

# **OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES**

## **Consolidated Financial Statements**

As of December 31, 2006 and 2005 and  
for the Years Ended  
December 31, 2006, 2005 and 2004

# OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

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## REPORT OF THE INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders of OJSC Mobile TeleSystems:

We have audited the accompanying consolidated balance sheets of Mobile TeleSystems, a Russian Open Joint-Stock Company, and subsidiaries (“the Group”) as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in shareholders’ equity and cash flows for each of the three years in the period ended December 31, 2006. 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 the standards of the Public Company Accounting Oversight Board (United States). 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Group as of December 31, 2006 and 2005, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Group’s internal control over financial reporting as of December 31, 2006, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated May 31, 2007 (June 7, 2007 as to Note 25), expressed an unqualified opinion on management’s assessment of the effectiveness of the Group’s internal control over financial reporting and an adverse opinion on the effectiveness of the Group’s internal control over financial reporting because of a material weakness.



May 31, 2007  
(June 7, 2007 as to Note 25)

# OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2006 AND 2005

*(Amounts in thousands of U.S. Dollars, except share and per share amounts)*

	December 31,	
	2006	2005
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents (Note 4)	\$ 219,989	\$ 78,284
Short-term investments, including related party amounts of \$55,000 and \$23,100 (Note 5)	56,047	28,059
Trade receivables, net (Note 6)	298,479	209,320
Accounts receivable, related parties (Note 17)	8,434	7,661
Inventory and spare parts (Note 7)	196,265	156,660
Prepaid expenses	244,680	234,345
Deferred tax assets (Note 14)	141,114	83,336
VAT receivable	339,614	398,021
Other current assets, including assets held for sale of \$63,209 and \$nil (Note 2)	124,497	89,337
<b>Total current assets</b>	<b>1,629,119</b>	<b>1,285,023</b>
<b>PROPERTY, PLANT AND EQUIPMENT</b> , net of accumulated depreciation of \$1,948,368 and \$1,350,783 (Note 8)	5,297,669	4,482,679
<b>LICENSES</b> , net of accumulated amortization of \$747,076 and \$561,137 (Notes 3 and 22)	405,498	603,116
<b>GOODWILL</b> (Notes 3 and 24)	165,462	155,221
<b>OTHER INTANGIBLE ASSETS</b> , net of accumulated amortization of \$680,425 and \$505,098 (Notes 3 and 9)	835,916	681,025
<b>DEBT ISSUANCE COSTS</b> , net of accumulated amortization of \$48,733 and \$23,692 (Note 11)	70,173	74,527
<b>INVESTMENTS IN AND ADVANCES TO ASSOCIATES</b> (Note 19)	141,473	107,959
<b>OTHER INVESTMENTS</b> (Note 20)	3,856	150,000
<b>RESTRICTED CASH</b> (Note 21)	24,779	6,230
<b>Total assets</b>	<b>\$ 8,573,945</b>	<b>\$ 7,545,780</b>

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

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### CONSOLIDATED BALANCE SHEETS (CONTINUED)

AS OF DECEMBER 31, 2006 AND 2005

(Amounts in thousands of U.S. Dollars, except share and per share amounts)

	December 31,	
	2006	2005
<b>CURRENT LIABILITIES:</b>		
Trade accounts payable	\$ 309,712	\$ 363,723
Accounts payable, related parties (Note 17)	135,256	40,829
Deferred connection fees, current portion (Note 10)	47,528	44,361
Subscriber prepayments and deposits	421,539	344,493
Debt, current portion (Note 11)	147,260	765,881
Capital lease obligation, current portion (Notes 12 and 17)	3,366	2,793
Income tax payable	29,110	7,565
Accrued liabilities (Note 13)	405,728	276,291
Bitel liability (Note 20)	170,000	-
Other payables	50,805	76,890
<b>Total current liabilities</b>	<u>1,720,304</u>	<u>1,922,826</u>
<b>LONG-TERM LIABILITIES:</b>		
Notes payable (Note 11)	1,199,178	1,199,052
Debt, net of current portion (Note 11)	1,725,361	879,903
Capital lease obligation, net of current portion (Notes 12 and 17)	3,287	2,928
Deferred connection fees, net of current portion (Note 10)	32,079	57,824
Deferred taxes (Note 14)	86,349	158,414
Other long-term liabilities	10,800	-
<b>Total long-term liabilities</b>	<u>3,057,054</u>	<u>2,298,121</u>
<b>Total liabilities</b>	<u>4,777,358</u>	<u>4,220,947</u>
<b>COMMITMENTS AND CONTINGENCIES (Note 23)</b>		
<b>MINORITY INTEREST</b>	44,806	30,744
<b>SHAREHOLDERS' EQUITY:</b>		
Common stock: (2,096,975,792 shares with a par value of 0.1 rubles authorized and 1,993,326,138 shares issued as of December 31, 2006 and 2005, 776,550,625 and 763,554,870 of which are in the form of ADS, respectively (Note 1))	50,558	50,558
Treasury stock (15,922,129 and 5,400,486 common shares at cost as of December 31, 2006 and 2005)	(114,778)	(5,534)
Additional paid-in capital	571,718	568,104
Unearned compensation (Note 16)	-	(1,210)
Shareholder receivable (Note 11)	-	(7,182)
Accumulated other comprehensive income (Note 2)	89,916	50,614
Retained earnings	3,154,367	2,638,739
<b>Total shareholders' equity</b>	<u>3,751,781</u>	<u>3,294,089</u>
<b>Total liabilities and shareholders' equity</b>	<u>\$ 8,573,945</u>	<u>\$ 7,545,780</u>

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

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004 (Amounts in thousands of U.S. Dollars, except share and per share amounts)

	Years ended December 31,		
	2006	2005	2004
<b>NET OPERATING REVENUE</b>			
Services revenue and connection fees	\$ 6,287,100	\$ 4,942,288	\$ 3,800,271
Sales of handsets and accessories	97,154	68,730	86,723
	<b>6,384,254</b>	<b>5,011,018</b>	<b>3,886,994</b>
Cost of services, excluding depreciation and amortization shown separately below (including related party amounts of \$113,732, \$78,253 and \$61,770, respectively)	1,223,715	732,867	481,097
Cost of handsets and accessories	209,260	254,606	218,590
General and administrative expenses (including related party amounts of \$13,301, \$9,486 and \$9,509, respectively) (Note 18)	941,047	758,729	575,296
Provision for doubtful accounts (Note 6)	84,858	50,407	26,459
Other operating expenses	87,822	67,173	29,777
Sales and marketing expenses (including related party amounts of \$171,792, \$80,146 and \$59,113, respectively)	607,835	608,092	460,983
Depreciation and amortization expenses	1,095,981	907,113	675,729
<b>Net operating income</b>	<b>2,133,736</b>	<b>1,632,031</b>	<b>1,419,063</b>
<b>CURRENCY EXCHANGE AND TRANSACTION GAINS</b>	(24,051)	(10,319)	(6,529)
<b>OTHER EXPENSES/(INCOME)</b>			
Interest income (including related party amounts of \$4,844, \$5,440 and \$6,801)	(13,055)	(24,828)	(21,792)
Interest expense, net of capitalized interest	177,145	132,474	107,956
Equity in net income of associates (Note 19)	(58,083)	(42,361)	(24,146)
Bitel investment and write off (Note 20)	320,000	-	-
Other expenses/(income), net (including related party amounts of \$2,460, \$2,070 and \$5,303)	65,913	13,211	(9,310)
<b>Total other expenses, net</b>	<b>491,920</b>	<b>78,496</b>	<b>52,708</b>
<b>Income before provision for income taxes and minority interest</b>	<b>1,665,867</b>	<b>1,563,854</b>	<b>1,372,884</b>
<b>PROVISION FOR INCOME TAXES</b> (Note 14)	576,103	410,590	354,664
<b>MINORITY INTEREST</b>	14,026	26,859	30,342
<b>NET INCOME</b>	<b>\$ 1,075,738</b>	<b>\$ 1,126,405</b>	<b>\$ 987,878</b>
Weighted average number of common shares outstanding	1,987,610,121	1,986,819,999	1,984,497,348
Earnings per share, basic and diluted	\$ 0.54	\$ 0.57	\$ 0.50

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

# OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004 (Amounts in thousands of U.S. Dollars, except share amounts)

	Common Stock		Treasury Stock		Accumulated Other Com- prehensive Income	Additional Paid-in Capital	Unearned Compensation	Shareholder Receivable	Retained Earnings	Total
	Shares	Amount	Shares	Amount						
<b>BALANCES, January 1, 2004</b>	\$ 1,993,326,138	\$ 50,558	(9,929,074)	\$ (10,197)	\$ 7,595	\$ 559,911	\$ (869)	\$ (27,610)	\$ 1,144,522	\$ 1,723,910
Receivable from Sistema:										
Increases for interest	-	-	-	-	-	1,190	-	(1,190)	-	-
Payments from Sistema	-	-	-	-	-	-	-	10,563	-	10,563
Issuance of stock options (Note 16)	-	-	-	-	-	1,811	(1,811)	-	-	-
Stock options exercised (Note 16)	-	-	2,726,966	2,801	-	1,248	-	-	-	4,049
Amortization of deferred compensation (Note 16)	-	-	-	-	-	-	900	-	-	900
Dividends declared (Note 1)	-	-	-	-	-	-	-	-	(218,826)	(218,826)
Currency translation adjustment	-	-	-	-	15,361	-	-	-	-	15,361
Change in fair value of interest rate swaps, net of tax	-	-	-	-	(512)	-	-	-	-	(512)
Net income	-	-	-	-	-	-	-	-	987,878	987,878
<b>BALANCES, December 31, 2004</b>	\$ 1,993,326,138	\$ 50,558	(7,202,108)	\$ (7,396)	\$ 22,444	\$ 564,160	\$ (1,780)	\$ (18,237)	\$ 1,913,574	\$ 2,523,323
Receivable from Sistema:										
Increases for interest	-	-	-	-	-	643	-	(643)	-	-
Payments from Sistema	-	-	-	-	-	-	-	11,698	-	11,698
Issuance of stock options (Note 16)	-	-	-	-	-	907	(907)	-	-	-
Stock options exercised (Note 16)	-	-	1,801,622	1,862	-	2,394	-	-	-	4,256
Amortization of deferred compensation (Note 16)	-	-	-	-	-	-	1,477	-	-	1,477
Dividends declared (Note 1)	-	-	-	-	-	-	-	-	(401,240)	(401,240)
Currency translation adjustment	-	-	-	-	24,898	-	-	-	-	24,898
Change in fair value of interest rate swaps, net of tax (Note 11)	-	-	-	-	3,272	-	-	-	-	3,272
Net income	-	-	-	-	-	-	-	-	1,126,405	1,126,405
<b>BALANCES, December 31, 2005</b>	\$ 1,993,326,138	\$ 50,558	(5,400,486)	\$ (5,534)	\$ 50,614	\$ 568,104	\$ (1,210)	\$ (7,182)	\$ 2,638,739	\$ 3,294,089
Receivable from Sistema:										
Increases for interest	-	-	-	-	-	-	-	-	-	-
Payments from Sistema	-	-	-	-	-	-	-	7,182	-	7,182
Stock options exercised (Note 16)	-	-	639,357	655	-	3,149	-	-	-	3,804
Amortization of deferred compensation (Note 16)	-	-	-	-	-	1,675	-	-	-	1,675
Effect of adoption of SFAS 123R (Note 2)	-	-	-	-	-	(1,210)	1,210	-	-	-
Dividends declared (Note 1)	-	-	-	-	-	-	-	-	(560,110)	(560,110)
Repurchase of common stock (Note 15)	-	-	(11,161,000)	(109,899)	-	-	-	-	-	(109,899)
Currency translation adjustment	-	-	-	-	41,315	-	-	-	-	41,315
Early termination and change in fair value of interest rate swaps, net of tax (Note 11)	-	-	-	-	(2,013)	-	-	-	-	(2,013)
Net income	-	-	-	-	-	-	-	-	1,075,738	1,075,738
<b>BALANCES, December 31, 2006</b>	\$ 1,993,326,138	\$ 50,558	(15,922,129)	\$ (114,778)	\$ 89,916	\$ 571,718	\$ -	\$ -	\$ 3,154,367	\$ 3,751,781

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

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004 (Amounts in thousands of U.S. Dollars)

	Years ended December 31,		
	2006	2005	2004
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 1,075,738	\$ 1,126,405	\$ 987,878
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>			
Minority interest	14,026	26,859	30,342
Depreciation and amortization	1,095,981	907,113	675,729
Debt issuance cost amortization	25,041	14,347	4,759
Amortization of deferred connection fees	(54,486)	(44,207)	(46,978)
Equity in net income of associates	(58,083)	(42,361)	(24,146)
Inventory obsolescence expense	-	9,112	4,610
Provision for doubtful accounts	84,858	50,407	26,459
Deferred taxes	(133,027)	(64,959)	(76,023)
Bitel liability and investment write off (Note 20)	320,000	-	-
Non-cash expenses associated with stock bonus and stock options	1,675	1,477	900
<b>Changes in operating assets and liabilities:</b>			
Increase in accounts receivable	(174,790)	(86,008)	(101,223)
Increase in inventory	(39,312)	(74,557)	(24,179)
Decrease/(increase) in prepaid expenses and other current assets	24,268	(157,400)	(18,571)
Decrease/(increase) in VAT receivable	58,446	(125,186)	(55,044)
Increase in trade accounts payable, accrued liabilities and other current liabilities	149,568	262,568	327,076
<b>Net cash provided by operating activities</b>	<b>2,389,903</b>	<b>1,803,610</b>	<b>1,711,589</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Acquisitions of subsidiaries, net of cash acquired	(38,188)	(178,917)	(355,744)
Purchases of property, plant and equipment	(1,449,954)	(1,757,980)	(1,204,400)
Purchases of intangible assets	(272,014)	(423,367)	(154,544)
Purchases of short-term investments	(57,147)	(37,375)	(114,440)
Proceeds from sale of short-term investments	29,159	82,724	286,340
Purchase of other investments	(3,856)	(150,000)	-
Proceeds from investments in and advances to associates	20,000	12,798	(413)
Increase in restricted cash	(18,549)	(6,230)	-
<b>Net cash used in investing activities</b>	<b>(1,790,549)</b>	<b>(2,458,347)</b>	<b>(1,543,201)</b>



## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED) FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004 (Amounts in thousands of U.S. Dollars)

	Years ended December 31,		
	2006	2005	2004
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from stock options exercise	3,804	4,256	4,049
Proceeds from issuance of notes	-	398,944	-
Repurchase of common stock	(109,899)	-	-
Repayment of notes	-	-	(600,000)
Debt issuance cost	(20,686)	(59,163)	(12,039)
Capital lease obligation principal paid	(5,815)	(8,129)	(15,274)
Dividends paid including taxes	(558,848)	(407,210)	(232,662)
Proceeds from loans	1,284,296	1,012,613	1,177,556
Loan principal paid	(1,064,100)	(491,481)	(320,511)
Payments from Sistema	7,182	11,698	9,654
<b>Net cash (used in)/provided by financing activities</b>	<u>(464,066)</u>	<u>461,528</u>	<u>10,773</u>
Effect of exchange rate changes on cash and cash equivalents	<u>6,417</u>	<u>(2,657)</u>	<u>4,613</u>
<b>NET INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS</b>	141,705	(195,866)	183,774
<b>CASH AND CASH EQUIVALENTS, beginning of the year</b>	<u>78,284</u>	<u>274,150</u>	<u>90,376</u>
<b>CASH AND CASH EQUIVALENTS, end of the year</b>	<u><u>219,989</u></u>	<u><u>78,284</u></u>	<u><u>274,150</u></u>
<b>SUPPLEMENTAL INFORMATION:</b>			
Income taxes paid	\$ 673,410	\$ 588,105	\$ 430,109
Interest paid	\$ 201,352	\$ 145,081	\$ 142,899
<b>Non-cash investing activities:</b>			
Additions to network equipment and software under capital lease	\$ 7,561	\$ 4,091	\$ 2,861
Amounts owed for capital expenditures	\$ 214,835	\$ 69,734	\$ 84,258
Additions to network equipment through ING BHF			
Bank and Commerzbank AG financing	\$ -	\$ -	\$ 8,800
Payable related to business acquisition (Note 3)	\$ -	\$ 23,618	\$ -

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

# OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

*(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)*

### 1. DESCRIPTION OF BUSINESS

**Business of the Group** – OJSC Mobile TeleSystems and its subsidiaries (“MTS” or “the Group”) is one of the leading providers of mobile telecommunications services in the Russian Federation (“RF”, or “Russia”), Ukraine, Uzbekistan and Turkmenistan in terms of the number of subscribers and revenues.

The Open Joint-Stock Company Mobile TeleSystems (“MTS OJSC”, or “the Company”) was created on March 1, 2000, through the merger of MTS CJSC and RTC CJSC, a wholly-owned subsidiary. MTS CJSC started its operations in the Moscow license area in 1994 and began expanding into nearby regions in 1997. Since that time, MTS has continued to grow by applying for Global System for Mobile Communication (“GSM”) licenses in new regions and acquiring existing GSM license holders and operators.

The Group provides a wide range of voice and data mobile telecommunications services, including text messages (“SMS”), picture messages (“MMS”) and other data services. Services are provided to both consumers and corporate customers, through a variety of both prepaid and contract tariff arrangements.

The Group’s mobile services are currently offered over a GSM network, on which a General Packet Radio Service (“GPRS”) service is also provided. In July 2006, Ukrainian Mobile Communications (“UMC”), MTS’s subsidiary in Ukraine, acquired a new CDMA (Code Division Multiple Access) license, which is a 3G telecommunications standard, ratified by the International Telecommunication Union. UMC plans to render the following services over the 3G network: wireless virtual data transmission services, remote access to corporate mail, high speed access to the Internet, multimedia services (e.g. video on demand). As of December 31, 2006, UMC has not commenced any commercial services under this new license.

The Group is organized by geography of its operations. MTS’s principal mobile operations are located in Russia, Ukraine and other CIS countries. In 2005, the Group’s business was managed by ten Russian macro-regions and foreign subsidiaries. In 2006, the Group established a new Business unit “MTS Russia”, that is responsible for the operational management of all Russian macro-regions; Business unit “UMC”; and Business unit “Foreign subsidiaries” that includes Uzdunrobita in Uzbekistan, Barash Communications Technologies, Inc. in Turkmenistan, and MTS Belarus, equity accounted affiliate of MTS, in Belarus.

MTS completed its initial public offering in 2000 and listed its shares of common stock, represented by American Depositary Shares, or ADSs, on the New York Stock Exchange under the symbol “MBT.”

**Ownership** – As of December 31, 2006 and 2005, MTS’s shareholders of record and their respective percentage direct interests in outstanding shares were as follows:

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
Joint-Stock Financial Corporation “Sistema” (“Sistema”)	32.2%	32.0%
Sistema Holding Limited (“Sistema Holding”)	9.8%	9.7%
Invest-Svyaz, Closed Joint-Stock Company (“Invest-Svyaz”)	8.1%	8.1%
VAST, Limited Liability Company (“VAST”)	3.0%	3.0%
ADS Holders	39.3%	38.4%
Free float, GDR Holders and others	7.6%	8.8%
	<u>100.0%</u>	<u>100.0%</u>

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

*(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)*

MTS's share capital comprises 1,977,404,009 and 1,988,565,009 of outstanding common shares as of December 31, 2006 and 2005, respectively. MTS's wholly-owned subsidiary, Mobile TeleSystems LLC, owned 4,761,129 and 5,400,486 shares in connection with the Group's management stock option plans. In December 2006, MTS repurchased 11,161,000 of its own common shares representing 2,232,200 ADSs for \$110.0 million. As a result, the total shares in treasury stock of the Group comprised 15,922,129 as of December 31, 2006.

Sistema owned 100% of Sistema Holding, Invest-Svyaz, and VAST, which collectively resulted in Sistema's effective ownership in MTS of 53.1% and 52.8% (or 1,050,165,886 of common shares) as of December 31, 2006 and 2005, respectively.

Vladimir P. Evtushenkov has a controlling interest in Sistema, and would be considered under U.S. securities laws as the beneficial owner of MTS's shares effectively held by Sistema.

Each ADS initially represented 20 shares of common stock of the Company. Effective January 2005, the ratio was changed from 1 ADS per 20 ordinary shares to 1 ADS per 5 ordinary shares. The Company initially issued a total of 17,262,204 ADS, representing 345,244,080 common shares. Subsequently, due to trading of shares on the open market and the repurchase of 2,232,200 ADS by MTS during 2006 the number of ADS changed to 155,310,125 and 152,710,974 (representing underlying ownership of 776,550,625 and 763,554,870 shares) as of December 31, 2006 and 2005, respectively.

Since 2003, common shares of MTS OJSC have been traded on the Moscow Interbank Currency Exchange ("MICEX").

The following table summarizes the Group's declared cash dividends for the years ended December 31, 2006, 2005 and 2004:

	<b>December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Dividends declared	\$ 561,629	\$ 402,600	\$ 220,000
Dividends, U.S. Dollars per ADS	1.4	1.01	2.2
Dividends, U.S. Dollars per share	0.282	0.202	0.110

As at December 31, 2006, dividends payable of \$1.3 million are outstanding.

On July 1, 2005, the Company completed a merger of eight of its wholly-owned subsidiaries in Russia. These subsidiaries were Telecom XXI, Kuban-GSM, Udmurtia Digital Network-900 ("UDN-900"), Dontelecom, MTS-Barnaul, MTS-Nizhniy Novgorod ("MTS-NN"), Telecom-900 and Amur Cellular Communication ("ACC").

On April 1, 2006, the Company completed a further merger of nine of its wholly-owned subsidiaries in Russia which were Gorizont-RT, TAIF Telcom, MTS-RTK, Sibchallenge, Tomsk Cellular Communications ("TSS"), BM Telecom, Far East Cellular Systems-900 ("FECS-900"), Siberia Cellular Systems-900 ("SCS-900") and Uraltel.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

*(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)*

#### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND NEW ACCOUNTING PRONOUNCEMENTS

**Accounting principles** – MTS maintains its accounting books and records in Russian rubles for its subsidiaries located in the Russian Federation, in Ukrainian hryvnias for UMC, Uzbek som for Uzdurobita, U.S. Dollars for Barash Communications Technologies, Inc. (“BCTI”) and Turkmenian manat for the branch of BCTI in Turkmenistan based on respective local accounting and tax legislations. The accompanying consolidated financial statements have been prepared in order to present MTS’s financial position and its results of operations and cash flows in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”) and are expressed in terms of U.S. Dollars.

The accompanying consolidated financial statements differ from the financial statements used for statutory purposes in that they reflect various adjustments, not recorded on the entities’ books, which are 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, deferred taxation, consolidation, acquisition accounting and depreciation and valuation of property, plant and equipment, intangible assets and investments.

**Basis of consolidation** – Wholly-owned subsidiaries and majority-owned subsidiaries where the Group has operating and financial control are consolidated. Those ventures where the Group exercises significant influence, but does not have operating and financial control are accounted for using the equity method. All intercompany accounts and transactions are eliminated upon consolidation. Investments in which the Group does not have the ability to exercise significant influence over operating and financial policies are accounted for under the cost method and included in other investments in the consolidated balance sheets. The Group’s share in the net income of unconsolidated associates is included in other income in the accompanying consolidated statements of operations and disclosed in Note 19. Results of operations of subsidiaries acquired are included in the consolidated statements of operations from the date of their acquisition.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

*(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)*

As of December 31, 2006 and 2005, the Company had investments in the following significant legal entities:

	Accounting Method	December 31,	
		2006	2005
<b>Russia</b>			
Primtelefon	Consolidated	100.0%	100.0%
ReCom	Consolidated	100.0%	100.0%
Volgograd Mobile	Consolidated	100.0%	100.0%
Astrakhan Mobile	Consolidated	100.0%	100.0%
MTS-Capital	Consolidated	100.0%	100.0%
Mar Mobile GSM	Consolidated	100.0%	100.0%
Novitel	Consolidated	100.0%	100.0%
MTS-Kostroma	Consolidated	100.0%	100.0%
Sibintertelecom	Consolidated	100.0%	100.0%
Telesot Alania	Consolidated	100.0%	100.0%
MSS	Consolidated	91.0%	91.0%
Sweet-Com	Consolidated	74.9%	74.9%
Dagtelecom	Consolidated	74.99%	-
MTS-RTK <sup>(1)</sup>	Merged / Consolidated	-	100.0%
SCS-900 <sup>(1)</sup>	Merged / Consolidated	-	100.0%
FECS-900 <sup>(1)</sup>	Merged / Consolidated	-	100.0%
Uraltel <sup>(1)</sup>	Merged / Consolidated	-	100.0%
BM Telecom <sup>(1)</sup>	Merged / Consolidated	-	100.0%
Sibchallenge <sup>(1)</sup>	Merged / Consolidated	-	100.0%
TSS <sup>(1)</sup>	Merged / Consolidated	-	100.0%
TAIF Telecom <sup>(1)</sup>	Merged / Consolidated	-	100.0%
Gorizont-RT <sup>(1)</sup>	Merged / Consolidated	-	100.0%
<b>Ukraine</b>			
UMC	Consolidated	100.0%	100.0%
<b>Other countries</b>			
MTS Finance <sup>(2)</sup>	Consolidated	100.0%	100.0%
Uzdunrobita	Consolidated	74.0%	74.0%
BCTI	Consolidated	100.0%	100.0%
MTS Bermuda Ltd. <sup>(3)</sup>	Consolidated	100.0%	-
MTS Belarus	Equity	49.0%	49.0%

<sup>(1)</sup> Represents wholly-owned entities merged with MTS OJSC on April 1, 2006.

<sup>(2)</sup> Represents beneficial ownership.

<sup>(3)</sup> A wholly-owned subsidiary in Bermuda established to repurchase the Group's ADSs (Note 1).

**Translation methodology** – Management believes that, based on the currencies of the primary economic environments in which the entities and macro-regions operate, the appropriate functional currencies for the Group's entities in 2006, 2005 and 2004 are the following:

- for Russian business – U.S. Dollar, except for the macro-region (“MR”) South (which includes the former subsidiary Kuban-GSM and other regions located in the South of Russia) where the functional currency is the Russian ruble;
- for UMC – Ukrainian hryvnia;
- for Turkmen branch of BCTI – Turkmenian manat; and
- for other entities – U.S. Dollar.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

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Each of the legal entities domiciled in Russia, Ukraine, Uzbekistan, Turkmenistan and Belarus maintain their records and prepare their financial statements in the local currency, either Russian ruble, Ukrainian hryvnia, Uzbek som, Turkmenian manat or Belarussian ruble, in accordance with the requirements of local statutory accounting and tax legislation.

The Group has selected the U.S. Dollar as its reporting currency. Remeasurement of financial statements into functional currencies and translation of financial statements into U.S. Dollars has been performed in accordance with the provisions of Statement of Financial Accounting Standard (“SFAS”) No. 52 “Foreign Currency Translation”:

- For entities whose records are not maintained in their functional currencies, monetary assets and liabilities have been remeasured at the period end exchange rates. Non-monetary assets and liabilities have been remeasured at historical rates. Revenues, expenses and cash flows have been remeasured at historical rates. Remeasurement differences resulting from the use of these rates have been accounted for as currency exchange and transaction gains and losses in the accompanying consolidated statements of operations;
- For MR South, UMC, and for the Turkmen branch of BCTI where the functional currency is other than the reporting currency, the Russian ruble, Ukrainian hryvnia and Turkmenian manat, respectively, all year-end balance sheet items have been translated into U.S. Dollars at the period-end exchange rate. Revenues and expenses have been translated at period average exchange rate. In addition, a “new cost basis” for all non-monetary assets of MR South has been established as of January 1, 2003, when the Russian economy ceased to be considered hyperinflationary. Cumulative translation adjustments related to the use of local currency as the functional currency of \$41,315, \$24,898 and \$15,361 were recorded directly in the consolidated statement of shareholders’ equity for the years ended December 31, 2006, 2005 and 2004, respectively.

**Management estimates** – The preparation of consolidated 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 during the reporting period. Actual results could differ from those estimates.

Examples of significant estimates include the allowance for doubtful accounts, the recoverability of intangible assets and other long-lived assets, valuation allowances on deferred tax asset accruals, and valuation of financial instruments.

**Cash and cash equivalents** – Cash represents cash on hand and in MTS’s bank accounts and short-term investments, including term deposits, having original maturities of less than three months.

**Short-term investments** – Short-term investments represent investments in time deposits, which have original maturities in excess of three months but less than twelve months. These investments are accounted for at cost.

**Allowance for doubtful accounts** – MTS provides an allowance for doubtful accounts based on management’s periodic review for recoverability of accounts receivable from customers and other receivables.

**Prepaid expenses** – Prepaid expenses are primarily comprised of advance payments made to vendors for inventory and services.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

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**Inventory** – Inventory mainly consists of handsets and accessories held for sale, spare parts, to be used for equipment maintenance within the next twelve months, advertising materials, and other inventory items. Inventory is stated at the lower of cost or market value.

Prior to January 1, 2006, inventory cost was determined using the first-in, first-out, or FIFO method. Starting from January 1, 2006, the Group changed its method of accounting for inventory cost from FIFO to the weighted average cost (“WAC”) method. The primary purpose for the change was to ensure a better comparability of the Group’s financial statements with those of other wireless operators as the WAC method is widely used throughout the industry. The effect of the change in accounting policy was not significant to the Group’s consolidated financial position, results of operations and cash flows and is not expected to be in the future.

Handsets and accessories held for sale are expensed when sold. The Group periodically assesses its inventories for obsolete and slow-moving stock.

**Value-added tax (“VAT”)** – Value-added tax related to sales is payable to the tax authorities on an accrual basis based upon invoices issued to the customer. VAT incurred for purchases may be reclaimed from the state, subject to certain restrictions, against VAT related to sales.

**Assets held for sale** – In 2006, management of the Group decided to discontinue using certain telecommunication equipment in Russian regions in accordance with Group’s network development strategy. This equipment had a net book value of approximately \$63.2 million as of December 31, 2006. The Company has negotiated with a third party to sell this equipment during the year ended December 31, 2007, at net book value. Accordingly, this equipment has been classified as a current asset in the Group’s financial statements as of December 31, 2006.

**Property, plant and equipment** – Property, plant and equipment, including improvements that extend useful lives, are stated at cost. Property, plant and equipment with a useful life of more than one year is capitalized at historical cost and depreciated on a straight-line basis over its expected useful life as follows:

Network and base station equipment	5-12 years
Leasehold improvements	shorter of 8-10 years or lease term
Office equipment and computers	5 years
Buildings	50 years
Vehicles	4 years

Construction in progress and equipment held for installation is not depreciated until the constructed or installed asset is ready for its intended use.

Maintenance and repair costs are expensed as incurred, while upgrades and improvements are capitalized.

Interest expense incurred during the construction phase of MTS network under development is capitalized as part of property, plant and equipment until the relevant projects are completed and placed into service.

As a result of the financial statement restatements by numerous U.S. public companies and publication of a letter by the Chief Accountant of the SEC regarding the interpretation of longstanding lease accounting principles in 2004, MTS corrected its accounting practices for leasehold improvements in the fourth quarter of 2004. The primary effect of this accounting correction was to accelerate to earlier periods depreciation expenses with respect to certain components of previously capitalized leasehold improvements.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

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These corrections resulted in a cumulative charge to net income of \$34.9 million, net of income tax, in the fourth quarter of 2004, of which \$21.5 million related to the years 1998 through 2003.

The net cumulative charge is comprised of a \$44.5 million increase in depreciation expense related primarily to depreciation of capitalized leasehold improvement expenses for base stations; a decrease of \$1.4 million in the equity net income from MTS Belarus also related to depreciation of capitalized leasehold improvement expenses for base station sites; and an increase of \$11.0 million related to an additional deferred tax benefit due to the change in accounting base for property, plant and equipment.

All components of the net charge were non-cash and did not impact historical or future cash flows or the timing of payments under the related leases.

**Asset retirement obligations** – In accordance with SFAS No. 143, “Accounting for Asset Retirement Obligations”, the Group calculates an asset retirement obligation and an associated asset retirement cost when the Group has a legal or constructive obligation in connection with the retirement of tangible long-lived assets. The Group’s obligations under SFAS No. 143 relate primarily to the cost of removing its equipment from sites. As of December 31, 2006 and 2005, the estimated asset retirement obligations were not significant to the Group’s consolidated financial position and results of operations.

In March 2005, the Financial Accounting Standards Board (“FASB”) issued Interpretation No. 47, “Accounting for Conditional Asset Retirement Obligations – an interpretation of FASB Statement No. 143.” This Interpretation clarifies that the term “conditional asset retirement obligation” as used in FASB Statement No. 143, “Accounting for Asset Retirement Obligations”, which refers to a legal obligation to perform an asset retirement activity, in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. Uncertainty about the timing and (or) method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists to make a reasonable estimate of the fair value of the obligation. Interpretation No. 47 was effective for the Group beginning January 1, 2006. The adoption of this Interpretation did not have a material impact on its consolidated financial position and results of operations.

**License costs** – License costs are capitalized as a result of (a) the purchase price allocated to licenses acquired in business combinations and (b) licenses purchased directly from government organizations, which require license payments.

The current operating licenses of the Group do not provide for automatic renewal upon expiration. As the Group and the industry do not have sufficient experience with the renewal of licenses, license costs are being amortized during the initial license period without consideration of possible future renewals, subject to periodic review for impairment, on a straight-line basis over three to ten years starting from the date such license becomes commercially operational.

**Other intangible assets and goodwill** – Intangible assets represent various purchased software costs, telephone numbering capacity, acquired customer base, rights to use radio frequencies and rights to use premises. A part of the rights to use premises was contributed by shareholders to the Group’s charter capital. Telephone numbering capacity with a finite contractual life is being amortized over the contract period which varies from five to ten years and the rights to use premises are being amortized over five to fifteen years. Amortization of numbering capacity costs starts immediately upon the purchase of numbering capacity. Telephone numbering capacity with unlimited contractual life is not amortized, but is reviewed, at least annually, for impairment in accordance with the provisions of SFAS No. 142, “Goodwill and Other Intangible Assets” (“SFAS No. 142”).



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Software and other intangible assets are amortized over three to fifteen years. Customer bases acquired after January 1, 2005, are amortized over their estimated average subscriber life, being from 32 to 60 months. In 2004 the average subscriber life ranged from 20 to 76 months. The effect of the change in this estimate in 2006 and 2005 was not material. Rights to use radio frequencies are amortized over the period of their contractual life, being from two to fifteen years. All finite-life intangible assets are amortized using the straight-line method.

Goodwill represents an excess of the cost of business acquired over the fair market value of identifiable net assets at the date of acquisition. Goodwill is reviewed for impairment at least annually or whenever it is determined that one or more impairment indicators exist. The Group determines whether impairment has occurred by assigning goodwill to the reporting unit identified in accordance with SFAS No. 142, and comparing the carrying amount of the reporting unit to the fair value of the reporting unit. If an impairment of goodwill has occurred, the Group recognizes a loss for the difference between the carrying amount and the implied fair value of goodwill. To date, no impairment of goodwill has occurred.

**Leasing arrangements** – The Group accounts for leases based on the requirements of SFAS No. 13, “Accounting for Leases.” Entities of the Group lease operating facilities, which include switches, base stations and other cellular network equipment. The Group also leases premises and other sites to install base stations equipment and towers. Rentals payable under operating leases are charged to the income statement on a straight line basis over the term of the relevant lease. For capital leases, the present value of future minimum lease payments at the inception of the lease is reflected as an asset and a liability in the balance sheet. Amounts due within one year are classified as short-term liabilities and the remaining balance as long-term liabilities.

**Investments impairment** – Management periodically assesses the recoverability of the carrying values of investments and, if necessary, records impairment losses to write the investments down to fair value. During the year ended December 31, 2006, the Group’s investment in Bitel LLC (“Bitel”) of \$150 million was written down to \$nil (Note 20). For the two years ended December 31, 2005 and 2004, no impairment of investments occurred.

**Impairment of long-lived assets** – MTS 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, MTS compares 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, MTS records impairment losses to write the asset down to fair value, measured by the estimated discounted net future cash flows expected to be generated from the use of the assets. No impairment of long-lived assets occurred during the three years ended December 31, 2006.

**Subscriber prepayments** – MTS requires the majority of its customers to pay in advance for telecommunication services. All amounts received in advance of services provided are recorded as a subscriber prepayment liability and are not recorded as revenues until the related services have been provided to the subscriber.

**Treasury stock** – Shares of common stock repurchased by the Group are recorded at cost as treasury stock and reduced the shareholders’ equity in the Group’s consolidated financial statements.

**Revenue recognition** – The Group records its revenues net of VAT. Revenues are recognized only when all of the following conditions have been met: (i) there is pervasive evidence of an arrangement; (ii) delivery of services and goods has occurred; (iii) the fees are fixed and determinable; and (iv) collectibility of the fees is reasonably assured.

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MTS categorizes its revenue sources in the statements of operations as follows:

- Service revenue and connection fees: (a) usage charges; (b) subscription fees; (c) value added service fees; (d) fees for connecting users of other operators' fixed line and wireless networks to MTS's network ("interconnect fees"); (e) roaming fees charged to other operators for guest roamers utilizing MTS's network; (f) connection fees; and
- Sales of handsets and accessories.

*Usage charges* – Usage charges consist of fees determined based on airtime used by a subscriber, the destination of the call and the service utilized, and access charges. MTS recognizes revenues related to usage charges and access charges in the period when services are rendered.

*Subscription fees* – MTS recognizes revenues related to the monthly network subscription fees in the month when the service is provided to the subscriber.

*Value added service fees* – Value added service fees are determined based on the usage of airtime or the volume of data transmitted for value added services, such as short message services ("SMS"), including content services via SMS, internet usage and data services. The Group evaluates the criteria outlined in Emerging Issues Task Force ("EITF") Issue No. 99-19 "Reporting Revenue Gross as a Principal Versus Net as an Agent" in determining whether it is appropriate to record the gross amount of services provided and related costs or the net amount earned as commissions. Revenue is recorded gross when MTS is primarily obligated in a transaction, has latitude in establishing prices and selecting suppliers of services, or has several but not all of these indicators.

*Roaming fees* – MTS charges roaming per-minute fees to other wireless operators for non-MTS subscribers utilizing MTS's network. MTS recognizes such revenues when the services are provided.

*Interconnect fees* – MTS recognizes interconnect fees for incoming calls to customers from fixed line or wireless networks owed by other operators in the month when services to the customer are actually provided.

Effective July 1, 2006, an amendment to the RF Federal Law on Communications implemented the "calling party pays", or CPP, principle prohibiting mobile operators from charging their subscribers for incoming calls. Previously, MTS charged subscribers in Russia for incoming calls. Under the new system, MTS charges the telecommunication operators of the calling party for incoming calls, and, in its turn, MTS pays other operators for the outgoing calls of its subscribers.

*Connection fees* – MTS defers the initial connection fees on its prepaid and postpaid tariff plans from the moment of initial signing of the contract with subscribers and activation of value added services over the estimated average subscriber life. Following management analysis of the subscriber base in the regions where the Group operates, effective January 1, 2004, average subscriber lives were changed. From January 1, 2004, the Group calculates an average expected term of the subscriber relationship for each region and amortizes regional connection fees accordingly. The average expected subscriber life ranged from 20 to 76 months in 2004, and from 12 to 60 months in 2005 and 2006. The effect of the change in this estimate was approximately \$8.5 million, net of income tax or \$0.004 per share, in 2004, and not material in 2005 and 2006.

*Sales of handsets and accessories* – MTS sells wireless handsets and accessories to customers who are entering into contracts for service and also as separate distinct transactions. The Group recognizes revenues from the sale of wireless handsets and accessories when the products are delivered to and accepted by the customer, as it is considered to be a separate earnings process from the sale of wireless services in accordance with "EITF" Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables". The costs of wireless handsets and accessories, whether sold to subscribers through

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the distribution channel or as part of the service contract, are expensed when the associated revenue is recognized.

*Customer incentives* – Incentives provided to customers are usually offered on signing a new contract or as part of a promotional offering. Incentives, representing the reduction of the selling price of the service (free minutes and discounts) are recorded in the period to which they relate, when the respective revenue is recognized, as a reduction to both accounts receivable and revenue. However, if the sales incentive is a free product or service delivered at the time of sale, the fair value of the free product or service is classified as an expense. In particular, in Ukraine, MTS sells handsets at prices below cost to contract subscribers. Such subsidies are recognized in the cost of equipment when the sale is recorded.

*Prepaid phone cards* – MTS sells prepaid phone cards to subscribers, separately from the handset. These cards allow subscribers to make a predetermined allotment of wireless phone calls and/or take advantage of other services offered by the Group, such as short messages and value-added services. The Group recognizes revenue from the services in the month when the services were actually rendered. Revenue from the sale of prepaid cards is deferred until the service is rendered to the customer uses the airtime or the card expires.

*Cost of services* – Expenses incurred by MTS in connection with the provision of wireless communication services mainly relate to interconnect and line rental costs, roaming expenses and costs of handsets and accessories sold.

Calls made by MTS subscribers from areas outside of the territories covered by the Group's licenses are subject to roaming fees charged by the wireless provider in those territories. These fees are recorded as roaming expenses, as MTS acts as the principal in the transaction with the subscriber, being a primary obligor in providing the services, bearing the credit risk and having latitude in establishing roaming prices. MTS charges its subscribers for roaming fees paid to other networks based on the Group's existing tariffs and records such roaming fees as service revenues at the time the services are performed.

*Taxation* – Deferred tax assets and liabilities are recognized for the expected future tax consequences of existing differences between financial reporting and tax reporting bases of assets and liabilities, and for the loss or tax credit carry-forwards using enacted tax rates expected to be in effect at the time these differences are realized. Valuation allowances are recorded for deferred tax assets for which it is more likely than not that these assets will not be realized.

*Sales and marketing expenses* – Sales and marketing expenses consist primarily of dealers' commissions and advertising costs. Dealers' commissions are linked to revenues received during the six-month period from the date a new subscriber is activated by a dealer. MTS expenses these costs as incurred. Advertising costs for the years ended December 31, 2006, 2005 and 2004, were \$321,451, \$248,610 and \$159,035.

*Borrowing costs* – Borrowing costs include interest incurred on existing indebtedness and debt issuance costs. Interest costs for assets that require a period of time to get them ready for their intended use are capitalized and amortized over the related assets' estimated useful lives. The capitalized interest costs for the years ended December 31, 2006, 2005 and 2004 were \$70,274, \$54,229 and \$33,209, respectively. Debt issuance costs are capitalized and amortized over the term of the respective borrowings using the effective interest method. Interest expenses net of amounts capitalized and amortization of debt issuance costs, for the years ended December 31, 2006, 2005 and 2004, were \$138,977, \$110,422 and \$97,092, respectively.

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**Government Pension Fund** – The Group contributes to the local state pension and social funds, on behalf of all its employees.

In Russia, starting from 2001, all social contributions, including contributions to the pension fund, were substituted with a unified social tax (“UST”) calculated by the application of a regressive rate from 35.6% to 2% of the annual gross remuneration of each employee, that was changed, starting January 1, 2005, to a rate from 26% to 2%. The UST is allocated to three social funds, including the pension fund, where the rate of contributions to the pension fund vary from 28% to 2% (from 20% to 2% starting January 1, 2005), depending on the annual gross salary of each employee. These contributions are expensed as incurred. The amount of UST paid by the Group in Russia amounted to \$35.8 million, \$35.3 million and \$33.7 million in 2006, 2005 and 2004, respectively.

In Ukraine, Uzbekistan and Turkmenistan the subsidiaries of the Group are required to contribute a specified percentage of each employee payroll up to a fixed limit to the local pension fund, unemployment and social security funds. Payments to the pension fund in the Ukraine amounted to \$9.1 million, \$6.6 million and \$2.9 million in 2006, 2005 and 2004 years, respectively. Amounts contributed to the pension funds in Uzbekistan and Turkmenistan were not significant.

The Group does not participate in any pension funds other than described above.

**Earnings per share** – Basic earnings per shares (“EPS”) have been determined using the weighted average number of shares outstanding during the year. Diluted EPS reflect the potential dilutive effect of stock options granted to employees. There are 1,435,001, 3,187,240 and 3,530,970 stock options outstanding as at December 31, 2006, 2005 and 2004, respectively.

The following is the reconciliation of the share component for basic and diluted EPS with respect to the Group’s net income:

	<b>December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Weighted average number of common shares outstanding	1,987,610,121	1,986,819,999	1,984,497,348
Dilutive effect of stock options, as if exercised	35,894	290,040	1,168,573
Weighted average number of common shares and potential shares outstanding	<u>1,987,646,015</u>	<u>1,987,110,039</u>	<u>1,985,665,921</u>

**Financial instruments and hedging activities** – From time to time in its acquisitions, the Group uses financial instruments, consisting of put and call options on all or part of the minority stakes of acquired companies, to defer payment of the purchase price and provide optimal acquisition structuring. These put and call options qualify as freestanding financial instruments and are accounted in accordance with the provisions of SFAS No. 150 “Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity” and EITF 00-6 “Accounting for Freestanding Derivative Financial Instruments Indexed to, and Potentially Settled in, the Stock of a Consolidated Subsidiary”. Put and call options for the acquisitions of Dagtelecom and Uzdunrobita minority interests are measured initially and subsequently at fair value. See also Note 3 “Businesses acquired” and Note 20 “Other investments”.

From time to time the Group enters into variable-to-fixed interest rate swap agreement to manage its exposure to variability in expected future cash flows of its variable-rate long term debt, which is caused by interest rate fluctuations.

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The Group accounts for these swaps in accordance with the provisions of SFAS No. 133 “Accounting for Derivative Instruments and Hedging Activities” and SFAS No. 149 “Amendment of Statement 133 on Derivative Instruments and Hedging Activities.” All derivatives are recorded as either assets or liabilities in the consolidated balance sheets and measured at their respective fair values.

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges are recognized in equity. The gain or loss relating to the ineffective portion is recognized immediately in the income statement.

The Group’s interest rate swap agreements are designated as cash flow hedges and the hedging relationship qualifies for hedge accounting. Accordingly, the effective portion of the change in the fair value of interest rate swap agreements is recorded in other comprehensive income and reclassified to interest expense in the same period that the related cash flows of the hedged transaction affect the interest expense.

At the inception of the hedge, and on a quarterly basis, the Group performs an analysis to assess whether changes in the cash flows of its interest rate swap agreements are deemed highly effective in offsetting changes in the cash flows of the hedged debt. If at any time the correlation assessment indicates that the interest rate swap agreements are no longer effective as a hedge, the Group discontinues hedge accounting and all subsequent changes in fair value are recorded in net income.

The Group does not use financial instruments for trading purposes.

**Fair value of financial instruments** – The fair market value of financial instruments, consisting of cash and cash equivalents, short-term investments, derivative financial instruments, accounts receivable and accounts payable, which are included in current assets and liabilities, approximates the carrying value of these items due to the short term nature of these amounts. As of December 31, 2006, the \$400 million Notes due in 2008 had a fair value of 106.2% or \$425 million, the \$400 million Notes due in 2010 had a fair value of 106.7% or \$427 million and the \$400 million Notes due in 2012 had a fair value of 106.7% or \$427 million. As of December 31, 2006, the fair value of other fixed rate debt including capital lease obligations approximated its carrying value. The fair value of variable rate debt approximates its carrying value.

**Comprehensive income** – Comprehensive income is defined as net income plus all other changes in net assets from non-owner sources. The following is the reconciliation of total comprehensive income, net of tax for the years ended December 31, 2006, 2005 and 2004:

	Year ended December 31,		
	2006	2005	2004
Net income	\$ 1,075,738	\$ 1,126,405	\$ 987,878
Translation adjustment	41,315	24,898	15,361
Early termination and change in fair value of interest rate swaps, net of tax of \$794, \$1,033 and \$123	(2,013)	3,272	(512)
Total comprehensive income	<u>\$ 1,115,040</u>	<u>\$ 1,154,575</u>	<u>\$ 1,002,727</u>

**Stock-based compensation** – Prior to December 31, 2005, MTS accounted for stock options issued to employees under the recognition and measurement provisions of APB Opinion No. 25 “Accounting for Stock Issued to Employees, Compensation” (“APB No.25”), as permitted by FASB Statement No. 123 “Accounting for Stock-Based Compensation” (“SFAS No.123”) and SFAS No. 148 “Accounting for Stock Based Compensation – Transition and Disclosure, an Amendment to FASB Statement No. 123”.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

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Under the requirements of these statements, the Group elected to use the intrinsic value of options on the measurement date as a method of accounting for compensation to employees. According to the terms of the option plan, the exercise price of the options equaled the average market share price during the hundred day period preceding the grant date. The difference in the exercise price of the option and market price at the date of grant was shown as unearned compensation in the consolidated statements of changes in shareholders' equity and was amortized to expense over the vesting period of two years.

Effective from January 1, 2006, MTS adopted the provisions of FASB Statement No. 123R "Share based payments" (SFAS No. 123R), using the modified-prospective-application transition method. Under this transition method, the compensation cost of \$1.7 million recognized in 2006 includes the compensation cost for all share-based awards granted prior to, but not yet vested as of December 31, 2006, determined based on the grant date fair value estimated in accordance with the original requirements of SFAS No. 123, using the same assumptions and taken into account the estimated forfeitures. The Group's consolidated financial statements for the periods prior to 2006 have not been restated, in accordance with SFAS No. 123R. Total compensation costs of \$1.5 million and \$0.9 million were recognized during the years ended December 31, 2005 and 2004, respectively. The effect from forfeitures comprised \$0.3 million and \$1.1 million the years ended December 31, 2005 and 2004, respectively. The effect of the estimated forfeitures upon adoption of SFAS No. 123R is not significant.

As a result of adopting SFAS No. 123R, the Group's net income for the year ended December 31, 2006, is \$1.5 million lower than if it had continued to account for share-based compensation under APB No. 25.

The reported basic and diluted earnings per share of \$0.63 for the year ended December 31, 2006, would not have changed significantly if the Group had not adopted SFAS No. 123R.

As of December 31, 2006, there is \$0.7 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements. This amount is expected to be recognized over a weighted-average period of 0.54 years.

If the Group had recognized compensation costs following the provisions of the SFAS No. 123 in the years ended December 31, 2004 and 2005, net income and earning per share amounts would have been as follows:

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
Net income as reported	\$ 1,126,405	\$ 987,878
Add: Stock-based compensation included in reported net income, net of related tax effects	1,175	900
Less: Pro forma stock-based compensation under SFAS No.123, net of related tax effects	(2,891)	(1,978)
Pro-forma net income	<u>\$ 1,124,689</u>	<u>\$ 986,800</u>
Earnings per share – basic and diluted		
As reported	\$ 0.57	\$ 0.50
Pro-forma	\$ 0.57	\$ 0.50

**Comparative information** – Certain prior year amounts have been reclassified to conform to the current period presentation.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

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(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)

*New and recently adopted accounting pronouncements* – In February 2006, the FASB issued FASB Statement No. 155, “Accounting for Certain Hybrid Financial Instruments, an amendment to FASB Statement No. 133 and 140” (“SFAS No 155”). SFAS No 155 addresses the application of SFAS No. 133 to beneficial interests in securitized financial assets and permits the remeasurement to fair value for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, requires the evaluation of interests in securitized assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, amends SFAS No. 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument, and clarifies certain other derivatives classification issues. This statement is effective for all financial instruments acquired, issued or subject to a remeasurement (new basis) event after the beginning of an entity’s fiscal year that starts after September 15, 2006, and is not expected to have a material impact on the Group’s financial position, results of operations and cash flows.

In June 2006, the FASB issued Interpretation No. 48 “Accounting for Uncertainty in Income Taxes – an interpretation of SFAS No. 109” (“FIN No. 48”) which is effective for fiscal years beginning after December 15, 2006. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Interpretation also requires enterprises to make explicit disclosures at the end of each reporting period about uncertainties in their income tax positions, including the detailed roll-forward of tax benefits taken that do not qualify for financial statement recognition. The Group adopted FIN No. 48 as of January 1, 2007. The adoption of FIN No. 48 did not have a material impact on the Group’s financial position, results of operations and cash flows.

In September 2006, the FASB issued FASB Statement No. 157, “Fair value measurements” (“SFAS No. 157”). SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands disclosure requirements of fair value measurement. SFAS No. 157 is applicable to other accounting pronouncements that require or permit fair value measurement, and accordingly, does not require any fair value measurement. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Group does not expect the adoption of SFAS No. 157 to have a material impact on the Group’s financial position, results of operations and cash flows.

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108, “Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements” (“SAB 108”). SAB 108 eliminates the diversity of practice surrounding how public companies quantify financial statement misstatements. It establishes an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the company’s financial statements and the related financial statement disclosures. SAB 108 must be applied to annual financial statements for the first fiscal year ending after November 15, 2006. The adoption of SAB 108 did not have a material impact on the Group’s financial position, results of operations and cash flows.

In February 2007, the FASB issued FASB Statement No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” – including an amendment of FASB Statement No. 115 (“SFAS No.159”), which permits an entity to measure certain financial assets and financial liabilities at fair value. SFAS No. 159 offers an irrevocable option to carry the vast majority of financial assets and liabilities at fair value, with changes in fair value recorded in earnings (the fair value option, or FVO). The Statement’s objective is to improve financial reporting by allowing entities to mitigate volatility in reported earnings caused by the measurement of related assets and liabilities using different attributes, without having to apply complex hedge accounting provisions. SFAS No.159 is effective as of the beginning of an entity’s first fiscal year beginning after November 15, 2007. Early adoption is

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

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permitted as of the beginning of the previous fiscal year provided that the entity (1) makes that choice in the first 120 days of that fiscal year, (2) has not yet issued financial statements, and (3) elects to apply the provisions of SFAS No.157. The Group is currently evaluating the provisions of SFAS No. 159 to determine the potential impact, if any, its adoption will have on the Group's financial statements.

### 3. BUSINESSES ACQUIRED

**Dagtelecom acquisition** – In July 2006, MTS acquired a 74.99% controlling stake in Dagtelecom for a cash consideration of \$14.7 million. In conjunction with this acquisition, the Group entered into a put and call option agreement to buy the remaining stake at fair market value within an exercise period commencing from September 1, 2009 and ending in July 2021, for the put option, and from 2009 to 2010 for the call option. The fair values of the option was \$nil at December 31, 2006. Dagtelecom is a GSM-900 mobile services provider in the Republic of Dagestan, a region in the South of Russia with a population of 2.6 million. Dagtelecom's customer base at the date of acquisition was approximately 170,000 subscribers (unaudited).

This acquisition was accounted for using the purchase method of accounting. The purchase price allocation for the acquisition was as follows:

Current assets	\$	605
Non-current assets		12,747
Customer base cost		1,785
Goodwill		12,574
Current liabilities		(7,610)
Non-current liabilities		(5,086)
Deferred taxes		(392)
Minority interest		77
Purchase price	\$	<u>14,700</u>

Goodwill is mainly attributable to the economic potential of the macro-region South, where Dagtelecom is located. Goodwill is not deductible for income tax purposes.

The customer base is amortized over the estimated average subscriber's life of approximately 60 months.

**ReCom acquisition** – In December 2005, MTS purchased the remaining 46.1% stake in ReCom for \$110.0 million. Previously MTS owned 53.9% of ReCom. As a result of the transaction, MTS' ownership in the subsidiary increased to 100%. The acquisition was accounted for using the purchase method of accounting. The allocation of the purchase price increased the recorded license costs by \$43.9 million, the customer base costs by \$15.0 million and resulted in recognition of goodwill of \$16.2 million.

Goodwill is mainly attributable to the economic potential of the market given the low regional penetration level as of the date of acquisition. Goodwill is not deductible for income tax purposes. License costs are amortized over the remaining contractual terms of the licenses of approximately 3 to 8 years and the customer base is amortized over the average subscriber's life of approximately 60 months.

**BCTI acquisition** – In June 2005, MTS entered into an agreement to acquire 100% of the outstanding stock of BCTI, which is a leading cellular operator in Turkmenistan with a customer base of approximately 59,100 subscribers (unaudited). BCTI holds a license to provide GSM-900/1800 services for the whole territory of Turkmenistan and a license for the provision of AMPS services.



## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

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The agreement provided for the acquisition of a 51% stake and included a forward commitment to complete the acquisition of the remaining 49% stake within eight months from the date of the original agreement subject to certain conditions.

MTS acquired the 51% stake in BCTI for a cash consideration of \$28.2 million, including a finder's fee of \$2.5 million. The Group accounted for the purchase of the remaining 49% stake in BCTI as a financing of the minority interest and, consequently, consolidated 100% of the subsidiary starting from June 30, 2005. In November 2005, MTS completed the acquisition of the remaining 49% stake in BCTI for a cash consideration of \$18.5 million.

This acquisition was accounted for using the purchase method of accounting. Total purchase price amounted to \$46.7 million. The purchase price allocation for the acquisition was as follows:

Current assets	\$	7,808
Non-current assets		3,804
License costs		50,503
Deferred taxes		(10,862)
Current liabilities		(4,566)
Purchase price	\$	<u>46,687</u>

License costs are amortized over the remaining contractual terms of the licenses of approximately 4 years. In accordance with certain provisions of the license agreement with the Government of Turkmenistan, the Group shares the net profit derived from the operations of the BCTI branch located in Turkmenistan. The amount of shared net profit is calculated based on the financial statements prepared in accordance with local generally accepted accounting principles subject to certain adjustments. The Group shared 49% of the net profit since the date of acquisition up to December 21, 2005, and 20% of the net profit commencing December 21, 2005.

**Gorizont-RT acquisition** – In December 2004, MTS acquired a 76.0% stake in Gorizont-RT, a mobile phone operator in the Republic of Sakha (Yakutia) in the Far East of Russia, for a cash consideration of \$53.2 million. Gorizont-RT holds licenses to provide GSM-900/1800 services in the Republic of Sakha (Yakutia). The Gorizont-RT's customer base as at the date of acquisition was approximately 100,000 subscribers (unaudited). MTS has consolidated the financial results of Gorizont-RT since the date of acquisition.

The acquisition was accounted for using the purchase method. The purchase price allocation was as follows:

Current assets	\$	3,820
Non-current assets		17,501
License costs		26,362
Customer base cost		1,050
Trademark		153
Goodwill		20,214
Current liabilities		(4,949)
Non-current liabilities		(529)
Deferred taxes		(6,814)
Minority interest		(3,604)
Purchase price	\$	<u>53,204</u>

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)

Goodwill is mainly attributable to the economic potential of the market given the low regional penetration level as of the date of acquisition. Goodwill is not deductible for income tax purposes. License costs are amortized over the remaining contractual terms of the licenses of approximately 10 years and the customer base is amortized over the average subscriber's life of approximately 60 months.

In June 2005, MTS acquired the remaining 24.0% stake in Gorizont-RT, increasing its ownership to 100%. The purchase price paid was \$13.5 million. The allocation of purchase price increased the recorded license costs by \$7.5 million.

**Telesot Alania acquisition** – In December 2004, MTS purchased a 52.5% stake in Telesot Alania, a GSM mobile phone operator in the Republic of North Ossetia located in the South of Russia, for a cash consideration of \$6.2 million. Telesot Alania holds a license to provide GSM-900/1800 services in the Republic of North Ossetia. MTS has consolidated the financial results of Telesot Alania since the date of acquisition, Telesot Alania's customer base as at the date of acquisition was approximately 54,000 subscribers (unaudited). In December 2005, MTS acquired the remaining 47.5% stake in Telesot Alania, increasing its ownership in the company to 100%. In accordance with the purchase agreement the purchase price amounted to \$32.6 million, from which \$9.0 million was paid in 2005, and the remaining \$23.6 million was paid during 2006.

The acquisition was accounted for using the purchase method of accounting. The final purchase price allocation was as follows:

Current assets	\$	2,229
Non-current assets		5,508
License costs		8,706
Customer base cost		90
Goodwill		23,967
Current liabilities		(767)
Deferred taxes		(887)
Purchase price	\$	<u>38,846</u>

The purchase price allocation was completed in 2006. The adjustment to the preliminary purchase price allocation made as of the date of the acquisition in 2005 resulted in a reduction of goodwill and increase of license cost of \$2.3 million.

License costs are amortized over the remaining contractual terms of the license of approximately 2 years and the customer base is amortized over the average subscriber's life of approximately 60 months.

Goodwill is mainly attributable to the economic potential of the market in the macro-region "South" where the company is located. Goodwill is not deductible for income tax purposes.

**Sibintertelecom acquisition** – In November 2004, MTS acquired a 93.53% stake in Sibintertelecom, a mobile phone operator in Chita region and Aginsk-Buryatsk District in the Far East of Russia, for a cash consideration of \$37.4 million. Sibintertelecom holds licenses to provide GSM-900 services in the Chita region and the Aginsk-Buryatsk District in the Far East of Russia. MTS has consolidated the financial results of Sibintertelecom since the date of acquisition. The company's customer base as at the date of acquisition was approximately 100,000 subscribers (unaudited).

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The acquisition was accounted for using the purchase method of accounting. The purchase price allocation was as follows:

Current assets	\$	5,939
Non-current assets		6,966
License costs		29,555
Customer base cost		1,488
Trademark		465
Goodwill		10,376
Current liabilities		(9,523)
Deferred taxes		(7,668)
Minority interest		(190)
Purchase price	\$	<u>37,408</u>

Goodwill is mainly attributable to the economic potential of the market given the low regional penetration level as of the date of acquisition. Goodwill is not deductible for income tax purposes. License costs are amortized over the remaining contractual terms of the licenses of approximately 5 years for the Chita region and 7 years for the Aginsk-Buryatsk District and the customer base is amortized over the average subscriber's life of approximately 44 months.

In December 2005, MTS acquired the remaining 6.47% stake in Sibintertelecom, which resulted in an increase of MTS ownership in Sibintertelecom to 100.0%. The amount paid for the stake amounted to \$2.8 million. The allocation of purchase price increased recorded the license costs by \$1.4 million.

**TAIF Telecom acquisition** – In September 2004, MTS exercised its option to acquire the 47.3% of common shares and 50.0% of preferred shares in TAIF Telecom for a cash consideration of \$63.0 million, increasing its ownership to 100%. The Group received title to the acquired shares in October 2004.

The purchase price allocation increased the license costs by \$35.8 million, the acquired customer base by \$4.2 million, with goodwill of \$21.2 million being recorded. Goodwill is mainly attributable to the economic potential of the market. Goodwill is not deductible for income tax purposes. On April 1, 2006, TAIF Telecom was merged with MTS OJSC.

**Uzdunrobita acquisition** – In July 2004, MTS entered into an agreement to acquire 74% of the Uzbekistan mobile operator JV Uzdunrobita (“Uzdunrobita”) for a cash consideration of \$126.4 million, including transaction costs of \$5.4 million. The acquisition was completed on August 1, 2004, and, starting from this date, Uzdunrobita's financial results have been consolidated by the Group. Uzdunrobita holds licenses to provide GSM-1800 mobile communication services on the whole territory of Uzbekistan, which has a population of approximately 25.2 million. Uzdunrobita's customer base as of the date of acquisition was approximately 230,000 subscribers (unaudited).

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The acquisition was accounted for using the purchase method. The purchase price allocation for the acquisition was as follows:

Current assets	\$	5,950
Non-current assets		67,293
License costs		40,861
Customer base cost		958
Trademark		3,622
Goodwill		46,470
Current liabilities		(14,705)
Non-current liabilities		(1,356)
Deferred taxes		(6,384)
Minority interest		(16,308)
Purchase price	\$	<u>126,401</u>

Goodwill is mainly attributable to the economic potential of the market given the low penetration level as of the date of acquisition. Goodwill is not deductible for income tax purposes. License costs are amortized over the remaining contractual terms of the licenses of approximately 12 years and the customer base is amortized over the average remaining subscriber's life of approximately 39 months.

MTS also entered into call and put option agreements with the existing shareholders of Uzdurobita to acquire the remaining 26% common shares of the company. The exercise period for the call and put option was 48 months from the acquisition date. The fair value of the option was \$5.9 million at December 31, 2005, and was included in other current assets in the accompanying consolidated balance sheet.

In August 2006, MTS signed an amendment to the call and put option agreement, which eliminates the call option and extends the exercise period to July 2008. The purchase price under the put option will be determined by an international investment bank to be selected jointly by both parties within 10 days of the date of service of a put notice. These changes were made in accordance with the wishes of all parties to maintain and develop a mutually beneficial partnership as demonstrated by the strong results of Uzdurobita.

The amendment of the agreement has resulted in the decrease of the fair value of the option to \$nil as at December 31, 2006, and recognition of an interest expense of \$5.9 million for the year ended December 31, 2006.

**Primtelefon acquisition** – In June 2004, MTS purchased 50% of a Far-Eastern operator, CJSC Primtelefon (“Primtelefon”), for a cash consideration of \$31 million, increasing its effective ownership to 100%, as 50.0% of Primtelefon's shares were controlled through Vostok Mobile, a wholly-owned subsidiary of MTS. MTS has consolidated the financial results of Primtelefon since the date of acquisition of the second stake. Primtelefon holds licenses to provide GSM 900/1800 mobile cellular communications in the Far East region of Russia. The company's subscriber base as of the date of acquisition of the controlling stake was approximately 216,000 subscribers (unaudited).

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

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The acquisition was accounted for using the purchase method. The purchase price allocation was as follows:

Current assets	\$	11,041
Non-current assets		16,809
License costs		21,891
Current liabilities		(7,488)
Non-current liabilities		(5,671)
Deferred taxes		(5,582)
Purchase price	\$	<u>31,000</u>

License costs acquired are amortized over the remaining contractual terms of the licenses of approximately 7 years and the customer base is amortized over the average remaining subscriber's life of approximately 41 months.

***Acquisitions of various regional companies*** – In December 2005, MTS acquired an additional 74% stake in MTS-Tver for \$1.4 million. As a result of the transaction, MTS's ownership in the company increased to 100%. The acquisition was accounted for using the purchase method.

In February 2005, MTS completed the acquisition of 74.9% stake in Sweet-Com LLC for a cash consideration of \$2.0 million. Sweet-Com LLC is the holder of 3.5GHz radio frequency allocation for the Moscow region. The company is providing wide-band radio access services for the "last mile" based on Radio-Ethernet technology. The acquisition was accounted for using the purchase method. As the result of the purchase price allocation, license costs increased by \$2.4 million.

In February 2005, MTS acquired a 74.0% stake in MTS-Komi Republic, increasing its ownership to 100.0%. The consideration paid under the transaction amounted to \$1.2 million. The acquisition was accounted for using the purchase method.

In August 2004, MTS acquired the remaining 50% stakes in Astrakhan Mobile and Volgograd Mobile, increasing its ownership to 100.0%. The acquisition price was paid in cash and amounted to \$1.1 million and \$2.9 million, respectively. The results of both companies have been consolidated by the Group since the date of acquisition. Astrakhan Mobile holds 800/1800 MHz license covering the Astrakhan region (population of approximately 1 million) and Volgograd Mobile holds 800/1800 MHz license covering the Volgograd region (population of approximately 2.7 million). As of July 31, 2004, the two companies provided AMPS/DAMPS services to approximately 10,000 subscribers (unaudited). The acquisition was accounted for using the purchase method. The allocation of purchase price for the first and second stakes in both companies resulted in an increase in license costs by \$16.5 million.

In August 2004, MTS acquired from OJSC Volgatelecom the remaining 49% stake in UDN-900 for \$6.4 million in cash. This acquisition increased MTS's ownership in UDN to 100%. The allocation of the purchase price increased recorded license costs by \$0.3 million. On July 1, 2005, UDN was merged with MTS OJSC. UDN-900 provides GSM 900 services under the MTS brand in the Udmurtia Republic. UDN's subscriber base as of July 31, 2004, was 219,760 (unaudited).

In April 2004, MTS acquired from OJSC Sibirtelecom an additional 7.5% stake in MSS, a company which operates in the Omsk region, for \$2.2 million in cash. This acquisition increased MTS's ownership in MSS to 91.0%. The acquisition was accounted for using the purchase method. The allocation of purchase price increased recorded license costs by \$1.1 million.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

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In April and May of 2004, MTS acquired the remaining stakes in the following subsidiaries:

- 35.0% of MTS-NN (a service provider in Nizhny Novgorod) for \$0.5 million, and
- 49.0% of Novitel (handsets dealer in Moscow) for \$1.3 million.

Both acquisitions increased MTS' share in the respective companies to 100%. The acquisitions were accounted for using the purchase method. The allocation of purchase price increased recorded goodwill by \$1.8 million. Goodwill is not deductible for income tax purposes.

If the additions of Dagtelecom had occurred of January 1, 2005, the effect on the Group's revenue, net income and earnings per share would not be significant.

#### 4. CASH AND CASH EQUIVALENTS

Cash and cash equivalents as of December 31, 2006 and 2005, comprised the following:

	December 31,	
	2006	2005
Ruble current accounts	\$ 92,626	\$ 46,119
Ruble deposit accounts	13,292	6,775
U.S. Dollar current accounts	8,445	4,599
U.S. Dollar deposit accounts	37,601	751
Hryvnia current accounts	14,931	4,540
Hryvnia deposit accounts	5,941	-
Uzbek som current accounts	1,816	920
Uzbek som deposit accounts	35,513	3,812
Turkmenian manat current accounts	7,441	10,651
Current accounts in other currencies	2,383	117
Total cash and cash equivalents	<u>\$ 219,989</u>	<u>\$ 78,284</u>

#### 5. SHORT-TERM INVESTMENTS

Short-term investments, consisting of deposits denominated in U.S. Dollars, as of December 31, 2006, comprised the following:

	Annual interest rate	Maturity Date	December 31, 2006
OJSC Moscow Bank of Reconstruction and Development	7.5%	March, 2007	\$ 42,700
OJSC Moscow Bank of Reconstruction and Development	7.5%	February, 2007	12,300
Other			1,047
Total short-term investments			<u>\$ 56,047</u>

OJSC Moscow Bank of Reconstruction and Development is a related party, whose controlling shareholder is Sistema (see also Note 17).

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

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Short-term investments, consisting of deposits denominated in U.S. Dollars, as of December 31, 2005, comprised the following:

	<u>Annual interest rate</u>	<u>Maturity Date</u>	<u>December 31, 2005</u>
East-West United Bank S.A.	2.0%	February 15, 2006	23,100
Other			4,959
Total short-term investments			<u>\$ 28,059</u>

East-West United Bank S.A., is a related party, whose controlling shareholder is Sistema.

#### 6. TRADE RECEIVABLES, NET

Trade receivables as of December 31, 2006 and 2005, comprised the following:

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
Accounts receivable, subscribers	\$ 183,038	\$ 147,138
Accounts receivable, interconnect	89,977	21,373
Accounts receivable, roaming	26,104	30,863
Accounts receivable, other	46,795	49,865
Allowance for doubtful accounts	(47,435)	(39,919)
Trade receivables, net	<u>\$ 298,479</u>	<u>\$ 209,320</u>

The following table summarizes the changes in the allowance for doubtful accounts for the years ended December 31, 2006, 2005 and 2004:

	<u>December 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Balance, beginning of the year	\$ 39,919	\$ 16,659	\$ 13,698
Provision for doubtful accounts	84,858	50,407	26,459
Accounts receivable written off	(77,342)	(27,147)	(23,498)
Balance, end of the year	<u>\$ 47,435</u>	<u>\$ 39,919</u>	<u>\$ 16,659</u>

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

*(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)*

#### 7. INVENTORY AND SPARE PARTS

Inventory and spare parts as of December 31, 2006 and 2005, comprised the following:

	December 31,	
	2006	2005
Spare parts for base stations	\$ 78,120	\$ 48,998
SIM cards and prepaid phone cards	34,611	26,902
Handsets and accessories	25,458	39,147
Advertising materials	9,021	5,513
Other materials	49,055	36,100
Total inventory and spare parts	<u>\$ 196,265</u>	<u>\$ 156,660</u>

Other materials mainly consist of stationery, fuel and auxiliary materials. Obsolescence expense for the years ended December 31, 2006, 2005 and 2004, amounted to \$nil, \$9,112 and \$4,610, respectively, and was included in general and administrative expenses in the accompanying consolidated statements of operations. Spare parts for base stations included in inventory are expected to be utilized within the next twelve months after the balance sheet date.

#### 8. PROPERTY, PLANT AND EQUIPMENT

The net book value of property, plant and equipment as of December 31, 2006 and 2005, was as follows:

	December 31,	
	2006	2005
Network, base station equipment (including leased network and base station equipment of \$7,676 and \$17,474, respectively) and related leasehold improvements	\$ 4,517,536	\$ 3,534,574
Office equipment, computers and other (including leased office equipment and computers of \$nil and \$402, respectively)	447,640	339,788
Buildings and related leasehold improvements	242,175	225,726
Vehicles (including leased vehicles of \$7,561 and \$nil, respectively)	31,949	21,830
Property, plant and equipment, at cost	<u>5,239,300</u>	<u>4,121,918</u>
Accumulated depreciation (including accumulated depreciation on leased equipment of \$4,321 and \$4,536)	(1,948,368)	(1,350,783)
Equipment for installation	582,827	621,346
Construction in progress	1,423,910	1,090,198
Property, plant and equipment, net	<u>\$ 5,297,669</u>	<u>\$ 4,482,679</u>

Depreciation expenses during the years ended December 31, 2006, 2005 and 2004, amounted to \$689.7 million, \$510.5 million and \$385.7 million, respectively, including depreciation expenses for leased property, plant and equipment in the amount of \$2.3 million, \$4.0 million and \$5.4 million, respectively.



## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

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*(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)*

#### 9. OTHER INTANGIBLE ASSETS

Intangible assets at December 31, 2006 and 2005, comprised the following:

	Useful lives	December 31, 2006			December 31, 2005		
		Gross carrying value	Accumulated amortization	Net carrying value	Gross carrying value	Accumulated amortization	Net carrying value
<b>Amortized intangible assets</b>							
Acquired customer base	30 to 60 months	\$ 114,850	\$ (95,751)	\$ 19,099	\$ 110,360	\$ (78,219)	\$ 32,141
Rights to use premises	1 to 15 years	4,177	(2,520)	1,657	8,749	(2,573)	6,176
Rights to use radio frequencies	2 to 15 years	163,963	(52,882)	111,081	130,839	(31,227)	99,612
Numbering capacity with finite contractual life	5 to 10 years	90,138	(64,522)	25,616	65,763	(50,325)	15,438
Billing and telecommunication software	13 to 180 months	919,400	(383,358)	536,042	704,594	(299,578)	405,016
Accounting software	13 to 48 months	125,277	(38,595)	86,682	102,753	(24,305)	78,448
Office software	13 to 48 months	63,605	(34,113)	29,492	33,854	(14,553)	19,301
Other software	3 to 15 years	14,754	(8,684)	6,070	8,867	(4,318)	4,549
		<u>1,496,164</u>	<u>(680,425)</u>	<u>815,739</u>	<u>1,165,779</u>	<u>(505,098)</u>	<u>660,681</u>
<b>Unamortized intangible assets</b>							
Numbering capacity with indefinite contractual life		20,177	-	20,177	20,344	-	20,344
		<u>20,177</u>	<u>-</u>	<u>20,177</u>	<u>20,344</u>	<u>-</u>	<u>20,344</u>
<b>Total other intangible assets</b>		<u>\$ 1,516,341</u>	<u>\$ (680,425)</u>	<u>\$ 835,916</u>	<u>\$ 1,186,123</u>	<u>\$ (505,098)</u>	<u>\$ 681,025</u>

As a result of the limited availability of local telephone numbering capacity in Moscow and the Moscow region, MTS has been required to enter into agreements for the use of telephone numbering capacity with several telecommunication operators in Moscow. The costs of acquiring numbering capacity with a finite contractual life are amortized over a period of five to ten years in accordance with the terms of the contract to acquire such capacity. Numbering capacity with an indefinite contractual life is not amortized.

A significant component of MTS's rights to use premises was obtained in the form of contributions to its charter capital in 1993. These premises included MTS' administrative offices and facilities utilized for mobile switching centers. By December 31, 2006, these rights were fully amortized and written-off due to their expiration. In addition, simultaneously with the acquisition of UMC in 2003, MTS obtained additional property rights of \$8.7 million. At December 31, 2006, UMC's rights to use premises amounted to \$1.7 million, net of accumulated amortization.

Amortization expense for the years ended December 31, 2006, 2005 and 2004, amounted to \$195.0 million, \$202.3 million and \$138.1 million, respectively. Based on the amortizable intangible assets existing at December 31, 2006, the estimated amortization expense is \$213.8 million for 2007, \$206.1 million for 2008, \$181.9 million for 2009, \$127.8 million for 2010, \$24.7 million for 2011 and \$61.4 million thereafter. The actual amortization expense reported in future periods could differ from these estimates as a result of new intangible asset acquisitions, changes in useful lives and other relevant factors.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

*(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)*

#### 10. DEFERRED CONNECTION FEES

Deferred connection fees for the years ended December 31, 2006 and 2005, were as follows:

	December 31,	
	2006	2005
Balance at beginning of the year	\$ 102,185	\$ 92,748
Payments received and deferred during the year	31,908	53,644
Amounts amortized and recognized as revenue during the year	(54,486)	(44,207)
Balance at end of the year	79,607	102,185
Less: current portion	(47,528)	(44,361)
Non-current portion	<u>\$ 32,079</u>	<u>\$ 57,824</u>

MTS defers initial connection fees paid by subscribers for the first time activation of network service as well as one time activation fees received for connection to various value added services. These fees are recognized as revenue over the estimated average subscriber life (Note 2).

#### 11. BORROWINGS

As at December 31, 2006 and 2005, the Group's borrowings comprised the following:

	December 31,	
	2006	2005
<b>Notes:</b>		
9.75% Notes due 2008	\$ 400,000	\$ 400,000
8.38% Notes due 2010	400,000	400,000
8.00% Notes due 2012	399,178	399,052
<b>Total notes, long-term</b>	<u>\$ 1,199,178</u>	<u>\$ 1,199,052</u>
Bank loans	\$ 1,872,621	\$ 1,645,784
Less: current portion	147,260	765,881
<b>Total debt, long-term</b>	<u>\$ 1,725,361</u>	<u>\$ 879,903</u>

**Notes** – On January 30, 2003, MTS Finance S.A. (“MTS Finance”), a 100% beneficially owned subsidiary of MTS, registered under the laws of Luxembourg, issued \$400.0 million 9.75% notes at par. These notes are fully and unconditionally guaranteed by MTS OJSC and mature on January 30, 2008. MTS Finance is required to make interest payments on the notes semi-annually in arrears on January 30 and July 30, commencing on July 30, 2003. The notes are listed on the Luxembourg Stock Exchange. Proceeds received from the notes issue were \$400.0 million and related issuance costs of \$3.9 million were capitalized.

On October 14, 2003, MTS Finance issued \$400.0 million notes bearing interest at 8.375% at par. The cash proceeds from the notes were \$395.4 million and related issuance costs of approximately \$4.6 million were capitalized. These notes are fully and unconditionally guaranteed by MTS OJSC and will mature on October 14, 2010. MTS Finance is required to make interest payments on the notes semi-annually in arrears on April 14 and October 14 of each year, commencing on April 14, 2004. The notes are listed on the Luxembourg Stock Exchange.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

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On January 27, 2005, MTS Finance issued \$400.0 million 8.0% unsecured notes at 99.736%. These notes are fully and unconditionally guaranteed by MTS OJSC and mature on January 28, 2012. MTS Finance is required to make interest payments on the notes semi-annually in arrears on January 28 and July 28, commencing on July 28, 2005. The notes are listed on the Luxembourg Stock Exchange. Proceeds received from the notes were \$398.9 million and related debt issuance costs of \$2.5 million were capitalized.

Subject to certain exceptions and qualifications, the indentures governing the notes contain covenants limiting the Group's ability to:

- incur debt;
- create liens;
- lease properties sold or transferred by the Group;
- enter into loan transactions with affiliates;
- merge or consolidate with another person or convey its properties and assets to another person; and
- sell or transfer any of its GSM licenses for the Moscow, St. Petersburg, Krasnodar and Ukraine license areas.

In addition, if the Group experiences certain types of mergers, consolidations or other changes in control, noteholders will have the right to require the Group to redeem the notes at 101% of their principal amount, plus accrued interest. The Group is also required to take all commercially reasonable steps necessary to maintain a rating of the notes from Moody's or Standard & Poor's. The notes also have cross default provisions with publicly traded debt issued by Sistema, the shareholder of the Group.

If the Group fails to meet these covenants, after certain notice and cure periods, the noteholders can accelerate the debt to be immediately due and payable.

Management believes that the Group is in compliance with all restrictive notes covenants provisions during the three year period ended December 31, 2006.

**Bank loans** – As at December 31, 2006 and 2005, the Group's loans from banking institutions were as follows:

	<u>Maturity</u>	<u>Annual interest rate (actual rate at December 31, 2006)</u>	<u>December 31,</u>	
			<u>2006</u>	<u>2005</u>
U.S. Dollar-denominated bank loans	2007-2014	LIBOR+0.13%-4.15% (5.50%-9.51%)	\$ 1,802,340	\$ 1,565,047
Euro-denominated bank loans	2007-2014	EURIBOR +0.35%- 0.65% (4.20%-4.50%)	66,281	80,050
Other loans	various	various	4,000	687
<b>Total debt</b>			<b>\$ 1,872,621</b>	<b>\$ 1,645,784</b>

The Group's loans represent amounts borrowed under credit facility agreements existing as of December 31, 2005, and under the syndicated loan facility agreement with a number of international financial institutions (The Bank of Tokyo-Mitsubishi UFJ, Ltd., Bayerische Landesbank, HSBC Bank plc, ING Bank N.V., Raiffeisen Zentralbank Oesterreich AG, Sumitomo Mitsui Banking Corporation Europe Limited), entered into in 2006. This facility allows the Group to borrow up to \$1,330.0 million which was available in two tranches of \$630.0 million and \$700.0 million. The proceeds were used by OJSC MTS for general corporate purposes, including acquisitions and refinancing of existing indebtedness. The first tranche bears interest of LIBOR+0.80% per annum and matures in 2009.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

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The second tranche bears interest of LIBOR+1.00% per annum within the first three years and LIBOR + 1.15% per annum thereafter, matures in April 2011 and is repayable in 13 equal quarterly installments, commencing in April, 2008. An arrangement fee of 0.10% of the original facility amount and agency fee of \$0.05 million per annum should be paid in accordance with the agreement. The commitment fee is 0.40% per annum on the undrawn facility in respect of second tranche. The debt issuance costs in respect of this loan of \$13.4 million were capitalized. As of December 31, 2006 the balances outstanding under the loan totaled \$860.0 million.

During 2006, MTS's loan agreements existing as of December 31, 2005, were amended to increase the amounts of available credit facilities by \$53.9 million. The Group's total available credit facilities as of December 31, 2006, amounted to \$625.3 million, including the \$470.0 million under the syndicated loan agreement described above.

The loans are subject to certain restrictive covenants, including, but not limited to, certain financial ratios, limitations on dispositions of assets and limitations on transactions with associates. Management believes that as of December 31, 2006, the Group is in compliance with all existing covenants.

The following table presents the aggregated scheduled maturities of the notes and debt principal outstanding as of December 31, 2006:

	<u>Notes</u>	<u>Debt</u>
Payments due in the year ended December 31,		
2007	\$ -	\$ 147,260
2008	400,000	200,502
2009	-	839,856
2010	400,000	202,567
2011	-	163,674
Thereafter	399,178	318,762
<b>Total</b>	<b><u>\$ 1,199,178</u></b>	<b><u>\$ 1,872,621</u></b>

**Hedges** – In December 2004, the Group entered into two variable-to-fixed interest rate swap agreements with ABN AMRO Bank N.V and HSBC Bank plc to hedge MTS's exposure to variability of future cash flows caused by the change in LIBOR related to the borrowed loan. MTS agreed with ABN AMRO to pay a fixed rate of 3.27% and receive a variable interest of LIBOR on \$100.0 million for the period from October 7, 2004 up to July 27, 2007. MTS agreed with HSBC Bank plc to pay a fixed rate of 3.25% and receive a variable interest of LIBOR on \$150.0 million for the period from October 7, 2004 up to July 27, 2007. As of December 31, 2005, the Group recorded an asset of \$3.6 million in relation to these contracts in the accompanying consolidated balance sheet and income of \$2.8 million, net of tax of \$0.8 million, as other comprehensive income in the accompanying consolidated statement of changes in shareholders equity in relation to the change in fair value of these agreements. The underlying loan was repaid ahead of schedule in July 2006, which resulted in early termination of the swap agreements.

In January 2006, the Group entered into a variable-to-fixed interest rate swap agreement with HSBC Bank plc to hedge MTS's exposure to variability of future cash flows caused by the change in EURIBOR related to the borrowed loan. MTS agreed with HSBC Bank plc to pay a fixed rate of 3.29% and receive a variable interest of EURIBOR on EUR 26.0 million for the period from April 28, 2006, up to October 29, 2013. As of December 31, 2006, the Group recorded an asset of \$1.0 million in relation to the hedge contract in the accompanying consolidated balance sheet and income of \$0.8 million, net of tax of \$0.2 million, as other comprehensive income in the accompanying consolidated statement of changes in shareholders equity in relation to the change in fair value of this agreement.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

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These instruments qualified as a cash flow hedges under the requirements of SFAS No. 133 as amended by SFAS No. 149. As of December 31, 2006, the outstanding hedge is highly effective. Approximately \$0.8 million is expected to be reclassified in net income during the next twelve months.

#### 12. CAPITAL LEASE OBLIGATIONS

The following table presents future minimum lease payments under capital leases together with the present value of the net minimum lease payments as of December 31, 2006:

Payments due in the year ended December 31,		
2007	\$	4,215
2008		2,934
2009		643
Thereafter		8
Total minimum lease payments (undiscounted)		<u>7,800</u>
Less: amount representing interest		<u>(1,147)</u>
Present value of net minimum lease payments		6,653
Less: current portion of lease payable		<u>(3,366)</u>
Non-current portion of lease payable	\$	<u><u>3,287</u></u>

The schedule includes a payable to Invest-Svyaz-Holding, a related party, in the amount of \$0.6 million (See Note 17).

#### 13. ACCRUED LIABILITIES

Accrued liabilities at December 31, 2006 and 2005, comprised the following:

	December 31,	
	2006	2005
Accruals for services	\$ 207,749	\$ 66,444
Accrued payroll and vacation	70,047	60,732
Accruals for taxes	68,098	97,712
Interest payable on debt	59,834	51,403
Total accrued liabilities	<u>\$ 405,728</u>	<u>\$ 276,291</u>

#### 14. INCOME TAX

MTS' provision for income taxes was as follows for the years ended December 31, 2006, 2005 and 2004:

	December 31,		
	2006	2005	2004
Current provision for income taxes	\$ 709,130	\$ 475,549	\$ 430,687
Deferred income tax benefit	(133,027)	(64,959)	(76,023)
Total provision for income taxes	<u>\$ 576,103</u>	<u>\$ 410,590</u>	<u>\$ 354,664</u>

The statutory income tax rates in 2004-2006 in Russia and Ukraine were 24% and 25%, respectively. The statutory income tax rates in 2004-2006 in Uzbekistan and Turkmenistan were 12% and 20%, respectively.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

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The statutory income tax rate reconciled to MTS's effective income tax rate is as follows for the years ended December 31, 2006, 2005 and 2004:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Statutory income tax rate for year	24.0%	24.0%	24.0%
Adjustments:			
Expenses not deductible for tax purposes	2.9	3.0	1.0
Currency exchange and transaction losses/(gain)	2.8	(0.8)	1.2
Bitel investment and liability write off, not deductible for tax purposes	4.6	-	-
Effect of higher tax rate of foreign subsidiaries	0.3	0.3	0.2
Other	-	(0.2)	(0.6)
Effective income tax rate	<u>34.6%</u>	<u>26.3%</u>	<u>25.8%</u>

Temporary differences between the tax and accounting bases of assets and liabilities give rise to the following deferred tax assets and liabilities at December 31, 2006 and 2005:

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
Assets/(liabilities) arising from tax effect of:		
<b>Deferred tax assets</b>		
Depreciation of property, plant and equipment	\$ 93,865	\$ 64,113
Deferred connection fees	19,214	24,784
Subscriber prepayments	25,755	23,153
Accrued expenses	72,864	33,803
Allowance for doubtful accounts	18,837	9,321
Inventory obsolescence	2,246	7,122
Other	9,994	8,013
Total deferred tax assets	<u>242,775</u>	<u>170,309</u>
Valuation allowance	(3,086)	(2,294)
Total deferred tax assets net of valuation allowance	<u>239,689</u>	<u>168,015</u>
<b>Deferred tax liabilities</b>		
Licenses acquired	\$ (83,462)	\$ (140,167)
Depreciation of property, plant and equipment	(48,574)	(42,394)
Customer base	(4,055)	(7,584)
Other intangible assets	(19,479)	(20,428)
Debt issuance cost	(16,841)	(17,836)
Other	(12,513)	(14,684)
Total deferred tax liabilities	<u>(184,924)</u>	<u>(243,093)</u>
Net deferred tax (asset/liability)	<u>54,765</u>	<u>(75,078)</u>
Net deferred tax asset, current	\$ 141,114	\$ 83,336
Net deferred tax liability, long-term	\$ (86,349)	\$ (158,414)

The Group does not record a deferred tax liability related to the undistributed earnings of UMC, Uzdunrobta and BCTI, as it intends to permanently reinvest these earnings. The undistributed earnings of UMC amounted to \$1,373.6 million and \$994.0 million for the years ended December 31, 2006 and 2005, respectively.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

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#### 15. SHAREHOLDERS' EQUITY

In accordance with Russian laws, earnings available for dividends are limited to profits determined in accordance with Russian statutory accounting regulations, denominated in rubles, after certain deductions. The net income of MTS OJSC for the years ended December 31, 2006, 2005 and 2004 that is distributable under Russian legislation totaled 32,094 million rubles (\$1,181.0 million), 12,544 million rubles (\$444.4 million) and 15,209 million rubles (\$527.9 million), respectively.

See also Note 1 for a description of the repurchase of the Company's own shares in December 2006.

#### 16. STOCK BONUS AND STOCK OPTION PLANS

In 2000, MTS established a stock bonus plan and stock option plan ("the Option Plan") for selected officers, key employees and key advisors. During its initial public offering in 2000 (see Note 1) MTS allotted 9,966,631 shares of its common stock to fund the Option Plan.

Since 2002, MTS has made several grants pursuant to its stock option plan to employees and directors of the Group. These options generally vest over a two year period from the date of the grant, contingent on continued employment of the grantee with the Company. A summary of the status of the Group's Option Plan is presented below:

	Number of shares	Weighted average exercise price (per share), U.S. Dollar	Weighted average fair value of options (per share), U.S. Dollar	Aggregate intrinsic value, thousands of U.S. Dollar
Outstanding at December 31, 2003	4,797,410	1.87	0.71	\$ 1,237
Granted	1,665,256	5.95	2.36	1,811
Exercised	(2,726,966)	1.49	0.50	(225)
Forfeited	(204,730)	1.92	0.73	(55)
Outstanding at December 31, 2004	3,530,970	4.09	1.65	\$ 2,777
Granted	1,778,694	6.89	1.74	907
Exercised	(1,801,622)	2.43	1.02	(924)
Forfeited	(320,802)	5.25	2.06	(305)
Outstanding at December 31, 2005	3,187,240	6.47	2.02	\$ 2,455
Granted	-	-	-	-
Exercised	(639,357)	5.95	2.36	(695)
Forfeited	(1,112,882)	6.23	2.17	(1,017)
Outstanding at December 31, 2006	1,435,001	6.89	1.74	\$ 743

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

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As of December 31, 2006 the Group had the following stock options outstanding:

<u>Exercise prices, U.S. Dollar</u>	<u>Number of shares</u>	<u>Remaining weighted average life (years)</u>
6.89	1,435,001	0.54

All options outstanding as of December 31, 2006 are non-vested and will vest in 2007.

The fair value of options granted during the years ended December 31, 2005 and 2004, were estimated using the binomial option pricing model using the following assumptions:

	<u>2005</u>	<u>2004</u>
Risk free rate	4.7%	4.5%
Expected dividend yield	3%	3%
Expected volatility	40.0%	48.8%
Expected life (years)	2	2
Fair value of options (per share)	\$1.74	\$2.36

In accordance with the Russian legislation, MTS Board members and key employees may be considered insiders with respect to the Group and thus may be restricted from selling their shares.

## 17. RELATED PARTIES

Related parties balances as of December 31, 2006 and 2005, comprised the following:

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
Accounts receivable:		
MTT for interconnection	\$ 5,164	\$ 862
Mediaplanning for advertising	2,041	1,400
Rosno for insurance	640	3,663
Maxima for advertising	152	1,689
Other	437	47
Total accounts receivable, related parties	<u>\$ 8,434</u>	<u>\$ 7,661</u>
Accounts payable:		
Sitronics for software	\$ 106,176	\$ 25,898
Kvazar-Micro.ru for systems integration services	8,172	6,564
SmartCards for SIM cards	6,304	-
MTT for interconnect	4,834	4,262
Maxima for advertising	4,167	1,082
Comstar UTS for interconnect	1,598	2,430
Mediaplanning for advertising	1,244	-
MGTS for interconnect	766	588
Other	1,995	5
Total accounts payable, related parties	<u>\$ 135,256</u>	<u>\$ 40,829</u>



## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

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Transactions with major related parties are described below.

***Moscow Bank of Reconstruction and Development (“MBRD”)*** – MTS maintains certain bank and deposit accounts with MBRD, whose major shareholder is Sistema. As of December 31, 2006 and 2005, MTS’s cash position at MBRD amounted to \$86.5 million and \$18.0 million in current accounts, respectively. Deposit accounts at MBRD amounted to \$55.0 million as of December 31, 2006, and \$nil as of December 31, 2005 (Note 5). The related interest accrued and collected on the deposits for the years ended December 31, 2006, 2005 and 2004, amounted to \$4.8 million, \$5.4 million and \$6.8 million, respectively, and was included as a component of interest income in the accompanying consolidated statements of operations.

***Rosno OJSC (“Rosno”)*** – MTS arranged medical insurance for its employees and property insurance with Rosno (a subsidiary of Sistema until February, 2007). Insurance premiums paid to Rosno for the years ended December 31, 2006, 2005 and 2004, amounted to \$11.3 million, \$12.6 million and \$7.6 million, respectively.

Starting from February, 2007, Rosno is no longer a related party of the Group, as Sistema sold its controlling stake in Rosno to Allianz.

***Maxima Advertising Agency (“Maxima”)*** – In 2006, 2005 and 2004, the MTS Group had agreements for advertising services with Maxima, a subsidiary of Sistema. Advertising costs related to Maxima for the years ended December 31, 2006, 2005 and 2004 amounted to \$117.8 million, \$58.6 million and \$48.9 million, respectively.

***Kvazar-Micro.ru (“Kvazar”)*** – In 2004, MTS signed agreements for software implementation services with Kvazar, a subsidiary of Sistema. Pursuant to these agreements, Kvazar provided systems integration services to MTS in 2006, 2005 and 2004 of approximately \$52.1 million, \$62.0 million and \$9.7 million, respectively.

***Comstar UTS (“Comstar”)*** – In 2006, 2005 and 2004, MTS had interconnection and line rental agreements with Comstar, a subsidiary of Sistema. The cost of interconnection and line rental services rendered by Comstar for 2006, 2005 and 2004 amounted to \$5.3 million, \$4.7 million and \$3.1 million, respectively.

During 2007 Telmos and MTU-Inform merged with Comstar. In 2006, 2005 and 2004, MTS had interconnect and line rental agreements with, and received domestic and international long-distance services from these entities. Interconnect and line rental expenses with these entities for 2006, 2005 and 2004 comprised \$25.9 million, \$25.2 million and \$27.3 million, respectively.

***Moscow City Telephone Network (“MGTS”)*** – In 2006, 2005 and 2004, MTS had line rental agreements with MGTS and rented a cable plant from MGTS for the installation of optic-fiber cable. MTS also rented buildings for administrative offices as well as premises for switchboard and base station equipment. Rental expenses for the years 2006, 2005 and 2004 amounted to \$13.1 million, \$8.3 million and \$5.9 million, respectively. Sistema is the majority shareholder of MGTS.

***Invest-Svyaz-Holding*** – In 2006, 2005 and 2004, MTS entered into agreements with Invest-Svyaz-Holding, a wholly-owned subsidiary of Sistema, for leasing of network equipment and billing system. These leases were recorded as capital leases in compliance with the requirements of SFAS No. 13 “Accounting for Leases.” The present values of future lease payments due within one year are classified as current liabilities and the remaining balance as long-term liabilities. The interest rate implicit in these leases varies from 26% to 30%.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

*(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)*

The present value of the future lease payments under capital leases to Invest-Svyaz-Holding comprise \$0.6 million and these payments are expected to be made in 2007.

For the year ended December 31, 2006, principal and interest paid to Invest-Svyaz-Holding were \$2.7 million and \$0.5 million, respectively. For the year ended December 31, 2005, principal and interest paid to Invest-Svyaz-Holding were \$6.1 million and \$2.0 million, respectively. Principal and interest paid to Invest-Svyaz-Holding for the year ended December 31, 2004, were \$6.4 million and \$4.1 million, respectively.

**Sitronics**– Sitronics Telecom Solutions Czech Republic and Russia, formerly Strom Telecom and Mediatel, are subsidiaries of Sistema. During 2006, 2005 and 2004, the Group acquired from these companies telecommunications equipment, billing systems and related services for approximately \$231.2 million, \$179.2 million and \$9.1 million, respectively. Advances paid under these agreements and outstanding as of December 31, 2006 and 2005, amounted to \$nil and \$45.7 million, respectively.

**Mediaplanning** – During 2006, 2005 and 2004, MTS entered into a number of agreements to purchase advertising services with Mediaplanning, a subsidiary of Sistema. Related advertising costs recorded for the years ended December 31, 2006, 2005 and 2004, amounted to \$45.1 million, \$21.5 million and \$11.3 million, respectively.

**MTT** – In 2006, 2005 and 2004, MTS had interconnect and line rental agreements with MTT, a subsidiary of Sistema. Interconnect expenses for 2006, 2005 and 2004 amounted to \$69.3 million, \$41.1 million and \$16.1 million, respectively. Interconnect revenue for the year ended December 31, 2006, amounted to \$7.0 million.

**SmartCards** – During 2006, the Group entered into a number of agreements with SmartCards, a subsidiary of Sistema, to purchase SIM cards. Pursuant to these contracts, the Group purchased SIM cards for approximately \$37.0 million.

**Sistema Telecom** – In May 2006, Sistema introduced a universal brand featuring a new egg-shaped logo for each of the telecommunication companies operating within the Sistema group, including MTS. The brand is owned by Sistema Telecom, a subsidiary of Sistema. The expenses related to the use of the brand name incurred by MTS and paid for in the year ended December 31, 2006, amounted to \$9.7 million.

## 18. GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses for the years ended December 31, 2006, 2005 and 2004, comprised the following:

	<b>December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Salaries and social contributions	\$ 430,443	\$ 336,203	\$ 256,989
Rent	123,378	79,869	54,054
General and administrative	118,980	100,257	72,586
Repair and maintenance	94,242	90,609	81,538
Taxes other than income	88,089	62,102	50,033
Billing and data processing	44,886	37,287	28,238
Consulting expenses	30,306	26,486	19,694
Insurance	10,723	16,804	7,554
Inventory obsolescence expense	-	9,112	4,610
General and administrative expenses	<u>\$ 941,047</u>	<u>\$ 758,729</u>	<u>\$ 575,296</u>

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

*(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)*

#### 19. INVESTMENTS IN AND ADVANCES TO ASSOCIATES

At December 31, 2006 and 2005, the Group's investments in and advances to associates comprised the following:

	December 31,	
	2006	2005
MTS Belarus – equity investment	\$ 119,802	\$ 66,288
MTS Belarus – loans receivable	21,341	41,341
Receivables from other investee companies	330	330
Total investments in and advances to associates	<u>\$ 141,473</u>	<u>\$ 107,959</u>

**MTS Belarus** – As of December 31, 2006 and 2005, the Group provided MTS Belarus with a total of \$21.3 million and \$41.3 million in loans, respectively. These loans bear interest of 3.00% to 11.00% per annum. In addition, the Group guarantees debt of MTS Belarus in the amount of \$3.0 million to Citibank International plc (see Note 23).

The Group's share in net income of associates is included in other income in the accompanying consolidated statements of operations. For the years ended December 31, 2006, 2005 and 2004, this share amounted to \$58.1 million, \$42.4 million and \$24.1 million, respectively.

#### 20. OTHER INVESTMENTS

In December 2005, MTS Finance acquired a 51.0% stake in Tarino Limited ("Tarino") for \$150.0 million in cash from Nomihold Securities Inc. ("Nomihold"). Tarino was at that time the indirect owner, through its wholly-owned subsidiaries, of Bitel LLC ("Bitel"), a Kyrgyz company holding a GSM 900/1800 license for the entire territory of Kyrgyzstan.

Concurrently with the purchase of a 51.0% stake, the Group entered into a put and call option agreement with Nomihold to acquire the remaining 49.0% interest in Tarino. The call option was exercisable by the Group from November 22, 2005 to November 17, 2006, and the put option was exercisable by the seller from November 18, 2006 to December 8, 2006. The call and put option price was \$170.0 million. The put and call option was recorded at fair value, which approximated \$nil at December 31, 2005. At December 31, 2006, a liability of \$170.0 million was recorded.

After the decision of the Kyrgyz Supreme Court on December 15, 2005, Bitel's corporate offices were seized by a third party. The Group could not re-gain operating control over Bitel's operations in 2005 and therefore accounted for its 51.0% investment in Bitel at cost as at December 31, 2005.

During 2006, the Group took steps to vindicate its ownership rights on Bitel although these efforts so far have not proven to be successful. The matter was brought to the Kyrgyz Prosecutor General for investigation. On January 15, 2007, the Prosecutor General informed the Group that it sees no grounds to become involved in the ownership dispute over Bitel and additionally stated that the Group had no basis to appeal the decision of the Kyrgyz courts in connection with ownership of Bitel.

In addition, an appeal to overturn certain adverse Kyrgyz courts rulings connected with ownership rights to Bitel was also filed with the Kyrgyz Supreme Court on December 15, 2006, but the time period in which the appeal should have been heard has expired without any action by the court.

## **OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES**

### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004**

***(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)***

Consequently the decision was made by the Group to write off the costs associated with the purchase of 51% stake in Bitel. As of December 31, 2006, the investment was fully impaired. Furthermore, as noted above, with the impairment of the underlying asset, a liability of \$170.0 million was recorded with an associated charge to non-operating expenses.

In January 2007, Nomihold commenced an arbitration proceeding against MTS Finance in the London Court of International Arbitration in order to compel MTS Finance to purchase the remaining shares. Nomihold seeks specific performance of the put option, unspecified monetary damages, interest, and costs. The matter is currently pending.

Also, there is on-going arbitration in the United Kingdom related to Tarino's ownership in Bitel. Kyrgyzstan Mobitel Investment Company Limited ("KMIC") has initiated a separate arbitration proceeding against the three Isle of Man companies affiliated with the Group ("the KFG Companies") claiming that the KFG Companies breached a May 31, 2003 Transfer Agreement concerning the shares of Bitel. The Transfer Agreement was made between the KFG Companies and IPOC International Growth Fund Limited ("IPOC") although IPOC subsequently assigned its interest KMIC, and KMIC was the claimant in the arbitration. This claim occurred prior to MTS Finance's acquisition of the KFG Companies. It is possible there may be additional or related disputes concerning agreements with respect to Tarino Limited. It is not possible at this time to predict the outcome or final resolution of any such disputes or litigation.

In addition, the KFG Companies have been named defendants in lawsuits filed by Bitel in the Isle of Man seeking the return of dividends received by these three companies in the first quarter of 2005 from Bitel in the amount of approximately \$25.2 million plus compensatory damages, and to recover approximately \$3.7 million in losses and accrued interest. In the event that the defendants do not prevail in these lawsuits, MTS may be liable to Bitel for such claims. The KFG Companies have also asserted counterclaims against Bitel, and claims against other defendants including Altimo and Altimo Holding, for the wrongful appropriation and control of Bitel. It is not possible at this time to predict the outcome or resolution of these claims.

#### **21. RESTRICTED CASH**

Restricted cash of \$24.8 million and \$6.2 million, as of December 31, 2006 and 2005, respectively, consists of cash deposited by Uzdunrobta in a special bank account. The cash will be further converted from Uzbek som into U.S. Dollars and used for settlements with suppliers of equipment and software.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

*(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)*

#### 22. OPERATING LICENSES

In connection with providing telecommunication services, the Group has been issued various operating GSM licenses by the Russian Ministry of Information Technologies and Communications. In addition to the licenses received directly from the Russian Ministry of Information Technologies and Communications, the Group has been granted access to various telecommunication licenses through acquisitions. In foreign subsidiaries, the licenses are granted by the local Communication authorities. At December 31, 2006 and 2005, the recorded values of the Group's telecommunication licenses were as follows:

	December 31,	
	2006	2005
Moscow license area	\$ 233,970	\$ 258,226
Asian Russian regions	179,473	193,109
Krasnodar, Adygeya and Northern Osetia	149,986	124,396
European Russia Regions	111,198	111,198
Tatarstan Republic	104,159	104,159
North - West region	74,639	74,639
Ukraine	63,535	61,717
Turkmenistan	50,503	50,503
Far East	48,107	48,107
Uzbekistan	40,861	40,861
Other	96,143	97,338
Licenses, at cost	1,152,574	1,164,253
Accumulated amortization	(747,076)	(561,137)
Licenses, net	<u>\$ 405,498</u>	<u>\$ 603,116</u>

Amortization expense for the years ended December 31, 2006, 2005 and 2004, amounted to \$211.3 million, \$194.3 million and \$151.9 million, respectively.

Based on the cost of amortizable operating licenses existing at December 31, 2006, the estimated future amortization expenses are \$163.8 million during 2007, \$100.2 million during 2008, \$47.8 million during 2009, \$43.4 million during 2010, \$23.0 million during 2011 and \$27.3 million thereafter. The actual amortization expense reported in future periods could differ from these estimates as a result of new intangible assets acquisitions, changes in useful lives and other relevant factors.

Each of the Group's licenses, except the licenses covering the Moscow license area and Uzbekistan, contain a requirement for service to be commenced and for subscriber number and territorial coverage targets to be achieved by a specified date. The Group has met these targets or received extensions to these dates in those regional license areas in which the Group has not commenced operations. Management believes that the Group is in compliance with all material terms of its licenses.

The Group's operating licenses do not provide for automatic renewal. However, licenses that expired during the year ended December 31, 2006, were renewed. The Group has limited experience with the renewal of its existing licenses. Management believes that licenses required for the Group's operations will be renewed upon expiration.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

*(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)*

#### 23. COMMITMENTS AND CONTINGENCIES

**Capital commitments** – As of December 31, 2006, the Group had executed non-binding purchase agreements of approximately \$299.6 million to acquire property, plant and equipment and capital services.

**Operating leases** – The Group has entered into non-cancelable agreements to lease the space for telecommunication equipment and offices, which expire in various years up to 2055. Rental expenses under these operating leases of \$123.4 million, \$73.2 million and \$54.0 million for the years ended December 31, 2006, 2005 and 2004, respectively, are included in operating expenses in the accompanying consolidated statements of operations. Future minimum lease payments due under these leases at December 31, 2006 are as follows:

Payments due in the years ended December 31,	
2007	\$ 69,932
2008	32,868
2009	25,359
2010	16,644
2011	11,095
Thereafter	42,559
Total	<u>\$ 198,457</u>

**Issued guarantees** – As of December 31, 2006, the Group had issued guarantees to third party banks on behalf of MTS Belarus, an equity investee, for \$3.0 million. The guarantees expired in April 2007. The fair value of issued guarantees is recorded as a liability in the accompanying consolidated balance sheet. At December 31, 2006, the fair value of these guarantees was \$0.1 million and was calculated as the difference between the interest expense on the carrying value of the debt per the loan agreement and the interest expense calculated based on an average market rate.

As of December 31, 2006, no event of default has occurred under any of the guarantees issued by the Group.

**Operating environment** – The Russian and Ukrainian economies, while deemed to be of market status, continue to display certain traits consistent with that of an emerging market. These characteristics have in the past included higher than normal inflation, insufficient liquidity of the capital markets, and the existence of currency controls. The continued success and stability of the Russian and Ukrainian economies will be subject to their government's continued actions with regard to supervisory, legal and economic reforms.

The new Federal Law on Communications sets the legal basis for the telecommunications business in Russia and defines the status that state bodies have in the telecommunications sector. In addition, the law created a universal service fund ("USF") charge, which became effective May 3, 2005, calculated as 1.2% of revenue from services provided to customers, excluding interconnection and other operators' traffic routing revenue. For the year ended December 31, 2006, and for the period from May to December 31, 2005, the Group incurred approximately \$54.2 million and \$30.3 million in USF charges, respectively, which are recorded in other operating expenses in the accompanying consolidated statements of operations.

The Group's operations in Turkmenistan are subject to certain restrictions in accordance with the local regulatory environment including, but not limited to, the sale of hard currency on the local market and hard currency repatriation. The effect of those restrictions on the financial statements is represented by a loss from currency translation transactions in Turkmenistan of \$24.3 million recognized as other non-operating expense in the Group statement of operations for the year ended December 31, 2006.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)

The amount of loss from currency translation transactions for the year ended December 31, 2005, was insignificant.

**Legal proceedings** – Russia and Ukraine currently have a number of laws related to various taxes imposed by both federal and regional governmental authorities. Applicable taxes include VAT, corporate income tax (profits 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 are more significant than typically found in countries with more developed tax systems.

In September 2006, the Russian tax authorities audited MTS OJSC’s compliance with tax legislation for the years ended December 31, 2003 and 2004. Based on the results of this audit, the Russian tax authorities assessed that 1,283,660 thousand rubles (approximately \$48.8 million as of December 31, 2006) of additional taxes, penalties and fines were payable by the Group. The Group has prepared and filed a petition with the Arbitration Court of Moscow to recognize the tax authorities’ resolution to be partially invalid. The amount of disputed taxes and fines equals 1,220,096 thousand rubles (approximately \$46.3 million). In 2007, a final court hearing considered this matter which resulted in a judgment in favour of the Group. Generally, tax declarations remain open and subject to inspection for a period of three years following the tax year. As of December 31, 2006, tax declarations of the Group for the preceding two fiscal years were open for further review.

There are regulatory uncertainties in Ukraine related to the treatment for VAT purposes of contributions payable to the Ukrainian State Pension Fund (“Pension Fund”) in respect of the cash paid for the consumption of telecommunication services by customers. Also it could have influence on income tax and other taxes paid by the Group.

As a result of the a tax audit of the period from October 1, 2002 to June 30, 2004, additional VAT charges (including penalties) calculated on the Pension Fund contributions could be up to \$13.5 million. In 2005, UMC initiated a litigation case in respect of this issue against the tax authorities, and has received favorable rulings from the courts on three occasions (the most recent from the Highest Administrative Court of Ukraine). Management believes that VAT was not applicable to the Pension Fund contributions during the period under the tax authorities’ review. Further, management believes that UMC is in line with industry practice and has already defended its position in the courts. At December 31, 2006, no VAT charges in relation to the above litigation had been accrued in the Group’s financial statements or paid to the tax authorities.

In January 2007, the U.S. the Internal Revenue Services (“the IRS”) started auditing BCTI’s compliance with U.S. Federal tax legislation for the year ended December 31, 2004. As of the date of these statements, the audit has not been finalized and no official assessment has been issued by the IRS. Based on the preliminary findings of the audit the Group’s consultants have assessed that the potential income tax exposure for the years 2003-2006 could be within a range up to \$28.3 million. The Group’s management has assessed its maximum potential liability equals up to \$3.3 million and that amount was recognized in the Group’s statements of operations for the year ended December 31, 2006.

As discussed in Note 20, in January 2007, Nomihold commenced an arbitration proceeding against MTS Finance in the London Court of International Arbitration in order to compel MTS Finance to purchase the remaining 49% stake in Tarino Limited for \$170.0 million. Nomihold seeks specific performance of the put option, unspecified monetary damages, interest, and costs. The matter is currently pending.

## **OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES**

### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004**

***(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)***

As also discussed in Note 20, there is on-going arbitration in the United Kingdom related to Tarino's ownership in Bitel. Kyrgyzstan Mobitel Investment Company Limited ("KMIC") has initiated a separate arbitration proceeding against the three Isle of Man companies affiliated with the Group ("the KFG Companies") claiming that the KFG Companies breached a May 31, 2003 Transfer Agreement concerning the shares of Bitel. It is possible there may be additional or related disputes concerning agreements with respect to Tarino Limited. It is not possible at this time to predict the outcome or final resolution of any such disputes or litigation.

As further discussed in Note 20, the KFG Companies have been named defendants in lawsuits filed by Bitel in the Isle of Man seeking the return of dividends received by these three companies in the first quarter of 2005 from Bitel and the KFG Companies have also asserted counterclaims against Bitel, and claims against other defendants including Altimo and Altimo Holding, for the wrongful appropriation and control of Bitel. It is not possible at this time to predict the outcome or resolution of these claims.

In addition, in the ordinary course of business, MTS may be party to various legal, tax and customs proceedings, and subject to claims, certain of which relate to the developing markets and evolving fiscal and regulatory environments in which MTS operates. In the opinion of management, the Group's liability, if any, in all such pending litigation, other legal proceeding or other matters will not have a material effect upon its financial condition, results of operations or liquidity of MTS.

Management believes that it has adequately provided for tax, customs and other legal liabilities in the accompanying consolidated financial statements; however, the risk remains that the relevant authorities could take differing positions with regard to interpretive issues and the effect could be significant.

## **24. SEGMENT INFORMATION**

SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information", 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's business is organized by ten Russian macro-regions and foreign subsidiaries. During 2005, the Russian business was managed on a macro-regional basis. In 2005, the Group had several operating segments, of which six were reportable segments – five Russian macro-regions and Ukraine.

In 2006, the Group established new business units: business unit "MTS Russia", which is responsible for the centralized operational management of business in all Russian macro-regions, all of which operate in the same economic environment and possess similar economic characteristics; business unit "UMC", MTS' subsidiary in Ukraine; and business unit "Foreign subsidiaries" that include Uzdurobita in Uzbekistan, Barash Communications Technologies, Inc. in Turkmenistan, and MTS Belarus, an equity accounted affiliate of MTS in Belarus.

Countries of operations are managed separately due to their different economic and regulatory environment that requires separate marketing and investment strategies. The chief operating decision maker evaluates performance based on the operating income of each business unit.

Following the introduction of business unit "MTS Russia", the Group's management has defined two operating reportable segments: Russia and Ukraine. Accordingly, MTS has retroactively restated its segment information for all periods presented.



## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

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Intercompany eliminations presented below consist primarily of sales transactions between segments conducted under the normal course of operations.

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Revenue:			
Russia	\$ 4,665,530	\$ 3,700,601	\$ 3,043,893
Ukraine	1,490,278	1,201,827	832,313
Other	242,455	119,932	26,783
Intercompany eliminations	(14,009)	(11,342)	(15,995)
Total revenue	<u>\$ 6,384,254</u>	<u>\$ 5,011,018</u>	<u>\$ 3,886,994</u>
Depreciation and amortization:			
Russia	\$ 819,316	\$ 722,977	\$ 539,767
Ukraine	233,744	153,795	124,935
Other	42,921	30,341	11,027
Total depreciation and amortization	<u>\$ 1,095,981</u>	<u>\$ 907,113</u>	<u>\$ 675,729</u>
Operating income:			
Russia	\$ 1,510,875	\$ 1,153,542	\$ 1,096,787
Ukraine	530,522	431,292	317,860
Other	92,339	47,197	4,416
Total operating income	<u>\$ 2,133,736</u>	<u>\$ 1,632,031</u>	<u>\$ 1,419,063</u>
Total operating income	\$ 2,133,736	\$ 1,632,031	\$ 1,419,063
Currency exchange and transaction gains	(24,051)	(10,319)	(6,529)
Interest income	(13,055)	(24,828)	(21,792)
Interest expense	177,145	132,474	107,956
Equity in net income of associates	(58,083)	(42,361)	(24,146)
Bitel investment and write off	320,000	-	-
Other expenses /(income)	65,913	13,211	(9,310)
Income before provision for income taxes and minority interest	<u>\$ 1,665,867</u>	<u>\$ 1,563,854</u>	<u>\$ 1,372,884</u>

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

*(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)*

	<u>2006</u>	<u>2005</u>
Additions to long-lived assets:		
Russia	\$ 1,135,637	\$ 1,486,158
Ukraine	644,524	719,279
Other	69,609	132,799
Total additions to long-lived assets	<u>\$ 1,849,770</u>	<u>\$ 2,338,236</u>
Additions to goodwill:		
Russia	\$ 12,574	\$ 46,382
Ukraine	-	-
Other	-	-
Total additions to goodwill	<u>\$ 12,574</u>	<u>\$ 46,382</u>
Goodwill:		
Russia	\$ 110,992	\$ 100,751
Ukraine	8,000	8,000
Other	46,470	46,470
Total goodwill	<u>\$ 165,462</u>	<u>\$ 155,221</u>
Long-lived assets:		
Russia	\$ 4,638,096	\$ 4,285,157
Ukraine	1,794,828	1,390,966
Other	271,621	245,918
Total long-lived assets	<u>\$ 6,704,545</u>	<u>\$ 5,922,041</u>
Total assets:		
Russia	\$ 6,257,781	\$ 5,530,911
Ukraine	1,955,188	1,560,762
Other	360,976	454,107
Total assets	<u>\$ 8,573,945</u>	<u>\$ 7,545,780</u>

## 25. SUBSEQUENT EVENTS

**Functional currency** – Prior to January 1, 2007, the functional currency for all of the Group’s subsidiaries, excluding UMC, MR South and BCTI where the functional currency is the local currency, was the U.S. Dollar. Starting from January 1, 2007, the Group’s subsidiaries in the Russian Federation introduced Russian ruble tariffs for settlements with the majority of its customers.

As a result of these changes, the Group reevaluated the functional currency criteria under SFAS No. 52, “Foreign Currency Translation”, and determined that, commencing January 1, 2007, the functional currency of the Group’s subsidiaries domiciled in Russia is the Russian ruble. The change is adopted prospectively commencing January 1, 2007, in accordance with SFAS No. 52.

**Bitel** – In January 2007, Nomihold commenced an arbitration proceeding against MTS Finance in the London Court of International Arbitration in order to compel MTS Finance to purchase the remaining 49% stake in Tarino Limited for \$170.0 million (see Note 20).

A group of individual shareholders of Sistema, the majority shareholder of MTS OJSC, has agreed to compensate MTS Finance for any potential loss up to \$170 million should the arbitration decision regarding exercise of the aforementioned put option prove unfavorable to MTS Finance.

## OJSC MOBILE TELESYSTEMS AND SUBSIDIARIES

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(Amounts in thousands of U.S. Dollars, except share and per share amounts or if otherwise stated)

In a separate arbitration proceeding initiated against the KFG Companies by Kyrgyzstan Mobitel Investment Company Limited (KMIC) under the rules of the LCIA, the arbitration tribunal in a partial final award dated May 25, 2007 and received by the Group on June 7, 2007, found that the KFG Companies breached a May 31, 2003 Transfer Agreement concerning the shares of Bitel (see Note 20). The tribunal ruled that the KFG Companies breached the Transfer Agreement when they failed to establish a date on which the equity interest in Bitel was to be transferred to KMIC and by failing to take other steps to transfer the Bitel interests. The arbitration tribunal ruled that KMIC is entitled only to damages in an amount to be determined in future proceedings. The Group is not able to predict the outcome of these proceedings or the amount of damages to be paid if any.

**Merger** – On April 1, 2007, the Russian registration authority approved the merger of ReCom and Telesot Alania, the Company's wholly-owned subsidiaries located in the Russian Federation, into MTS OJSC.

**3G licenses** – In April, 2007, MTS OJSC received a federal license to provide 3G services in Russia, that allow subscribers to use high-tech and innovative services coupled with high service quality and level of customer service. MTS is planning to start commercial use of a 3G network within the next two years.

Along with MTS OJSC, Uzdunrobita in Uzbekistan acquired a new 3G license. Uzdunrobita is planning to launch its 3G network in 2008.