Rubles ("RUB") to the Moscow City Government (\$9.4 million as of December 31, 2008) under this program which will be offset against the future liability arising as a result of the investment program (Note 10).

In the course of implementation of the investment program, MGTS entered into a series of agreements with a related party 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 2009 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 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 building. During 2008 and 2007 project development and site preparation works were started by Sistema Hals on 98 sites, which resulted in \$11.0 million and \$17.6 million additions to construction in-progress in 2008 and 2007, respectively, and recognition of a payable to Sistema Hals (see Note 23). No construction or other works were performed in relation to the other sites in 2008, as the business plans are still under development (see Note 25).

# OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

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### 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND RECENT ACCOUNTING PRONOUNCEMENTS

**Basis of Presentation** – The accompanying consolidated financial statements have been prepared in conformity with the accounting principles generally accepted in the United States of America (“U.S. GAAP”). The Group’s entities, except MGTS Finance, maintain accounting records in RUB in accordance with the requirements of Russian accounting legislation. MGTS Finance maintains accounting records in accordance with legislation of Luxembourg. The accompanying financial statements differ from the financial statements prepared for statutory purposes in the Russian Federation (the “RF”) or Luxembourg in that they reflect certain adjustments, appropriate to present the financial position, results of operations and cash flows in accordance with U.S. GAAP.

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 consolidated financial statements for the years ended December 31, 2008 and 2007 include the accounts of MGTS and its wholly-owned subsidiaries – AMT, Petrodvor and MGTS Finance. All significant intercompany transactions, balances and unrealized gains and losses have been eliminated.

**Use of Estimates** – The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses for the period. Actual results could differ from these 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, analysis of investments and loans for impairment, estimates used in actuarial valuation of the liability under defined benefit pension plan and valuation allowances on deferred taxes.

**Concentration of Business Risk** – The Group’s major business activities are within the RF. Laws and regulations affecting businesses operating in the RF are subject to rapid changes, which could impact the Group’s assets and operations.

**Foreign Currency Translation Methodology** – The primary financial statements of the entities of the Group are prepared and presented in the currency of the primary economic environment, in which each entity operates, i.e. its functional currency.

Management determined that the functional currency of all the Group entities is the Russian Ruble, except for MGTS Finance, whose functional currency was the U.S. Dollar (“USD”) until June 30, 2007. The Group selected USD as its reporting currency and translates functional currency financial statements of its entities into USD. 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, expenses and items in the statement of cash flows are translated by applying the actual exchange rates to underlying transactions or approximations to these rates. The resulting translation adjustment is recorded as a separate component of other comprehensive income in the accompanying consolidated statement of changes in shareholders’ equity.

Effective June 30, 2007, MGTS Finance changed its functional currency from USD to RUB. The change resulted in approximately \$6.9 million of the translation adjustment gain recorded in

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

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the statement of changes in shareholders' equity as part of other comprehensive income as of the date of the change.

The official rate of exchange, as set by the Central Bank of the RF ("CBR"), between the RUB and the USD at December 31, 2008 was 29.38 RUB to 1 USD (December 31, 2007: 24.55).

The translation of RUB-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 local telephone and data transmission services and services to operators which primarily consist of:

- (i) Usage charges;
- (ii) Monthly subscription fee;
- (iii) Agent fees for initiation of domestic and international long-distance calls;
- (iv) Service activation and installation fees;
- (v) Charges for value-added telecommunication services;
- (vi) Interconnection fees from other telecommunications operators; and
- (vii) Lease income from operating leases.

The Group records revenues, net of Value Added Taxes, in the periods they are earned as follows:

- (i) Revenues derived from local telephone usage and data transmission are recognized as the services are provided;
- (ii) Monthly telephone service fees are recognized in the month during which the telephone services are provided to customers;
- (iii) Domestic and international long-distance ("DLD/ILD") services are provided to the Group's subscribers by licensed long distance operators – OJSC "Rostelecom" ("Rostelecom"), a subsidiary of Telecommunication Investment Joint Stock Company ("Svyazinvest"), and OJSC "Mezhregionalny Tranzit Telecom" ("MTT"), an affiliate of Sistema. Fees received from these operators for calls initiated by MGTS subscribers are recorded in the period earned on a net basis;
- (iv) Upfront fees received for activation and installation of wireline and data transmission services are deferred and recognized over the expected customer relationship period. According to management estimates, the customer relationship period for wireline voice phone subscribers is 15 years for residential customers and 5 years for all other categories of subscribers;
- (v) Revenues derived from value-added telecommunication services are recognized when the services are provided to customers;
- (vi) Interconnection fees from other telecommunications operators are recognized when the services are provided to the operators; and
- (vii) Lease income from operating leases is recognized over the term of the lease.

Local telephone services and services provided to other operators, such as traffic charges, connection fees and line rental services are regulated tariff services, and changes in rate structure are subject to approval of Federal Tariff's Service ("FTS"). In 2008 and 2007, approximately 68% and 75%, respectively, of the Group's revenues were generated from regulated tariff services.

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

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Historically, the Group has entered into interconnect agreements, under which the Group provides services to, and receives services from, other operators for a fixed annual fee, regardless of the volume of the outgoing or incoming traffic. Revenues and expenses under these agreements were recognized in the amount of the net fixed fee receivable or payable by the Group.

Following the introduction of the new interconnect rules, 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 amount of revenue receivable by the Group and expenses are recorded as charges payable by the Group.

**Contributions from the RF Budget** – 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 RF budget for these discounts. Due to the lack of certainty of reimbursement, MGTS did not recognize any revenues related to these amounts until such amounts were collected. During the year ended December 31, 2007, MGTS recorded \$36.6 million as revenues, related to amounts received from the RF budget for the periods prior to January 1, 2005. As of December 31, 2008, MGTS' claims to the federal budget in respect of aforementioned reimbursements were fully satisfied.

In accordance with the new 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.

**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.

**Short-Term Investments and Loans** – Short-term investments and loans represent investments in promissory notes, loans and time deposits and other investments which 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.

The estimated fair value of such financial instruments as of December 31, 2008 approximated their carrying value due to the short-term nature of the investment.

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

**Value-Added Taxes ("VAT")** – 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.

**Fair Value of Financial Instruments** – Financial instruments carried on the balance sheet include cash and bank balances, receivables, investments and loans, accounts payable, capital lease obligations, debt and written options granted in connection with the acquisition of Svyazinvest shares (Note 15). The particular recognition methods adopted are disclosed in the individual policy statements associated with each item.

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

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**Accounts Receivable** – Accounts receivable are stated at their net realizable value after deducting an allowance for doubtful accounts. Such allowance reflects either specific cases of delinquency or defaults 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.

**Inventories and Spare Parts** – Inventories and spare parts comprise cables, spare parts, telephones, accessories and other inventory and are stated at the lower of cost calculated using the weighted average method or market value. 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.

**Property, Plant and Equipment** – Property, plant and equipment is stated at cost less accumulated depreciation.

The Group 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 items which are contributed to the Group free of charge are capitalized at their fair value at the date of transfer and deferred revenue is recorded and amortized to the consolidated statement of operations over the contributed assets' lives.

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 determination of net income.

Property, plant and equipment is depreciated on a straight-line basis over the following estimated useful lives:

	<u>Years</u>
Buildings and site improvements	44-47
Switches and transmission devices <sup>1</sup>	10-31
Other fixed assets	3-21

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

Property, plant and equipment held and used by the Group is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of assets may have been impaired. Management is not aware of any indicators of impairment relating to the Group's investments in property, plant and equipment as of December 31, 2008 and 2007.

**Intangible Assets** – Intangible assets comprise mostly billing systems and other software and are stated at acquisition cost. Amortization is computed on a straight-line basis over their estimated useful lives, which is generally five years.

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<sup>1</sup> Analogue switching equipment of MGTS, depreciation of which has been accelerated to reflect the anticipated disposal of such equipment is depreciated over remaining useful lives ranging from 1 to 4 years.

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

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**Stock-Based Compensation** – The Group accounts for stock-based compensation in accordance with the provisions of SFAS No. 123R (revised 2004), “Share-Based Payment” (“SFAS 123R”). Under SFAS 123R, the Group calculates and records the cost of equity instruments, such as stock options or restricted stock, awarded to employees for services received in the statement of operations. The cost of the equity-based awards is measured based on the fair value of the instruments using a Black-Scholes option pricing model or Monte-Carlo simulation model, whichever is more appropriate, and is recognized on a straight-line basis over the vesting period of the award. Stock-based compensation expense includes the estimated effects of forfeitures. Such estimates are adjusted over the requisite service period to the extent actual forfeitures differ, or are expected to differ from such estimates. Changes in estimated forfeitures are recognized in the period of change and also impact the amount of expense to be recognized in future periods.

**Asset Retirement Obligations** – In accordance with SFAS No. 143, “Accounting for Asset Retirement Obligations” (“SFAS 143”), the Group calculates an asset retirement obligation and an associated asset retirement cost when the Group has a legal constructive obligation in connection with the retirement of tangible long-lived assets. The Group’s obligations under SFAS 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 2008, the estimated asset retirement obligations were not significant to the Group’s consolidated financial position and results of operations.

**Long-Term Investments and Loans** – 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 (see also Note 9).

The Group does not discount promissory notes of and loans granted to related parties, interest rates on which are different from market rates. Accordingly, the fair value of such notes and loans may be different from their carrying value.

**Lease Accounting** – 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.

**Impairment of Long-Lived Assets** – The Group 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 Group 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.

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, 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 includes current service costs and amortization of prior service costs. The expense is recognized during an employee’s years of active service with the Group (see Note 14). The recognition of expense for retirement pension plans is significantly impacted by estimates made by management such as discount rates used to value certain liabilities, expected return on assets, future rates of compensation increase and other related assumptions. 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).

The plan is managed by a related party “Sistema” Pension Fund, a subsidiary of Sistema.

**Distributions to Shareholders** – Dividends are recognized at the date they are declared. Distributable retained earnings of the Group are based on amounts extracted from the statutory accounts of MGTS and may differ from amounts calculated on the basis of U.S. GAAP (see Note 18).

**Derivative Financial Instrument (Call and Put Option)** – The derivatives were initially recognized at fair values at the date the contracts were entered into. A derivative with a positive fair value is recognized as a financial asset whereas a derivative with a negative fair value is recognized as a financial liability. Such financial assets and liabilities are remeasured to their fair values at each balance sheet date. The resulting gain or loss is recognized in net income immediately.

The Group accounts for the call and put option granted in connection with acquisition of 7.7% stake in Svyazinvest (see Note 15) in accordance with SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities”, as amended (“SFAS 133”) and SFAS No. 150, “Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity”.

**Debt** – Debt issued by the Group is initially recorded based on proceeds received and is subsequently measured at amortized cost. Fair values of corporate bonds issued by MGTS are disclosed in Note 11. As of December 31, 2008, the fair value of other fixed rate debt, including capital lease obligations, and variable rate debt approximated carrying value.

**Income Taxes** – Income taxes have been computed in accordance with the laws of the country of incorporation of respective companies included in the Group. In 2008 and 2007, general statutory income tax rate in the RF equals to 24%; effective January 1, 2009 income tax rate in Russia has been reduced to 20%. Income tax rate on dividends paid within Russia was 9% in 2007, and can be reduced to nil% effective January 1, 2008 subject to certain restrictions.

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 using enacted tax rates in effect for the year in which the difference is expected to reverse. 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.

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

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On January 1, 2007, the Group adopted the provisions of the FASB Interpretation No. 48 (“FIN 48”), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109. FIN 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 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 48 resulted in the cumulative effect adjustment to decrease the retained earnings as of January 1, 2007 by approximately \$1.5 million.

**Borrowing Costs** – The Group capitalizes interest on borrowings during the active construction period of major capital projects. Capitalized interest is added to the cost of the qualifying assets and is amortized over the useful lives of the assets. For the years ended December 31, 2008 and 2007, capitalized borrowing costs amounted to \$15.4 million and \$15.7 million, respectively. 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. Other borrowing costs are recognized as an expense in the period in which they were incurred.

**Earnings Per Share** – Earnings per share is computed using the two-class method. Net income available to common shareholders is divided by the weighted average number of common shares outstanding during the year. Net income available to common shareholders is determined by reducing net income by the income attributable to the holders of preferred shares. As the Group had not issued any dilutive instruments, basic earnings per share are equal to diluted earnings per share.

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

**Segment Information** – SFAS No. 131, “Disclosures about Segments of an Enterprise and Related Information” (“SFAS 131”), established standards for reporting information about operating segments in financial statements. Operating segments are defined as components of an enterprise engaging in business activities about which separate financial information is available that is evaluated regularly by the chief operating decision maker or group in deciding how to allocate resources and in assessing performance.

The Group is organized in a single segment as the dominant majority of the Group’s revenue is derived from the provision of traditional fixed-line telecommunication services in the Moscow metropolitan area. The chief operating decision maker of the Group evaluates the performance of the Group based on consolidated financial information.

**Comparative Information** – Certain prior year amounts and disclosures have been reclassified to conform to the 2008 presentation, including (i) reclassification of certain operating expenses; (ii) separate presentation of old age pensions and other benefits; (iii) presentation of line items within deferred tax assets and liabilities categories; (iv) presentation of related parties disclosure.

**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 was effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The adoption of SFAS No. 157 had no material effect on the Group’s financial statements.

## **OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)**

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SFAS No. 157 also establishes a hierarchy that classifies the inputs used to measure fair value.

This hierarchy prioritizes the use of inputs to the valuation techniques into three levels based on observable and unobservable inputs. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Group. Unobservable inputs, which require more judgment, are those inputs described above that reflect management's assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into the three levels based on the reliability of inputs.

During the years ended December 31, 2008 and 2007 the only Group's assets and liabilities which were measured at fair value on a recurring basis were comprised of a derivative financial instruments (see Note 15). This instrument is measured using significant unobservable inputs (i.e., "level 3" inputs in the SFAS No. 157 hierarchy). Reconciliations of the beginning and closing balances of the derivative financial instrument for the years ended December 31, 2008 and 2007 are presented in Note 15.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS No. 159") – 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. 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 the adoption had no impact on the Group's financial statements.

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 Group's financial statements.

In April 2008, the FASB issued FASB Staff Position ("FSP") No. FAS 142-3, "Determination of the Useful Life of Intangible Assets" ("FSP No. 142-3"). FSP No. 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142. The objective of FSP No. 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141R and other U.S. GAAP. FSP No. 142-3 applies to all intangible assets, whether acquired in a business combination or otherwise, and is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years and should be applied prospectively to intangible assets acquired after the effective date. Early adoption is prohibited. The Group expects FSP No. 142-3 will have an impact on its accounting for future acquisitions of intangible assets once adopted, but the effect is dependent upon the acquisitions that are made in the future.

In December 2008, the FASB issued FASB Staff Position ("FSP") 132(R)-1, "Employers' Disclosure about Postretirement Benefit Plan Assets." This FSP provides guidance on an employer's disclosures regarding plan assets of a defined benefit pension or other postretirement plan. The objectives of the disclosures required under this FSP are to provide users of financial statements with an understanding

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

of (a) how investment allocation decisions are made; (b) the major categories of plan assets; (c) the inputs and valuation techniques used to measure the fair value of plan assets; (d) the effect of fair value measurements using significant unobservable inputs on changes in plan assets for the period; and (e) significant concentrations of risk within plan assets. The disclosures about plan assets required by this FSP are required for fiscal years ending after December 15, 2009, and earlier application is permitted. This FSP is not expected to have a material impact on the Group's financial statements, other than enhanced disclosures about the Group's pension plan assets.

#### 4. CASH AND CASH EQUIVALENTS

Cash and cash equivalents as of December 31, 2008 and 2007 consisted of the following:

	<u>2008</u>	<u>2007</u>
Cash in RUB	\$ 6,246	\$ 25,321
Cash in USD	2,296	505
Cash in other currencies	5	2,576
Cash equivalents	12	65,222
<b>Total</b>	<b>\$ <u>8,559</u></b>	<b>\$ <u>93,624</u></b>

Cash and cash equivalents held by the Group with a related party Moscow Bank for Reconstruction and Development ("MBRD"), a subsidiary of Sistema, as of December 31, 2008 and 2007 amounted to \$3.9 million and \$51.6 million, respectively.

#### 5. SHORT-TERM INVESTMENTS AND LOANS

Short-term investments as of December 31, 2008 and 2007 consisted of the following:

	<u>Interest rate as at December 31, 2008</u>	<u>2008</u>	<u>2007</u>
Related parties (Note 23)			
RUB-denominated promissory notes of Delfa, an affiliate of Sistema	18%	\$ 27,229	\$ -
RUB-denominated loan to Sistema Hals	11%	16,688	19,975
RUB-denominated note receivable from MBRD		-	16,943
RUB-denominated loans receivable from RemstroyTrest-701		-	34,629
RUB-denominated notes receivable of Zenith bank		-	14,666
RUB-denominated notes receivable of Transcreditbank		-	14,666
RUB-denominated notes receivable of Eurofinance Mosnarbank		-	10,185
Other notes receivable		154	611
<b>Total</b>		<b>\$ <u>44,071</u></b>	<b>\$ <u>111,675</u></b>

In November 2007, the Group provided a RUB 490.3 million (equivalent of \$16.7 million as of December 31, 2008) loan to Sistema Hals, a subsidiary of Sistema. The loan bears interest at 11% per annum and matures in December 2009. Effective January 1, 2009 interest rate on the loan was increased to 16% per annum.

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

In November 2007, the Group provided an RUB 850 million (equivalent of \$34.6 million as of December 31, 2007) loan to Remstroytrest – 701, an affiliate of Sistema. The loan bore interest at 10.0% per annum and was repaid in September 2008.

In December 2008, the Group purchased promissory notes of Delfa, an affiliate of Sistema, for the total amount of RUB 800.0 million (approximately \$27.2 million as of December 31, 2008). The notes, together with accrued interest, were redeemed in January 2009.

#### 6. ACCOUNTS RECEIVABLE, ADVANCES AND TAXES RECEIVABLE, NET

Accounts receivable, advances and taxes receivable as of December 31, 2008 and 2007 consisted of the following:

	<u>2008</u>	<u>2007</u>
Accounts receivable from related parties (Note 23)	\$ 64,675	\$ 48,109
Accounts receivable from individuals	40,988	49,219
Accounts receivable from legal entities, net of accounts receivable from related parties	33,857	37,506
Miscellaneous taxes receivable	7,904	7,283
Other receivables and advances	4,533	9,803
VAT recoverable	4,241	10,301
Less: allowance for doubtful accounts	(5,368)	(12,126)
<b>Total</b>	<b>\$ <u>150,830</u></b>	<b>\$ <u>150,095</u></b>

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

Property, plant and equipment as of December 31, 2008 and 2007 consisted of the following:

	<u>2008</u>	<u>2007</u>
Buildings and site improvements	\$ 354,340	\$ 375,973
Switches and transmission devices	1,448,952	1,371,212
Other fixed assets	205,275	245,131
Construction in-progress	84,643	251,636
Property, plant and equipment, at cost	2,093,210	2,243,952
Less: Accumulated depreciation	(686,938)	(733,885)
<b>Property, plant and equipment, net</b>	<b>\$ <u>1,406,272</u></b>	<b>\$ <u>1,510,067</u></b>

Depreciation expense for the years ended December 31, 2008 and 2007, net of amortization of property, plant and equipment contributions (see Note 16) and including depreciation of assets under capital lease (see Note 11), amounted to \$113.7 million and \$108.2 million, respectively.

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

#### 8. INTANGIBLE ASSETS, NET

Intangible assets as of December 31, 2008 and 2007 consisted of the following:

	Weighted average amortization period, years	2008			2007		
		Gross carrying value	Accu- mulated amortization	Net carrying value	Gross carrying value	Accu- mulated amortization	Net carrying value
Billing and other IT systems	5	\$ 71,238	\$ (42,137)	\$ 29,101	\$ 76,160	\$ (36,478)	\$ 39,682
Other intangible assets	5	3,377	(1,802)	1,575	2,377	(1,731)	646
<b>Total intangible assets</b>		<b>\$ 74,615</b>	<b>\$ (43,939)</b>	<b>\$ 30,676</b>	<b>\$ 78,537</b>	<b>\$ (38,209)</b>	<b>\$ 40,328</b>

Amortization expense recorded on intangible assets for the years ended December 31, 2008 and 2007 amounted to \$14.4 million and \$12.0 million, respectively. Other intangible assets include software and capitalized fees paid to other operators for the connection to their networks. Based on the intangible assets existing at December 31, 2008, the estimated amortization expense for each of the succeeding years is as follows:

#### Year ended December 31

2009	\$	11,119
2010		9,287
2011		6,533
2012		2,822
2013		915
<b>Total</b>	<b>\$</b>	<b>30,676</b>

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

#### 9. LONG-TERM INVESTMENTS AND LOANS

Long-term investments as of December 31, 2008 and 2007 consisted of the following:

	2008		2007	
	Ownership, %	Carrying value	Ownership, %	Carrying value
Svyazinvest, a related party (Note 23)	7.7%	\$ 381,913	7.7%	\$ 457,128
USD-denominated loan to Comstar One Limited, a subsidiary of Comstar UTS (Note 23)		35,000		-
RUB-denominated loan to Ruslan TV, a subsidiary of Sistema, (Note 23)		30,633		-
Other investees, at cost	Various	6,840	Various	7,484
RUB-denominated loan to Intellect-Telecom, a subsidiary of Sistema (Note 23)		5,310		6,355
Other long-term investments		-		135
<b>Total</b>		<b>\$ 459,696</b>		<b>\$ 471,102</b>

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

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In December 2006, the Group acquired a 7.7% stake in Svyazinvest from Mustcom Limited for a total cash consideration of \$400 million and together with a call and put option (see below) the fair value of which was determined to be \$90.0 million at the date of acquisition. In a series of transactions, Comstar UTS and MGTS Finance have acquired 4,879,584,306 ordinary shares of Svyazinvest representing 25% stake plus one share, with Comstar UTS buying 3,378,173,750 shares, or 17.3% of total outstanding shares of Svyazinvest, and MGTS Finance buying 1,501,410,556 shares, or 7.7% of total outstanding shares of Svyazinvest. The Group's investment in Svyazinvest shares is pledged as a collateral for a Sberbank credit facility of Comstar UTS.

Simultaneously with the acquisition of the 7.7% stake in Svyazinvest, MGTS Finance and "2711 Centerville Cooperatief U.A." ("2711 UA"), an affiliate of Mustcom Limited, signed a call and put option agreement, which gave 2711 UA a right to purchase and sell 46,232,000 shares of Comstar UTS, representing 11.06% of total outstanding shares of Comstar UTS, from MGTS Finance (Note 15). Comstar UTS' share in the fair value of the call and put option at the grant date amounting to \$62.3 million was accounted for as a reduction of retained earnings in the consolidated statement of changes in shareholders' equity for the year ended December 31, 2006.

Given the economic downturn in Russia and the global economy and the volatility in the markets described in Note 1, management determined that as of December 31, 2008 there were potential indicators of impairment of the Group's investment in Svyazinvest. As management does not have access to underlying financial data of Svyazinvest, it does not believe it is able to accurately determine the fair value of the investment. In order to assess the investment for a potential impairment, the Group aggregated market value of Svyazinvest's holdings in its publicly traded subsidiaries which totaled \$253.6 million (RUB 7,450.8 million) at December 31, 2008 and \$314.7 million (RUB 10,630.5 million) at April 24, 2009. These amounts exclude the value of Svyazinvest's non-public holdings, as well as any control premium or the effect of bringing the assets together under Svyazinvest. In addition, management has reviewed relevant publicly available information relating to Svyazinvest, including Svyazinvest and its subsidiaries' news releases, analyst reports and share price data for its publicly-traded subsidiaries. On the basis of this information and the significant increase in value of the public entities subsequent to December 31, 2008, management has determined that its investment is not other than temporarily impaired.

Management continues to consider various options with respect to the Group's stake in Svyazinvest, including but not limited to sale or non-monetary exchange of the stake. Accordingly, there remains an uncertainty as to how the value of Svyazinvest stake will be realized by the Group. Future events, additional information regarding the fair value of the investment or a disposal transaction involving Svyazinvest investment could result in recognition of impairment of the carrying value of the Group's investment in Svyazinvest in future periods.

In 2007 management has recorded an impairment loss on the loan granted to P-Com, an affiliate of Sistema, in the amount of \$4.5 million. In addition, for the year ended December 31, 2007 the Group recorded an impairment loss on other loans to investees in the amount of \$1.4 million.

In July 2007 the Group provided a RUB 156.0 million loan (equivalent to \$5.3 million as of December 31, 2008) to a related party Intellect-Telecom, a subsidiary of Sistema (see also Note 23). The loan bears interest at 7.0% per annum and is repayable in 2012.

In August 2008 the Group granted a \$35.0 million loan to Comstar One Ltd., a subsidiary of Comstar UTS (see also Note 23). The loan bears interest at 8.7% per annum and is repayable in 2011.

In December 2008 the Group granted a RUB 900.0 million loan (equivalent to \$30.6 million as of December 31, 2008) to a related party Ruslan TV, a subsidiary of Sistema (see also Note 23). The loan bears interest at 11.3% per annum and is repayable in 2010.

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

#### 10. LONG-TERM TRADE AND OTHER RECEIVABLES

In connection with the long-term program of digitalization of MGTS' network and planned renovation of certain MGTS' buildings (see Note 2), during the fourth quarter of 2005 MGTS has made a RUB 275 million (\$9.4 million as of December 31, 2008) 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.

Long-term trade receivables as of December 31, 2008 and 2007 include \$1.5 million and \$5.0 million, respectively, due from Comstar UTS (see also Note 23). The amount is not interest-bearing and will be repaid in equal quarterly installments in 2010.

Long-term trade receivables as of December 31, 2008 include \$1.0 million due from Intellect-Telecom (see also Note 23). The amount is not interest-bearing and will be repaid in equal quarterly installments in 2010-2013.

In addition, long-term other receivables include a balance of input VAT related to addition to construction in-progress from Sistema Hals (see Note 2) and amounted to \$5.6 million and \$4.7 million as of December 31, 2008 and 2007, respectively.

#### 11. DEBT OBLIGATIONS

Debt obligations as of December 31, 2008 and 2007 consisted of the following:

	Currency	Annual interest rate (actual at December 31, 2008)	2008	2007
Bonds 5 <sup>th</sup> issue	RUB	7.1%	\$ 5,202	\$ 59,903
Bonds 4 <sup>th</sup> issue	RUB	7.1%	5,232	29,337
<b>Total corporate bonds</b>			<b>10,434</b>	<b>89,240</b>
Loans from related parties:				
CTS	RUB	10.0%	34,036	-
Ruslan TV	RUB	11.3%	30,633	-
Strategiya	RUB	10.0%	26,327	-
Antel Metrocom Ltd.	USD	8.7%	22,500	-
RTC	RUB	10.0%	17,018	-
Inter-TV Media	RUB	10.0%	14,745	-
Comstar One Ltd.	USD	8.7%	9,200	-
MBRD	EUR	5.7%	1,502	2,182
Comstar UTS	USD		-	101,000
Access Telecommunications				
Cooperatief U.A.	USD	16.0%	263,552	-
VTB	EUR	6.7%	7,614	18,984
Other	Various		-	8
Long-term portion of capital leases	EUR		896	6,136
Short-term portion of capital leases	EUR		5,016	10,231
<b>Total debt</b>			<b>443,473</b>	<b>227,781</b>
Less amounts maturing within one year			(281,778)	(111,183)
<b>Long-term debt</b>			<b>\$ 161,695</b>	<b>\$ 116,598</b>

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

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**Corporate Bonds** – In April 2004, MGTS issued 5-year RUB-denominated bonds (fourth issue) with the face value of RUB 1,500 million (equivalent to \$51.1 million as of December 31, 2008). The bonds carried a coupon of 10.0% per annum, which was decreased to 7.1% per annum in April 2006. Interest is paid semi-annually. MGTS made unconditional offers to repurchase the bonds at par value in April 2006, 2007, and 2008 which were exercised in the amounts of approximately \$30.1 million, \$0.2 million, and \$24.1 million, respectively.

In May 2005, MGTS issued 5-year RUB-denominated bonds (fifth issue) with a face value of RUB 1,500 million (equivalent to \$51.1 million as of December 31, 2008). 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 2009, at which date the interest rate will be re-set at management discretion. Interest is paid semi-annually. In June 2006 and in May 2008, the Group repurchased the bonds at par value for the amount of \$0.6 million and \$55.5 million, respectively.

MGTS has an unconditional outstanding offer to repurchase the fourth and the fifth issues of the bonds at par in April and May 2009, respectively. Accordingly, both issues are classified as current liabilities in the accompanying consolidated balance sheet as of December 31, 2008.

As of December 31, 2008, the aggregate fair value of the bonds was approximately \$11.3 million.

**Comstar UTS** – In December 2006, to finance the acquisition of 7.7% stake in Svyazinvest, MGTS Finance issued USD denominated notes payable of \$401.0 million which bore an interest of 7.5% per annum to Comstar UTS. In August 2008 the amount was fully repaid. Interest amounted to \$4.6 million and \$29.3 million for 2008 and 2007, respectively.

**Access Telecommunications Cooperatief U.A.** – In November 2008, MGTS Finance issued Access Telecommunications Cooperatief U.A. (“Access”) a \$363.6 million USD-denominated promissory note as part payment of its obligation under the put option (see Note 15). Of this amount, \$100.0 million was repaid in December 2008, and remaining \$263.6 million is repayable in the first quarter of 2009 in monthly installments. The note bears interest at 16% per annum and is guaranteed by Sistema and Comstar UTS, which liabilities are limited to \$230.0 million and \$69.0 million, respectively. Interest is paid monthly. As of December 31, 2008, Comstar UTS shares acquired during exercise of the put option are pledged to secure this liability. The pledge was terminated in January 2009. As of the date of these financial statements, the Group has fully repaid the amounts due to Access.

**Related party balances** – In August 2008, the Group entered into several RUB-denominated loan agreements with certain subsidiaries of Comstar UTS for a total amount of RUB 2,707 million (equivalent of \$92.0 million as of December 31, 2008). These loans mature in 2011 and bear interest at 10% per annum, payable on maturity.

In December 2008, MGTS entered into a loan agreements with Ruslan TV, an affiliate of Sistema, for RUB 900.0 million (equivalent of \$30.6 million as of December 31, 2008). Interest on the loan is payable annually at 11.3% per annum. The loan matures in 2010.

In December 2008, MGTS entered into USD-denominated loan agreements with Antel Metrocom Ltd. and Comstar One Ltd., subsidiaries of Comstar UTS, for \$22.5 million and \$9.2 million, respectively. The loans bear interest at 8.7% per annum which is payable at maturity. The loans mature in 2010.

Interest accrued on loans from related parties during the year ended December 31, 2008 totaled \$8.7 million.

**VTB** – In January 2006, MGTS entered into a credit agreement with VTB (formerly known as Vneshtorgbank) for an amount of EUR 7.7 million (equivalent of \$10.9 million as of December 31, 2008)

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

to finance acquisition of equipment. The loan matures in January 2012 and bears interest at Euribor+3.75% (equivalent of 6.70% as of December 31, 2008) per annum. Interest is paid semi-annually. As of December 31, 2008, the amount outstanding under the agreement was \$7.6 million.

In March 2005, MGTS entered into a credit agreement with VTB for an amount of EUR 5.2 million (equivalent of \$7.6 million as of December 31, 2007) to finance purchase of equipment. The loan had to mature in September 2010 with implied interest at Euribor+5.0% per annum. In 2008, MGTS fully repaid the loan ahead of schedule.

In July 2004, MGTS entered into two credit agreements with VTB for a total amount of EUR 7.3 million (equivalent of \$10.7 million as of December 31, 2007) to finance purchase of equipment. In 2008 MGTS fully repaid these loans ahead of the schedule.

**MBRD** – In July 2006, MGTS entered into a loan agreement with MBRD for an amount of EUR 2.1 million (equivalent of \$3.0 million as of December 31, 2008) to finance purchase of equipment. The loan is repayable in equal semi-annual installments in 2008-2011 and bears interest at Euribor+2.75% per annum (equivalent of 5.70% per annum as of December 31, 2008). As of December 31, 2008, the amount outstanding under the agreement was \$1.5 million. Interest is paid semi-annually.

The debt obligations as of December 31, 2008 have the following maturities:

2009	\$	281,778
2010		66,005
2011		94,602
2012		1,088
<b>Total</b>	<b>\$</b>	<b><u>443,473</u></b>

**Capital Leases** – During 2001-2006 MGTS entered into several lease agreements for telecommunications equipment. The agreements expire in 2006-2010 and assume transfer of ownership for equipment to MGTS after the last lease payment is made. Interest expense on capital leases for the years ended December 31, 2008 and 2007 amounted to \$1.1 million and \$2.3 million, respectively. The interest rate implicit in the leases varies from 10% to 14%. Respective obligations are denominated in Euro. In addition to the agreements with InvestSvyazHolding, the Group has certain other leasing agreements with third parties; assets capitalized under these agreements and respective liabilities are not material.

The following is a summary of leased assets and respective depreciation as of December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Gross book value of leased assets	\$ 69,282	\$ 82,926
Accumulated depreciation	(22,874)	(20,318)
Net book value of leased assets	<b><u>\$ 46,408</u></b>	<b><u>\$ 62,608</u></b>

Depreciation of the assets recorded under capital leases is included in depreciation and amortization in the accompanying consolidated statements of operations and comprehensive income.

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

The following table presents future minimum lease payments under finance leases together with the present value of the net minimum lease payments as of December 31, 2008:

Payments due in the year ended December 31,		
2009	\$	5,284
2010		917
		_____
Total minimum lease payments (undiscounted)	\$	6,201
Less: amount representing interest		(289)
		_____
Present value of minimum lease payments	\$	5,912
Less: current portion of lease obligations		(5,016)
		_____
<b>Non-current portion of lease obligations</b>	<b>\$</b>	<b>896</b>
		_____

### 12. ACCOUNTS PAYABLE, TAXES PAYABLE AND ACCRUED LIABILITIES

Accounts payable, taxes payable and accrued liabilities as of December 31, 2008 and 2007 consisted of the following:

	2008	2007
Accounts payable to related parties (Note 23)	\$ 49,035	\$ 37,125
Accounts payable for PP&E	28,331	3,929
Accrued payroll	18,970	27,192
Taxes payable	18,147	16,287
Trade accounts payable to third parties	16,827	10,124
Interest payable to third parties	1,751	918
Other current liabilities	3,850	5,282
<b>Total</b>	<b>\$ 136,911</b>	<b>\$ 100,857</b>
	_____	_____

### 13. DEFERRED REVENUE

Deferred revenue as of December 31, 2008 and 2007 consisted of the following:

	2008	2007
<b>Short-term portion</b>		
Deferred connection fees	\$ 24,190	\$ 33,422
Advances from customers	15,233	17,158
<b>Total</b>	<b>\$ 39,423</b>	<b>\$ 50,580</b>
	_____	_____
<b>Long-term portion</b>		
Deferred connection fees	\$ 80,713	\$ 108,268
<b>Total</b>	<b>\$ 80,713</b>	<b>\$ 108,268</b>
	_____	_____

# OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

### 14. RETIREMENT AND POST-RETIREMENT BENEFITS

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, 2008, there were 10,853 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:

	2008	2007
Discount rate	9.00% p.a.	6.50% p.a.
Expected return on plan assets	10.62% p.a.	7.11% p.a.
Projected salary growth	10.24% p.a.	9.20% p.a.
Discount rate used for annuity contracts calculation	7.00% p.a.	7.00% p.a.
Rate at which pension payments are assumed to be indexed	0.00% p.a.	0.00% p.a.
Long-term inflation	6.00% p.a.	5.00% p.a.
Staff turnover (for ages below 50)	10.00% p.a.	10.00% p.a.

The change in the projected benefit obligation and the change in plan assets for the years ended December 31, 2008 and 2007 are presented in the following table:

	2008			2007		
	Old age pension	Other benefits	Total	Old age pension	Other benefits	Total
<b>Change in projected benefit obligation</b>						
Projected benefit obligation, beginning of the year	\$ 17,381	\$ 20,909	\$ 38,290	\$ 7,236	\$ 8,706	\$ 15,942
Service cost	807	794	1,601	706	850	1,556
Interest cost	1,102	1,083	2,185	440	530	970
Plan amendments losses/(gains)	66	1,844	1,910	(746)	-	(746)
Actuarial (gains)/losses	(2,355)	265	(2,090)	10,404	7,751	18,155
Benefit payments	-	(5,701)	(5,701)	-	(1,395)	(1,395)
Settlement and curtailment gain	(2,689)	-	(2,689)	(1,574)	(1,102)	(2,676)
Termination benefits	-	2,102	2,102	-	4,471	4,471
Foreign currency translation effect	(2,388)	(3,499)	(5,887)	915	1,098	2,013
<b>Projected benefit obligation, end of the year</b>	<b>11,924</b>	<b>17,797</b>	<b>29,721</b>	<b>17,381</b>	<b>20,909</b>	<b>38,290</b>
<b>Change in fair value of plan asset</b>						
Fair value of plan assets, beginning of the year	2,473	-	2,473	5,760	-	5,760
Actual return on plan assets	187	-	187	103	-	103
Employer contributions	604	5,701	6,305	1,365	1,395	2,760
Benefits paid	-	(5,701)	(5,701)	-	(1,395)	(1,395)
Settlement	(2,689)	-	(2,689)	(1,575)	-	(1,575)
Foreign currency translation effect	(104)	-	(104)	270	-	270
Other	-	-	-	(3,450)	-	(3,450)
<b>Fair value of plan assets, end of the year</b>	<b>471</b>	<b>-</b>	<b>471</b>	<b>2,473</b>	<b>-</b>	<b>2,473</b>
<b>Unfunded status of the plan, end of the year, net</b>	<b>\$ (11,453)</b>	<b>\$ (17,797)</b>	<b>\$ (29,250)</b>	<b>\$ (14,908)</b>	<b>\$ (20,909)</b>	<b>\$ (35,817)</b>

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

Reconciliations of the unfunded status of the plan for the years ended December 31, 2008 and 2007 are as follows:

	2008			2007		
	Old age pension	Other benefits	Total	Old age pension	Other benefits	Total
Unfunded status of the plan, beginning of the year	\$ 14,908	\$ 20,909	\$ 35,817	\$ 1,476	\$ 8,706	\$ 10,182
Net periodic benefit cost	2,570	4,576	7,146	1,043	5,851	6,894
Contributions made	(604)	(5,701)	(6,305)	(1,365)	(1,395)	(2,760)
(Credit)/charge to other comprehensive income, net	(3,137)	1,512	(1,625)	9,659	6,649	16,308
Foreign currency translation effect	(2,284)	(3,499)	(5,783)	645	1,098	1,743
Other	-	-	-	3,450	-	3,450
<b>Unfunded status of the plan, end of the year</b>	<b>\$ 11,453</b>	<b>\$ 17,797</b>	<b>\$ 29,250</b>	<b>\$ 14,908</b>	<b>\$ 20,909</b>	<b>\$ 35,817</b>

The components of the net periodic benefit costs for the years ended December 31, 2008 and 2007 are as follows:

	2008			2007		
	Old age pension	Other benefits	Total	Old age pension	Other benefits	Total
Service cost	\$ 807	\$ 794	\$ 1,601	\$ 706	\$ 850	\$ 1,556
Interest cost	1,102	1,083	2,185	440	530	970
Return on assets	(187)	-	(187)	(103)	-	(103)
Termination benefits in connection with established staff reduction program	-	2,102	2,102	-	4,471	4,471
Net actuarial loss recognized in a year	933	597	1,530	-	-	-
Amortization of prior service cost	(85)	-	(85)	-	-	-
<b>Net periodic pension expense</b>	<b>\$ 2,570</b>	<b>\$ 4,576</b>	<b>\$ 7,146</b>	<b>\$ 1,043</b>	<b>\$ 5,851</b>	<b>\$ 6,894</b>

Amounts recognized in other comprehensive income for the years ended December 31, 2008 and 2007 are as follows:

	2008			2007		
	Old age pension	Other benefits	Total	Old age pension	Other benefits	Total
Unrecognized losses	\$ (3,289)	\$ (331)	\$ (3,620)	\$ 10,423	\$ 6,649	\$ 17,072
Unrecognized prior service cost/(credit)	152	1,843	1,995	(764)	-	(764)
<b>Total recognized in other comprehensive income</b>	<b>\$ (3,137)</b>	<b>\$ 1,512</b>	<b>\$ (1,625)</b>	<b>\$ 9,659</b>	<b>\$ 6,649</b>	<b>\$ 16,308</b>

The estimated net loss and prior service cost 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, 2009 are \$1.1 million and \$0.1 million, respectively.

The Group's management expects contributions to the plan during the year ended December 31, 2009 to amount to \$3.4 million.

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

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The future benefit payments to retirees under the defined benefit plan are expected to be as follows: 2009 – \$3.4 million; 2010 – \$1.7 million; 2011 – \$2.1 million; 2012 – \$2.2 million, 2013 – \$2.6 and an aggregate of \$22.9 million in 2014 to 2018.

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 salary growth was increased to 9.2% per annum, which resulted in a difference of approximately \$13.6 million between PBO and accumulated benefit obligation (“ABO”) as of December 31, 2007. Accumulated benefit obligation as of December 31, 2008 and 2007 amounted to \$18.9 million and \$24.7 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.

#### 15. DERIVATIVE FINANCIAL INSTRUMENT

The Group reviews its fair value hierarchy classifications quarterly. Changes in significant observable valuation inputs identified during these reviews may trigger reclassification of fair value hierarchy levels of financial assets and liabilities. During the years ended December 31, 2008 and 2007, no such reclassifications occurred. Liability under the call and put option was measured using significant unobservable inputs (Level 3).

##### *Written Call and Put Option*

Simultaneously with the acquisition of the 7.7% stake in Svyazinvest (see Note 9), MGTS Finance and 2711 UA, an affiliate of Mustcom Limited, signed a call and put option agreement, which gave 2711 UA a right to purchase and sell 46,232,000 shares of Comstar UTS, representing 11.06% of total issued shares, from MGTS Finance. 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 had a right to 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’ Global Depository Receipts during the 90 trading days period preceding the exercise of the put option.

Fair value of the call and put option as of December 11, 2006 was estimated at \$90.0 million. MGTS’ share of the fair value of the call and put option as of December 11, 2006 was included in cost of investment, while Comstar UTS’ share in the fair value of the call and put option at the grant date amounting to \$62.3 million was accounted for as a reduction of retained earnings in the consolidated statement of changes in shareholders’ equity for the year ended December 31, 2006. 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.

On December 7, 2007, Access, previously known as 2711 UA exercised the call option for 46,232,000 shares and paid \$322.4 million in cash to the Group.

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On August 25, 2008, Access initiated the process of exercising the put option, and on November 26, 2008 sold MGTS Finance 46,232,000 shares of Comstar UTS for a total of \$463.6 million, \$100.0 million of which had been paid on November 26, 2008 in cash, and the remaining portion had been restructured in the form of an interest-bearing promissory note repayable in four monthly installments (see Note 11).

The market price of one GDR of Comstar UTS on London Stock Exchange as of December 31, 2008 and 2007 was USD 3.95 and USD 12.59, respectively. Total value of these shares, based on market prices, were \$228.1 million and \$144.9 million at December 31, 2008 and 2007, respectively.

The reconciliations of the beginning and closing balances of the liability under the call and put option for the years ended December 31, 2008 and 2007, are as follows:

	<b>Year ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
Balance at January 1	\$ 88,000	\$ 150,000
Revaluation charge included in earnings	27,940	145,859
Exercise of the call option	-	(223,444)
Exercise of the put option	(116,812)	-
Currency translation effect (included in other comprehensive income)	872	15,585
Balance at December 31	<u>\$ -</u>	<u>\$ 88,000</u>

#### 16. PROPERTY, PLANT AND EQUIPMENT CONTRIBUTIONS

The Group 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 the Group during the years ended December 31, 2008 and 2007 were as follows:

	<b>2008</b>	<b>2007</b>
Unamortized property, plant and equipment contributions at the beginning of the year	\$ 123,209	\$ 113,354
Contributions received during the year	2,939	6,299
Currency translation effect	(20,102)	8,023
	<u>106,046</u>	<u>127,676</u>
Amortization for the year	(4,720)	(4,467)
<b>Unamortized property, plant and equipment contributions at the end of the year</b>	<b>\$ <u>101,326</u></b>	<b>\$ <u>123,209</u></b>

#### 17. INCOME TAXES

The Group's provision for income tax for the years ended December 31, 2008 and 2007 is as follows:

	<b>2008</b>	<b>2007</b>
Current income tax	\$ 76,623	\$ 85,900
Deferred income tax	23,930	17,403
<b>Total income tax expense</b>	<b>\$ <u>100,553</u></b>	<b>\$ <u>103,303</u></b>

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

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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 and minority interests. The items causing this difference are as follows:

	<u>2008</u>	<u>2007</u>
Income tax charge computed on income before taxes at standard tax rate applicable to the Group of 24%	\$ 85,645	\$ 67,575
Effect of change in tax rate from 24% to 20% (Note 3)	(9,437)	-
Decrease in deferred tax liability on property subject to registration	-	(10,018)
Change in fair value of a derivative financial instrument (Note 15)	6,185	35,006
Foreign currency transactions differences	8,133	(4,497)
Non-deductible expenses and other items, net	10,027	15,237
<b>Income tax expense</b>	<b>\$ <u>100,553</u></b>	<b>\$ <u>103,303</u></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 the respective property tax deductible. As a result, the Group 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 0.1.

Effective January 1, 2009, the corporate profit tax rate in Russia was decreased to 20%.

Temporary differences between the tax and accounting bases of assets and liabilities gave rise to the following deferred tax assets and liabilities at December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
<b>Deferred tax assets</b>		
Accrued operating expenses	\$ 4,002	\$ 5,363
Property, plant and equipment contributions	20,265	29,570
Deferred revenues	20,879	33,705
Other	2,625	7,949
<b>Total</b>	<b>\$ <u>47,771</u></b>	<b>\$ <u>76,587</u></b>
<b>Deferred tax liabilities</b>		
Treasury stock	\$ (1,518)	\$ (2,180)
Depreciation of property, plant and equipment	(83,151)	(99,384)
Allowance for doubtful accounts	(4,761)	-
Other	(54)	(101)
<b>Total</b>	<b>\$ <u>(89,484)</u></b>	<b>\$ <u>(101,665)</u></b>
<b>Deferred tax position, net, including:</b>	<b>\$ <u>(41,713)</u></b>	<b>\$ <u>(25,078)</u></b>
Deferred tax assets, current portion	6,208	18,835
Deferred tax liabilities, long-term portion	(47,921)	(43,913)

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

A reconciliation of the beginning and ending amounts of unrecognized income tax benefits, excluding interest and penalties, for the years ended December 31, 2008 and 2007 is as follows:

	Year ended December 31,	
	2008	2007
Balance at January 1	\$ 1,229	\$ 1,481
Additions based on tax positions related to the current year	482	289
Additions of tax positions of prior years	1,561	890
Reductions of tax positions of prior years	(1,214)	(1,524)
Currency translation effect	(330)	93
Balance at December 31	1,728	1,229

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

#### 18. SHAREHOLDERS' EQUITY

Common shares carry voting rights with no guarantee of dividends. Preferred shares carry guaranteed non-cumulative dividend rights amounting to the higher of (a) 10% of standalone net income of MGTS 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. Where the preferred dividend is not paid in any year, the preferred shares become voting at par with common shares. At the annual shareholders meeting in June 2008, dividend of RUB 4.70 and RUB 46.98 per common and preferred share, respectively, comprising a total of RUB 1,125 million (an equivalent of \$38.3 million as of December 31, 2008) for the year ended December 31, 2007 was approved.

Except as described above, preferred shares carry no voting rights except on resolutions regarding liquidation or reorganization of MGTS, changes to dividend levels of preferred shares, or the issuance of additional preferred stock. The preferred shares have no rights of redemption. In the event of liquidation, preferred shares have priority over common shares. Under these circumstances, holders of preferred shares receive the par value of their shares, or the amounts payable to common shareholders, if higher.

In accordance with the Charter, MGTS may, at its own discretion, repurchase on the open market up to 10% of its common and preferred shares each year. Repurchased shares must either be sold or cancelled within one year of being purchased.

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. The distributable earnings of MGTS as of December 31, 2008 as determined under Russian accounting regulations amounted to approximately RUB 26,536 million (equivalent of \$903.2 million as of December 31, 2008).

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

#### 19. OPERATING REVENUES

Operating revenues for the years ended December 31, 2008 and 2007 consisted of the following:

	<u>2008</u>	<u>2007</u>
<b>Residential subscribers</b>		
Voice	\$ 495,369	\$ 516,371
Additional telecommunication services	12,288	11,516
Internet	6,239	28
Payphones	445	793
Other	3,447	3,109
<b>Total residential subscribers</b>	<b>517,788</b>	<b>531,817</b>
<b>Corporate subscribers</b>		
Voice	\$ 174,272	\$ 167,586
Access node and trunks rental	73,792	67,884
Additional telecommunication services	15,531	15,724
Internet	2,913	237
Other	17,794	15,584
<b>Total corporate subscribers</b>	<b>284,302</b>	<b>267,015</b>
<b>Operators</b>		
Rent of access nodes	145,448	188,537
Rent of data transmission ports	76,582	64,908
Initiation and termination of traffic, including DLD/ILD	77,057	35,037
Other	38,245	25,172
<b>Total operators</b>	<b>337,332</b>	<b>313,654</b>
<b>Total</b>	<b>\$ 1,139,422</b>	<b>\$ 1,112,486</b>

#### 20. OPERATING EXPENSES, NET

Operating expenses for the years ended December 31, 2008 and 2007 consisted of the following:

	<u>2008</u>	<u>2007</u>
Employee costs	\$ 231,581	\$ 235,222
Interconnection and line rental	138,220	87,746
Depreciation and amortization	128,073	120,179
Repairs and maintenance	61,375	59,220
Utilities and energy	38,285	33,482
Taxes other than income taxes	35,350	33,594
Rent	21,846	22,018
Advertising, selling and marketing	19,849	10,998
Security services	18,449	19,725
Bank charges	16,676	17,281
Transportation	10,170	8,570
Consulting and audit	5,303	9,708
Insurance	3,348	5,040
Bad debt expense	674	1,168
Inventories' obsolescence charge	-	2,386
In-kind compensation from the third parties	(10,679)	(10,778)
Other operating expenses, net	31,895	25,864
<b>Total</b>	<b>\$ 750,415</b>	<b>\$ 681,423</b>

## **OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES**

### **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)**

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During the years ended December 31, 2008 and 2007 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 \$10.7 million and \$10.8 million, respectively, which has been capitalized in the cost of property, plant and equipment.

#### **21. STOCK-BASED COMPENSATION**

##### *The 2006 Program*

On September 15, 2006, the Extraordinary General Meeting of shareholders of Comstar UTS approved the stock option and stock bonus program (“the 2006 Program”) for the Board of Directors and senior management of Comstar UTS and its subsidiaries. The Program is being implemented based on separate decisions of the Board of Directors of Comstar UTS.

In November 2006, Comstar UTS’ board of directors approved the grant of options to purchase common shares of Comstar UTS to members of senior management of MGTS. The exercise price for these options is RUB 122, or approximately \$4.6 per share as of the grant date. These stock options were to vest in November 2008.

During the year ended December 31, 2007, these options have been forfeited, as employment of the grantees with MGTS has been terminated. Accordingly, \$0.04 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. No compensation cost under the 2006 Program is recognized in the financial statements subsequent to that date.

The cost recognized in accordance with the 2006 Program for the years ended December 31, 2008 and 2007 amounted to \$nil and \$0.2 million, respectively, and was included in operating expenses in the accompanying consolidated statement of operations.

##### *Comstar UTS Phantom Option Program*

In March 2008, the Board of Directors of MGTS approved the employee phantom option program, under which the Group’s top and middle management were granted certain phantom options effective April 1, 2008. Each phantom option is subject to the successful attainment of multiple market and performance conditions, such as shareholder return, market position and revenue growth.

The compensation expense for these awards may be adjusted for subsequent changes in the Group’s estimated or actual outcome of the performance conditions. The phantom options granted during 2008 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 Global Depositary Receipt (“GDR”) of Comstar UTS for the 60 calendar days preceding March 31, 2010 and April 1, 2008, respectively, timed by the number of phantom options granted.

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

The following table summarizes information about phantom options during the year ended December 31, 2008:

	<u>Quantity</u>	<u>Exercise price, USD</u>	<u>Weighted average grant- date fair value, USD</u>
Outstanding as of January 1, 2008	-		
Granted	3,510,000	10.2368	2.31
Forfeited	<u>(350,000)</u>	<u>10.2368</u>	<u>2.37</u>
Outstanding as of December 31, 2008 (all non-vested)	<u>3,160,000</u>	<u>10.2368</u>	<u>2.31</u>

The Group estimates the fair value of the phantom options using stock option pricing model based on Monte-Carlo simulation technique. The following assumptions were used in the option-pricing model as of December 31, 2008:

Risk-free interest rate	2.4%
Expected residual option life (months)	15
Expected dividends of Comstar UTS	Notional
Expected volatility of Comstar UTS GDR's	82%
Fair value of options (per share) as of December 31, 2007	USD 0.36

Expected volatility was based on historical volatility of the Comstar UTS' GDRs in the fourth quarter of 2008. The costs recognized in accordance with phantom option plan for the year ended December 31, 2008 amounted to \$0.6 million. Total expected future compensation cost related to non-vested awards not yet recognized as of December 31, 2008 amounted to \$2.7 million, which will be recognized on a straight line basis over 15 months ending March 31, 2010.

## 22. EARNINGS PER SHARE

Earnings per common share have been calculated using the two-class method on the basis of income available for common shareholders, calculated as follows:

	<u>2008</u>	<u>2007</u>
Net income	\$ 249,324	\$ 178,260
Less: income attributable to preferred shares	(41,554)	(29,710)
<b>Net income available to common shareholders</b>	<b>\$ <u>207,770</u></b>	<b>\$ <u>148,550</u></b>

If the Group had elected to distribute the total amount of net income for the periods presented, the preferred shareholders of MGTS would have been entitled to dividend payments of not less than the per share dividend received by the common shareholders. The Group uses this assumption in calculation of earnings per share. Weighted average number of common shares outstanding was 79,829,200 for the years ended December 31, 2008 and 2007.

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

#### 23. RELATED PARTIES

Related parties include entities under common ownership and control with the Group, members of key management personnel and affiliated companies, Svyazinvest and its subsidiaries, in which the Group together with Comstar UTS owns 25% plus one share stake (see Note 9) and which, in turn, owns approximately 28% voting shares in MGTS. The Group enters into various trading transactions, such as sales and purchases of interconnection, rental and other services, and miscellaneous investing and financing transactions with related parties. The amounts recognized are not necessarily indicative of the amounts that would be recognized for transactions with third parties.

Related party balances as of December 31, 2008 and 2007 comprised of the following:

	<u>2008</u>	<u>2007</u>
<b>Accounts receivable and advances issued</b>		
Comstar UTS and its subsidiaries	\$ 36,580	\$ 27,987
Sistema Mass media	14,264	-
Rostelecom	3,990	12,218
Mobile TeleSystems ("MTS")	2,309	2,628
Sistema Hals	1,992	-
Central Telegraph, a subsidiary of Svyazinvest	1,792	1,353
Sitronics	733	1,052
Other receivables	3,015	2,871
<b>Total accounts receivable from related parties</b>	<b>\$ 64,675</b>	<b>\$ 48,109</b>
Long term accounts receivable from related parties – Comstar UTS (Note 10)	1,502	4,951
Long term accounts receivable from related parties – Intellect-Telecom (Note 10)	1,006	-
	<u>2008</u>	<u>2007</u>
<b>Short-term investments</b>		
Promissory notes of Delfa (an affiliate of Sistema) (see Note 9)	\$ 27,229	\$ -
RUB-denominated loan to Sistema Hals	16,688	19,975
RUB-denominated loan to RemstroyTrest - 701	-	34,629
RUB-denominated notes receivable from MBRD	-	16,943
<b>Long-term investments</b>		
USD-denominated loan to Comstar One Ltd., a subsidiary of Comstar UTS	35,000	-
RUB-denominated loan to Ruslan TV, a subsidiary of Sistema	30,633	-
Investment in MBRD	5,402	6,466
RUB-denominated loan to Intellect-Telecom, a subsidiary of Sistema	5,310	6,355
NPF Sistema	756	220
<b>Total LT and ST investments</b>	<b>\$ 121,018</b>	<b>\$ 84,588</b>

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

	<u>2008</u>	<u>2007</u>
<b>Accounts payable, accrued liabilities and deferred revenue</b>		
Sitronics	\$ 17,521	\$ 15,607
MTS	9,620	2,906
Sistema Mass Media	7,674	-
Comstar UTS and it's subsidiaries	5,799	11,904
MTT	5,459	4,615
Rostelecom	1,894	2,807
Central Telegraph	1,567	511
Sistema Hals	502	-
Other payables	139	90
<b>Total accounts payable, accrued liabilities and deferred revenue to related parties</b>	<b>\$ <u>50,175</u></b>	<b>\$ <u>38,440</u></b>
Long term accounts payable to related parties – Sistema Hals (Note 2)	\$ 36,807	\$ 30,815
Long term portion of deferred revenue to related parties – Comstar UTS and it's subsidiaries	2,463	2,870

Interest income earned on investments in and loans to related parties is summarized as follows:

	<u>2008</u>	<u>2007</u>
MBRD (including interest earned on cash balances with MBRD)	\$ 6,591	\$ 3,458
Remstroytrest - 701	2,319	364
Alt, Delfa (affiliates of Sistema)	2,291	-
Sistema Hals	2,203	147
Comstar One Limited	1,358	-
Intellect Telecom, a subsidiary of Sistema	439	168
Stream TV and subsidiaries	168	-
<b>Total interest income earned on investments in and loans to related parties</b>	<b>\$ <u>15,369</u></b>	<b>\$ <u>4,137</u></b>

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

The Group provides communication services and rents premises to subsidiaries and affiliates of Sistema and Svyazinvest. The following table summarizes revenues received from related parties during the years ended December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
<b>Communication services</b>		
Comstar UTS and it's subsidiaries	\$ 128,149	\$ 114,345
Rostelecom	33,556	41,666
MTS	18,786	17,067
MTT	13,587	11,505
Central Telegraph	7,546	14,897
	<u><b>201,624</b></u>	<u><b>199,480</b></u>
<b>Rent of premises and equipment</b>		
Comstar UTS and it's subsidiaries	\$ 7,377	\$ 5,190
Sitronics	3,314	2,010
Rostelecom	2,830	2,687
MTS	2,294	2,201
Intellect Telecom	964	-
Metro Telecom	245	-
VAO Intourist	181	-
Central Telegraph	178	81
	<u><b>17,383</b></u>	<u><b>12,169</b></u>

The following table summarizes the traffic and other costs incurred by the Group through transactions with related parties during the years ended December 31, 2008 and 2007.

	<u>2008</u>	<u>2007</u>
MTS	\$ 35,807	\$ 26,881
Comstar UTS and it's subsidiaries	29,009	931
Rostelecom	21,565	17,397
MTT	8,055	32,261
Central Telegraph	3,818	4,977
Others	3,714	4,789
	<u><b>\$ 101,968</b></u>	<u><b>\$ 87,236</b></u>

#### *Svyazinvest and subsidiaries*

In addition to the transactions and balances disclosed above, in December 2007 the Group recognized an allowance for uncollectible receivables due from Rostelecom of \$7.2 million. In 2008 and 2007, the Group paid dividends to Svyazinvest totaling \$3.6 million and \$7.6 million, respectively, and received dividends from Svyazinvest of \$0.6 million and \$0.5 million, respectively.

#### *Sitronics*

The Group purchases telecommunications equipment, software and technical maintenance services from Sitronics, a subsidiary of Sistema. The cost of equipment, software and relevant services purchased from Sitronics in 2008 and 2007 was \$40.0 million and \$48.9 million, respectively.

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

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#### *Sistema Hals*

As described in Note 2, 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, 2008 and December 31, 2007, as a result of the work performed by Sistema Hals under these contracts, MGTS recorded a liability of \$36.8 million and \$30.8 million, respectively, payable to Sistema Hals.

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 - 701 (see Note 5), a variable interest entity whose primary beneficiary was Sistema Hals. The loan to Remstroytrest - 701 was fully repaid in 2008.

#### *InvestSvyazHolding*

In 2005 and 2004, the Group entered into agreements with InvestSvyazHolding, a subsidiary of Sistema, for leasing of network equipment and billing system. These leases were recorded as capital leases based on the requirements of SFAS No. 13, "Accounting for Leases". The gross amount of leased assets equaled \$52.0 million and \$62.2 million as of December 31, 2008 and 2007, respectively; the accumulated depreciation of leased assets was \$7.0 million and \$7.1 million as of December 31, 2008 and 2007, respectively. The interest rate implicit in the leases varies from 10% to 14%.

The table presented in Note 11 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, 2008.

For the years ended December 31, 2008 and 2007, the Group paid to InvestSvyazHolding \$10.4 million and \$14.6 million, respectively, in principal and \$1.1 million and \$2.3 million, respectively, in interest. In addition, the Group provides guarantees to Commerzbank (Eurasia) and Komerčni banka, a.s., Prague under InvestSvyazHolding credit facilities, see Note 24.

#### *MBRD*

During the years ended December 31, 2008 and 2007 the Group maintained certain bank and deposit accounts and acquired promissory notes from MBRD, a subsidiary of Sistema. Interest income received from MBRD on bank and deposit accounts during the years ended December 31, 2008 and 2007 amounted to \$8.7 million and \$3.5 million, respectively.

## 24. COMMITMENTS AND CONTINGENCIES

***Issued Guarantees*** – MGTS was a guarantor under several credit facilities between Commerzbank (Eurasia) and InvestSvyazHolding. The credit facilities matured in 2008.

In 2006-2007, MGTS became a guarantor under two credit facilities provided to InvestSvyazHolding by Komerčni banka, a.s., Prague. The credit facilities mature in 2011. MGTS' guarantee amounted to \$12.2 million as of December 31, 2008.

In 2006, MGTS became a guarantor under a credit facility provided to MBRD 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 \$1.5 million as of December 31, 2008.

## OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

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In 2007, MGTS became a guarantor under a credit facility provided to Comstar UTS by Sberbank of Russia. The credit facilities mature in 2012. MGTS' guarantee amounted to \$30.6 million as of December 31, 2008.

Under these guarantees the Group could be potentially liable for a maximum amount of \$44.4 million in case of borrower's default under the obligations. As of December 31, 2008, 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.

**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, corporate income (profit) tax, a number of turnover-based taxes, 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 is more significant than typically found in countries with more developed tax systems.

Generally, tax declarations remain open and subject to inspection for a period of three years following the tax year. Tax declarations of MGTS for 2006 and 2007 were examined by the tax audit, however a higher tax authority may re-open these years for further examination in the future.

Management believes that the Group 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.

**Legal Disputes** – In May 2007, certain minority shareholders won a 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 that such decision of MGTS' general shareholders' meeting in respect of dividends for 2005 was null and void. Such dividend, if declared and paid, may amount to RUB 879.0 million (approximately \$29.9 million as of December 31, 2008). 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 December 2008, certain minority shareholders of MGTS filed a case to claim null and void certain decisions of MGTS' Board of Directors, which, they believe, represent a series of interrelated transactions and should have been approved by MGTS' general shareholder meeting. Management believes that the claim is insubstantial.

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

**Licenses** – Substantially all the Group's revenues are derived from operations conducted pursuant to licenses to operate in Moscow and the Moscow region granted by the Russian Government. The voice phone communication license expires in December 2013. Suspension or termination of the Group's main license or any failure to renew it could have a material adverse effect on the financial position and operations of the Group. However, the Group has no reason to believe that the license will not be renewed, or suspended, or terminated, and the management estimates the possibility of such events as remote.

# OJSC MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (Amounts in thousands of USD, unless otherwise stated)

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

### 25. SUBSEQUENT EVENTS

#### *MGTS Investment Program*

In February 2009, the Board of Directors of MGTS approved the cancellation of agreements with Sistema Hals (see Note 2) with respect to 26 sites, which also extinguishes the respective portion of MGTS' liability to Sistema Hals, and signing of 26 new agreements with investor companies (the "New Agreements"). Under the New Agreements, the investor companies would perform all necessary reconstruction work and obtain the property rights for the reconstructed buildings except for the premises locating the digitalized nodes which would remain MGTS property. In addition, within 12 months after transfer of the building into the investment project, MGTS is to receive cash payment equal to MGTS' share in the value of the building before reconstruction as appraised by an independent valuation firm in 2008, plus interest at 20% per annum accrued for the period from transfer of the building into the project and the date of payment. Currently, management is evaluating the appropriate accounting treatment of the New Agreements. As of the date of these financial statements, the agreements have not been signed by Sistema Hals.

#### *New loan and investment agreements with subsidiaries of Comstar UTS*

In January and February 2009 the Group entered into two USD loan agreements with Comstar One Ltd. and Antel Metrokom Ltd. (subsidiaries of Comstar UTS) for a \$68.0 and \$65.5 million, respectively. Loans bear interest at 2% and mature in 2011.

In March 2009 the Group entered into two ruble loan agreements with Comstar UTS and Skif Line (a subsidiary of Comstar UTS) for a RUB 1,400 million and RUB 900 million (equivalent of \$47.7 million and \$30.6 million as of December 31, 2008), respectively. Loans bear interest at 11.3% and mature in 2011.

In February and March 2009 the Group received \$27.3 million and \$15.8 million under loan agreements with Antel Metrokom Ltd. and Comstar One Ltd. (subsidiaries of Comstar UTS) entered into December 2008 (see also Note 11).

In March 2009 the Group granted a RUB 900 million loan (equivalent of \$30.6 million as of December 31, 2008) to Skif Line, a subsidiary of Comstar UTS. The loan bears interest at 11.3% per annum and is repayable in 2011.

#### *Depreciation of the Ruble against the USD and Euro*

As of April 24, 2009, the official rates of exchange, as determined by the CBR, were 33.78 RUB to 1 US dollar and 44.02 RUB to 1 Euro, which caused certain foreign exchange losses due to revaluation of liabilities denominated in USD and Euro. These losses will be reported in the financial statements for the year ended December 31, 2009.