Interim condensed consolidated financial statements
(Unaudited)

For the three months ended 31 March 2014

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Report on review of interim condensed consolidated financial statements

The Board of Directors and Shareholders
OJSC MegaFon

Introduction

We have reviewed the accompanying interim condensed consolidated statement of financial position of Open Joint Stock Company MegaFon and its subsidiaries (hereinafter collectively referred to as the "Company") as of 31 March 2014 and the related interim condensed consolidated statements of comprehensive income, changes in equity and cash flows for the three-month period then ended and explanatory notes. Management is responsible for the preparation and presentation of these interim condensed consolidated financial statements in accordance with International Financial Reporting Standard IAS 34 *Interim Financial Reporting* ("IAS 34"). Our responsibility is to express a conclusion on these interim condensed consolidated financial statements based on our review.

Scope of review

We conducted our review in accordance with International Standard on Review Engagements 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying interim condensed consolidated financial statements are not prepared, in all material respects, in accordance with IAS 34.

Ernst & Young LLC

28 May 2014

MegaFon

Interim condensed consolidated statement of comprehensive income

(In millions of Rubles, except per share amounts)

	Note	Three months ended 31 March 2014 (Unaudited)	Three months ended 31 March 2013 (Unaudited)
Revenues			
Wireless services		64,719	59,603
Wireline services		5,294	4,522
Sales of equipment and accessories		4,863	3,599
Total revenues		**74,876**	**67,724**
Operating expenses			
Cost of services		14,695	12,684
Cost of equipment and accessories		5,178	3,104
Sales and marketing expenses	8	3,868	2,902
General and administrative expenses	9	18,632	16,653
Depreciation		11,917	11,287
Amortisation		2,046	1,346
Loss on disposal of non-current assets		142	137
Total operating expenses		**56,478**	**48,113**
Operating profit		**18,398**	**19,611**
Finance costs		(3,552)	(2,766)
Finance income		42	418
Share of loss of associates and joint ventures		(272)	(145)
Other non-operating (expense)/income		(305)	68
Gain/(loss) on financial instruments		62	(74)
Foreign exchange loss, net		(4,875)	(816)
Profit before tax		**9,498**	**16,296**
Income tax expense	10	2,223	3,655
Profit for the period		**7,275**	**12,641**
Other comprehensive income/(loss)			
Other comprehensive income/(loss) to be reclassified to profit or loss in subsequent periods:			
Foreign currency translation difference, net of tax		(312)	(77)
Net movement on cash flow hedges, net of tax		90	—
Net other comprehensive loss to be reclassified to profit or loss in subsequent periods		(222)	(77)
Total comprehensive income for the period, net of tax		**7,053**	**12,564**
Profit for the period			
Attributable to equity holders of the Company		7,228	12,624
Attributable to non-controlling interest		47	17
Total comprehensive income for the period			
Attributable to equity holders of the Company		7,094	12,566
Attributable to non-controlling interest		(41)	(2)
Earnings per share, Rubles			
Basic, profit for the period attributable to ordinary equity holders of the Company		13	22
Diluted, profit for the period attributable to ordinary equity holders of the Company		12	22

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

MegaFon

Interim condensed consolidated statement of financial position

(In millions of Rubles)

	Note	31 March 2014 (Unaudited)	31 December 2013 (Audited)
Assets			
Non-current assets			
Property and equipment	5	218,036	221,805
Intangible assets, other than goodwill		56,121	57,776
Goodwill		31,637	31,530
Investments in associates and joint ventures		35,188	35,460
Non-current financial assets		1,115	425
Non-current non-financial assets		1,341	1,300
Deferred tax assets		3,852	3,673
Total non-current assets		**347,290**	**351,969**
Current assets			
Inventory		8,078	8,376
Current non-financial assets		5,721	5,960
Prepaid income taxes		4,938	2,777
Trade and other receivables		11,995	10,732
Other current financial assets	6	2,787	39,296
Cash and cash equivalents		63,214	9,939
Total current assets		**96,733**	**77,080**
Assets held for sale		1,194	1,516
Total assets		**445,217**	**430,565**
Equity and liabilities			
Equity			
Equity attributable to equity holders of the Company		145,447	138,034
Non-controlling interests		230	271
Total equity		**145,677**	**138,305**
Non-current liabilities			
Loans and borrowings	6	134,513	130,825
Other non-current financial liabilities	6	22,988	20,838
Non-current non-financial liabilities		1,202	1,170
Provisions		5,513	5,355
Deferred tax liabilities		17,729	17,844
Total non-current liabilities		**181,945**	**176,032**
Current liabilities			
Trade and other payables		29,580	33,875
Loans and borrowings	6	22,289	21,184
Other current financial liabilities	6	44,926	40,785
Current non-financial liabilities		19,862	19,490
Income taxes payable		938	894
Total current liabilities		**117,595**	**116,228**
Total equity and liabilities		**445,217**	**430,565**

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

MegaFon

Interim condensed consolidated statement of changes in equity

(In millions of Rubles)

For the three months ended 31 March 2014 and 31 March 2013

	Attributable to equity holders of the Company									
	Ordinary shares		Treasury shares							
	Number of shares	Amount	Number of shares	Amount	Capital surplus	Retained earnings	Other capital reserves	Total	Non-controlling interests	Total equity
As of 1 January 2013	**620,000,000**	**526**	**54,690,089**	**(39,133)**	**12,567**	**143,468**	**(73)**	**117,355**	**518**	**117,873**
Profit for the period	—	—	—	—	—	12,624	—	12,624	17	12,641
Other comprehensive loss	—	—	—	—	—	—	(58)	(58)	(19)	(77)
Total comprehensive income	—	—	—	—	—	**12,624**	**(58)**	**12,566**	**(2)**	**12,564**
Share-based compensation expense	—	—	—	—	—	—	472	472	—	472
As of 31 March 2013 (unaudited)	**620,000,000**	**526**	**54,690,089**	**(39,133)**	**12,567**	**156,092**	**341**	**130,393**	**516**	**130,909**
As of 1 January 2014	**620,000,000**	**526**	**46,940,089**	**(33,588)**	**12,567**	**157,986**	**543**	**138,034**	**271**	**138,305**
Profit for the period	—	—	—	—	—	7,228	—	7,228	47	7,275
Other comprehensive loss	—	—	—	—	—	—	(134)	(134)	(88)	(222)
Total comprehensive income	—	—	—	—	—	**7,228**	**(134)**	**7,094**	**(41)**	**7,053**
Share-based compensation expense	—	—	—	—	—	—	319	319	—	319
As of 31 March 2014 (unaudited)	**620,000,000**	**526**	**46,940,089**	**(33,588)**	**12,567**	**165,214**	**728**	**145,447**	**230**	**145,677**

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

MegaFon

Interim condensed consolidated statement of cash flows

(In millions of Rubles)

	Note	Three months ended 31 March 2014 (Unaudited)	2013
Operating activities			
Profit before tax		9,498	16,296
Non-cash adjustments to reconcile profit before tax to net cash flows:			
Depreciation		11,917	11,287
Amortisation		2,046	1,346
Loss on disposal of non-current assets		142	137
(Gain)/loss on financial instruments		(62)	74
Net foreign exchange loss		4,875	816
Share of loss of associates and joint ventures		272	145
Change in impairment allowance for receivables		449	242
Finance costs		3,552	2,766
Finance income		(42)	(418)
Share-based compensation		319	472
Other non-operating expense/(income)		305	(68)
Working capital adjustments:			
Decrease/(increase) in inventory		300	(1,658)
Increase in trade and other receivables		(2,157)	(745)
Decrease/(increase) in current non-financial assets		275	(127)
Increase in trade and other payables		576	2,267
Decrease in current non-financial liabilities		(1,881)	(933)
Change in VAT, net		2,134	38
Income tax paid		(4,695)	(3,100)
Income tax refunded		120	600
Interest received		209	297
Interest paid, net of interest capitalised		(2,096)	(2,148)
Net cash flows from operating activities		**26,056**	**27,586**
Investing activities			
Purchase of property, equipment and intangible assets	5	(15,445)	(7,270)
Proceeds from sale of property and equipment	5	450	70
Acquisition of subsidiaries, net of cash acquired	5	(91)	—
Net change in short-term demand deposits		41,360	(18,431)
Net cash flows received from/(used in) investing activities		**26,274**	**(25,631)**
Financing activities			
Proceeds from borrowings, net of fees paid		3,452	20,015
Repayment of borrowings		(1,427)	(20,890)
Payment of liability for marketing related licences		(184)	(146)
IPO transaction fees paid		—	(207)
Net cash flows received from/(used in) financing activities		**1,841**	**(1,228)**
Net increase in cash and cash equivalents		54,171	727
Net foreign exchange difference		(896)	5
Cash and cash equivalents at beginning of period		9,939	2,387
Cash and cash equivalents at end of period		**63,214**	**3,119**

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

1. General

Open Joint Stock Company MegaFon (“MegaFon”, the “Company” and together with its consolidated subsidiaries the “Group”) is a leading universal telecommunications operator in Russia and provides a broad range of voice, data and other telecommunications services to retail customers, businesses, government clients and other telecommunications services providers.

In November 2012, MegaFon completed an initial public offering (“IPO”) and listed its ordinary shares on the Moscow Exchange and its ordinary shares represented by Global Depositary Receipts, or GDRs, on the London Stock Exchange, in each case under the symbol ‘‘MFON’’.

2. Basis of preparation

These interim condensed consolidated financial statements have been prepared in accordance with IAS 34, *Interim Financial Reporting*, and should be read in conjunction with the annual consolidated financial statements of the Group for the year ended 31 December 2013.

These interim condensed consolidated financial statements are unaudited and do not include all the information and disclosures required in the annual IFRS financial statements. The Company omitted disclosures which would substantially duplicate the information contained in its 2013 audited consolidated financial statements, such as accounting policies and details of accounts which have not changed significantly in amount or composition. Additionally, the Company has provided disclosures where significant events have occurred subsequently to the issuance of its 2013 audited consolidated financial statements. Management believes that the disclosures in these interim condensed consolidated financial statements are adequate to make the presented information not misleading if these interim condensed consolidated financial statements are read in conjunction with the Group’s 2013 audited consolidated financial statements and the notes related thereto. In the opinion of management, the financial statements reflect all adjustments necessary to present fairly the Group’s financial position, financial performance and cash flows for the interim reporting period in accordance with IAS 34, *Interim Financial Reporting*.

The accompanying interim condensed consolidated financial statements are presented in millions of Rubles, except for per share amounts which are in Rubles, unless otherwise indicated.

The interim condensed consolidated financial statements were authorised for issue by the Company’s Chief Executive Officer (“CEO”) and Chief Accountant on 28 May 2014.

3. Significant accounting policies

The accounting policies and methods of computation applied in the preparation of these interim condensed consolidated financial statements are consistent with those disclosed in the annual consolidated financial statements of the Group for the year ended 31 December 2013, except for the adoption of new standards and interpretations effective from 1 January 2014.

3. Significant accounting policies (continued)

IAS 32 Offsetting Financial Assets and Financial Liabilities (Amendments)

These amendments clarify the meaning of “currently has a legally enforceable right to set-off” and the criteria for non-simultaneous settlement mechanisms of clearing houses to qualify for offsetting. These amendments did not have an impact on the interim condensed consolidated financial statements for the Group.

Standards issued but not yet effective

Amendments to IAS 16 and IAS 38

In May 2014 the IASB issued amendments to IAS 16, *Property, plant and equipment*, and IAS 38, *Intangible assets*, which clarify that the use of revenue-based methods to calculate depreciation of an asset is not appropriate, because revenue generated by an activity that includes the use of an asset generally reflects factors other than the consumption of the economic benefits embodied in the asset.

The IASB also clarified that revenue is generally presumed to be an inappropriate basis for measuring the consumption of the economic benefits embodied in an intangible asset. This presumption, however, can be rebutted in certain limited circumstances.

The amendments are to be applied prospectively for annual periods beginning on or after 1 January 2016. Earlier application is permitted. The amendments are not expected to have a material impact on the Group’s financial position or performance.

Amendments to IFRS 11, Accounting for acquisitions of interests in joint operations

Also in May 2014, the IASB issued amendments to IFRS 11, which require the acquirer of an interest in a joint operation in which the activity constitutes a business, as defined in IFRS 3, *Business combinations*, to apply all of the principles on business combinations accounting in IFRS 3 and other IFRSs, except for those principles that conflict with the guidance in this IFRS. In addition, the acquirer shall disclose the information required by IFRS 3 and other IFRSs for business combinations.

The amendments are to be applied prospectively for annual periods beginning on or after 1 January 2016. Earlier application is permitted. The amendments are not expected to have a material impact on the Group’s financial position or performance.

4. Segment information

The Group manages its business primarily based on eight geographical operating segments within Russia, which provide a broad range of voice, data and other telecommunication services, including wireless and wireline services to clients, interconnection services, data transmission services and value added services ("VAS"). The Chief Operating Decision Maker ("CODM") evaluates the performance of the Group's operating segments based on revenue and operating income before depreciation and amortisation ("OIBDA"). Total assets and liabilities are not allocated to operating segments and not analysed by the CODM. Operating segments with similar economic characteristics have been aggregated into an integrated telecommunication services segment, which is the only reportable segment. The remaining operating segments, including less significant subsidiaries and retail business, do not meet the quantitative thresholds for reportable segments. Less than 1% of the Group's revenues and results are generated by segments outside of Russia. No single customer represents 10% or more of the consolidated revenues.

Reconciliation of consolidated OIBDA to consolidated profit before tax for the three months ended 31 March:

	2014	**2013**
OIBDA	**32,503**	**32,381**
Depreciation	(11,917)	(11,287)
Amortisation	(2,046)	(1,346)
Loss on disposal of non-current assets	(142)	(137)
Finance costs	(3,552)	(2,766)
Finance income	42	418
Share of loss of associates and joint ventures	(272)	(145)
Other non-operating income/(expense)	(305)	68
Gain/(loss) on financial instruments	62	(74)
Foreign exchange loss, net	(4,875)	(816)
Profit before tax	**9,498**	**16,296**

Seasonality of operations

The Company's services are impacted by seasonal trends throughout the year. Higher revenues and operating profits are usually expected in the second half of the year rather than in the first six months. Higher revenues during the period July to September are mainly attributed to the increased demand for telecommunication services during the peak holiday season. Higher revenues also occur in the month of December, due to increased demand for telecommunication services and equipment from private customers. Also the number of working days is significantly higher in the second half of a calendar year than in the first half of the year due to long public holidays in January and May in Russia, which also contributes to higher revenues in the second half of the year. This information is provided to allow for a better understanding of the results; however, management has concluded that this does not constitute 'highly seasonal' as considered by IAS 34.

5. Property and equipment and other investments

During the three months ended 31 March 2014, the Group acquired assets with a cost of 7,944 (31 March 2013: 3,600). Assets (other than those classified as held for sale) with a net book value of 83 were disposed of by the Group during the three months ended 31 March 2014 (31 March 2013: 222), resulting in a net loss on disposal of 64 (31 March 2013: 124).

On 5 February 2014, the Group acquired 100% of the shares of LLC Tele MIG, a wireline operator and internet-provider in Novyi Urengoy region, for cash consideration of 110 and contingent consideration of 10. The aggregate 120 consideration has been allocated mainly between goodwill of 88 and tangible assets.

6. Financial assets and liabilities

New derivative financial instrument

In March 2014 the Company entered into a cross-currency swap agreement with a notional amount of $243 million (8,672 at the exchange rate as of 31 March 2014) that limits its exposure from changes in foreign currency exchange rates on certain long-term debt.

The terms of the swap agreement did not meet the requirements for hedge accounting, therefore the Group has reported all gains and losses from the change in fair value of this derivative financial instrument directly in the consolidated statement of comprehensive income. Total loss recorded in profit and loss in respect of the derivative was 116 for the period ended 31 March 2014.

6. Financial assets and liabilities (continued)

Fair values

Set out below is a comparison by class of the carrying amounts and fair values of the Group's financial instruments and certain non-financial assets that are carried in the financial statements.

		Carrying amount		Fair value	
		31 March 2014 (Unaudited)	**31 December 2013**	**31 March 2014 (Unaudited)**	**31 December 2013**
Financial assets					
Financial assets at fair value through profit or loss:					
Euroset settlement put option	Level 3	1,533	1,176	1,533	1,176
Cross-currency swap not designated as hedge	Level 2	743	300	743	300
Financial assets at fair value through OCI:					
Cross-currency swap designated as cash flow hedge	Level 2	410	125	410	125
Loans and receivables at amortised cost	Level 3	1,216	38,120	1,216	38,120
Assets held for sale at carrying value	Level 3	1,194	1,516	1,529	1,851
Total financial assets		**5,096**	**41,237**	**5,431**	**41,572**
Financial liabilities					
Financial liabilities at amortised cost:					
Loans and borrowings	Level 3	126,802	122,009	128,572	125,190
Ruble bonds	Level 1	30,000	30,000	29,672	29,980
Convertible debt instrument	Level 2	22,959	20,678	22,959	20,678
Liability for marketing related licences	Level 3	—	177	—	177
Long-term accounts payable	Level 3	1,102	950	1,102	950
Deferred consideration for Scartel	Level 3	43,364	39,198	43,364	39,198
Financial liabilities at fair value through profit or loss:					
Cross-currency swap not designated as hedge	Level 2	84	—	84	—
Financial liabilities at fair value through OCI:					
Interest-rate swaps designated as cash flow hedges	Level 2	165	209	165	209
Cross-currency swaps designated as cash flow hedges	Level 2	—	128	—	128
Due to employees and related social charges, non-current	Level 2	240	283	240	283
Total financial liabilities		**224,716**	**213,632**	**226,158**	**216,793**

6. Financial assets and liabilities (continued)

Management has determined that cash, short-term deposits, trade receivables, trade payables, bank overdrafts and other current liabilities approximate their carrying amounts largely due to the short-term maturities of these instruments.

The Group, using available market information and appropriate valuation methodologies, where they exist, has determined the estimated fair values of its financial instruments. However, judgment is necessarily required to interpret market data to determine the estimated fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Group could realise in a current market exchange.

While management has used available market information in estimating the fair value of its financial instruments, the market information may not be fully reflective of the value that could be realised in the current circumstances.

Fair values of the Group’s loans and borrowings and other liabilities carried at amortised cost, except for market quoted Ruble bonds, are determined by a discounted cash flow method using a discount rate that reflects the issuer’s borrowing rate as at the end of the reporting period. The own nonperformance risk as at 31 March 2014 and 31 December 2013 was assessed to be insignificant.

The fair value of the Group’s assets held for sale, which mainly consists of the office building in Saint Petersburg, is determined based on real estate transaction prices observed in the market.

During the three months ended 31 March 2014 there were no transfers between levels of the fair value hierarchy.

The Group, in connection with its current activities, is exposed to various financial risks, such as foreign currency risks, interest rate risks and credit risks. The Group manages these risks and monitors their exposure on a regular basis.

The table below presents a reconciliation of the beginning and ending balances of financial instruments having fair value measurements based on significant unobservable inputs (Level 3) for the three months ended 31 March 2014:

	Beginning balance at 1 January 2014	Line items in profit or loss	Realised gains/(losses) recognised in profit or loss	Unrealised gains/(losses) recognised in profit or loss	Settlements	**Ending balance at 31 March 2014**
Euroset settlement put option	**1,176**	Loss on financial instruments	—	357	—	**1,533**

Valuation techniques and assumptions

The fair values of interest rate swaps and cross-currency swaps are based on a forward yield curve and represent the estimated amount the Group would receive or pay to terminate these

6. Financial assets and liabilities (continued)

agreements at the reporting date, taking into account current interest rates, foreign exchange spot and forward rates, creditworthiness, nonperformance risk, and liquidity risks associated with current market conditions.

The Group estimated the fair value of the Euroset settlement put option using Monte Carlo simulation. The significant unobservable inputs used for the Euroset settlement put option valuation are:

Exercise date	6 December 2014
Volatility	30.8%
Risk-free rate	0.09%
Dividend yield	7.5%

Volatility and the risk-free rate are correlated with the option term: postponement of the exercise date increases the option term and, consequently, increases volatility and the risk-free rate. If the exercise date is 6 December 2015 the option fair value will increase by approximately 160.

Loans and borrowings

In February 2014 the Group signed a new credit facility agreement with Société Générale and Nordea Bank Finland plc (“Finnvera VIII credit facility”) for up to $150 million (5,353 at the exchange rate as of 31 March 2014). The Finnvera VIII credit facility must be used to finance purchases of Nokia Solutions and Networks (“NSN”) equipment and services. The facility carries interest at a rate of 2.2% per annum plus bank margin. The Finnvera VIII credit facility requires the Group to make semi-annual payments, plus accrued interest, during the period from 2014 to 2022. To date, no amount has been drawn under this Finnvera VIII credit facility.

7. Share-based compensation

Long-term incentive programme 2013

In August 2013 the Company’s Board of Directors approved a long-term motivation and retention program for certain key executive and senior level employees under which the parties selected to participate are awarded phantom share options. In the aggregate, the value ascribed to the full package of phantom share options for which options may be awarded is 1.1% of the share capital of the Company (equal to 7,000,000 phantom shares) at the base price of $24.25 per share. The plan has a three-year duration and the awarded share options vest in April-May 2015 and April-May 2016 and are settled in cash upon vesting. Payments are made on the basis of the difference between the base price and the weighted-average price of the Company’s shares in the period between 15 January and 15 March of the relevant year of vesting. Vesting of the options is generally contingent upon the recipient’s continuing employment with the Company. As of 31 March 2014 no options have been granted under the programme.

7. Share-based compensation (continued)

Long-term incentive programme 2012

In October 2012 the Company's Board of Directors approved a long-term motivation and retention programme for certain key executive and senior level employees under which the parties who are selected to participate are awarded phantom share options. In the aggregate, the value ascribed to the full package of phantom share options for which options may be awarded is 1.1% of the share capital of the Company (equal to 7,000,000 phantom shares) at the base price of $17.86 per share. The plan has a three-year duration and the awarded share options vest in April-May 2014 and 2015 and are settled in cash upon vesting, based on the difference between the base price and the weighted-average price of the Company's shares in the period between 15 January and 15 March of the relevant year of vesting. Vesting of the options is contingent upon the recipient's continuing employment with the Group.

In February 2013 a total number of 2,133,000 phantom share options were granted to certain key executive and senior level employees under the 2012 long-term incentive programme.

The respective awards are classified as a liability. The fair value of the options has been estimated using the Monte Carlo model. The fair value of each grant is estimated at the end of each reporting period. The expected volatility was estimated based on the average historical volatility of the Company over the period equal to the expected life of the options granted. The dividend yield was included into the model based on expected dividend payments. The risk free rate was determined on the basis of U.S. Treasury yield curve rates with a remaining term to maturity equal to the expected life of the options. The expected term of the options equals their vesting term as the options are settled in cash at the end of vesting period.

The fair value of options outstanding at 31 March 2014 is 332 Rubles per option. The carrying amount of the liability relating to these awards at 31 March 2014 is 506, including liability for related social charges. The employee benefits expense recognised in the reporting period in the interim condensed consolidated statement of comprehensive income is 37, including related social charges.

CEO long-term incentive plan

As part of a long-term incentive plan approved by the Company's Board of Directors in November 2012, Mr. Ivan Tavrin, the CEO of the Company, agreed to purchase, within 30 days of the Group's IPO, 7,750,000 of the Group's ordinary shares (or 1.25% of the total issued shares) at the IPO price of $20 per share. Pursuant to the plan, Mr. Tavrin was also given three options to buy up to a further 1.25% of the total issued shares on each of his employment anniversary dates in May 2013, May 2014 and May 2015 at the IPO price. The options could be exercised, in whole or in part, on those dates or subsequently, up till May 2017, when any unexercised portion will lapse. Their exercise is subject to Mr. Tavrin's continued employment with the Group and Mr. Tavrin holding at least a 1.25% interest in the Company on the relevant exercise date. Mr Tavrin exercised the first of these three options in May 2013.

On 4 March 2014 the Board of Directors of the Company agreed unanimously to amend the terms of the CEO long-term incentive plan and to accelerate the vesting of Mr. Tavrin's final two options to acquire a 1.25% interest in the Company, so that all the remaining options may now be exercised at any time after 1 May 2014. The change resulted in an additional employee

7. Share-based compensation (continued)

benefits charge of 138 for the three months ended 31 March 2014 due to the accelerated vesting. Incremental fair value in amount of 111 will be recognised during the three months ended 30 June 2014. In addition, the Board agreed to remove a restriction on Mr. Tavrin holding more than 5% of the authorised share capital of the Company at any time prior to May 2017.

The table below summarises the grant date fair value of options:

Nonvested as of 1 January 2014	578
Vested (recognised employee benefits cost)	(319)
Nonvested as of 31 March 2014	**259**

8. Sales and marketing expenses

Sales and marketing expenses for the three months ended 31 March are as follows:

	2014	**2013**
Dealer commissions for connection of new subscribers	1,515	1,059
Advertising	1,442	884
Cash collection and other commissions	911	959
Total sales and marketing expenses	**3,868**	**2,902**

During the three months ended 31 March 2014, advertising costs reflect the de-recognition of approximately 1,000 of amounts accrued in previous periods.

9. General and administrative expenses

General and administrative expenses for the three months ended 31 March are as follows:

	2014	**2013**
Employee benefits and related social charges	7,134	7,059
Rent	3,720	3,140
Operating taxes	1,635	1,675
Network repairs and maintenance	1,373	1,261
Radio frequency fees	1,249	948
Utilities	1,175	1,008
Office maintenance	527	411
Change in allowance account for trade and other receivables	449	242
Vehicle costs	214	148
Professional services	157	262
Materials and supplies	61	58
Insurance	17	24
Other expenses	921	417
Total general and administrative expenses	**18,632**	**16,653**

10. Income tax

The Group calculates the period income tax expense using the tax rate that would be applicable to the expected total annual earnings.

The major components of income tax expense for the three months ended 31 March in the interim condensed consolidated statement of comprehensive income are as follows:

	2014	**2013**
Current income tax	2,551	3,008
Deferred income tax	(328)	647
Total income tax expense	**2,223**	**3,655**

11. Related parties

As of 31 March 2014 and 31 December 2013, the Group is primarily owned by USM Group, an indirect controlling shareholder, which is ultimately controlled by Mr Alisher Usmanov, and TeliaSonera Group, another major shareholder with significant influence over the Group, whose parent is a publicly owned Swedish company.

The following tables provide the total amount of transactions that have been entered into with related parties and balances of accounts with them for the relevant financial periods:

	Three months ended 31 March	
	2014	**2013**
Revenues from TeliaSonera Group	160	85
Revenues from Euroset	24	—
Revenues from USM Group	5	133
	189	**218**
Services from Euroset	389	94
Services from TeliaSonera Group	340	212
Services from USM Group	198	217
	927	**523**
Other non-operating expense from USM Group	300	—

11. Related parties (continued)

	31 March 2014	31 December 2013
Due from Euroset	144	184
Due from TeliaSonera Group	105	72
Due from USM Group	49	20
	298	**276**
Due to USM Group	66,586	60,275
Due to TeliaSonera Group	127	149
Due to Euroset	114	293
	66,827	**60,717**

Terms and conditions of transactions with related parties

Outstanding balances as of 31 March 2014 and 31 December 2013 are unsecured. There have been no guarantees provided or received for any related party receivables or payables. As of 31 March 2014 and 31 December 2013, the Group has not recorded any impairment of receivables relating to amounts owed by related parties.

USM Group

The outstanding balances and transactions with USM Group relate to operations with Garsdale Services Investment Limited ("Garsdale"), the Group's parent, USM Holdings Limited, an indirect owner of Garsdale, and their consolidated subsidiaries.

Amounts due to USM Group mainly represent the convertible debt instrument related to its investment in Euroset made in 2012 *(Note 6)* and the deferred consideration for the Scartel acquisition (*Note 6*).

In 2012 the Group became a member of the not-for-profit partnership "Development, Innovations, Technologies" (the "Partnership") which was established by companies in the USM Group. The Partnership may determine to incur education, science and other social costs as well as to maintain certain social infrastructure assets in Skolkovo Innovation Centre which are not owned by MegaFon and not recorded in the consolidated statement of financial position. The Group's contributions to the Partnership of 300 during the three months ended 31 March 2014 and nil during the three months ended 31 March 2013, are included into other non-operating expenses in the interim condensed consolidated statement of comprehensive income.

TeliaSonera Group

The outstanding balances and transactions with TeliaSonera Group relate to operations with various companies in that Group. Revenues and cost of services principally related to roaming agreements between MegaFon and members of the TeliaSonera Group located outside Russia and a wireline interconnection agreement with TeliaSonera International Carrier Russia.

11. Related parties (continued)

Euroset

Beginning from December 2012, Euroset is the Group's joint venture with OJSC VimpelCom. In December 2012 the Group entered into a dealership agreement with Euroset which qualifies as a related party transaction.

12. Commitments, contingencies and uncertainties

Operating environment

Russia continues economic reforms and development of its legal, tax and regulatory frameworks as required by a market economy. The future stability of the Russian economy is largely dependent upon these reforms and developments and the effectiveness of economic, financial and monetary measures undertaken by the government. Management believes it is taking appropriate measures to support the sustainability of the Group's business in the current circumstances.

During the three months ended 31 March 2014 economic and political instability in Ukraine increased significantly. The Group's assets in the Ukraine are essentially insignificant, so that its direct exposure to events in Ukraine is minimal. However, the Group could be affected, perhaps adversely, by sanctions imposed by the US, EU and other countries in response to the situation in Ukraine. The Group is monitoring and assessing the situation in Ukraine closely and is in the process of implementing a number of measures in order to minimise the effects of the possible risks arising out of the Ukrainian instability in general and the imposition of sanctions in particular.

4G/LTE licence capital commitments

In July 2012 the Federal Service for Supervision in Communications, Information Technologies and Mass Media granted the Group a licence and allocated frequencies to provide services under the 4G/LTE standard in Russia.

Under the terms and conditions of this licence, the Group is obligated to provide 4G/LTE services in each population center with over 50,000 inhabitants in Russia by 2019. The Group is also obligated to make capital expenditures of at least 15,000 annually toward the 4G/LTE roll-out until the network is fully deployed, to clear frequencies currently allocated to the military at its own cost and to compensate other operators for surrendering frequencies in an aggregate amount of 401. In 2012 the Group has fully paid the compensation due to the other operators. It is currently not able to reasonably estimate the amount of the cost of clearing military frequencies.

Apple agreement

In January 2014, the Group entered into an agreement with LLC Apple Rus ("Apple"), a Russian affiliate of Apple Computer Inc., to purchase at least 750,000 iPhone handsets over a three-year period ending on 31 December 2016 for further resale in Russia. According to the agreement, the Group is also required to spend on marketing, advertising and promotion of iPhone handsets an amount of approximately 1,000 over the same period.

12. Commitments, contingencies and uncertainties (continued)

Social infrastructure expenses

From time to time, the Group may determine to maintain certain social infrastructure assets which are not owned by the Group and not recorded in the consolidated financial statements as well as to incur education, science and other social costs. Such activities are conducted in collaboration with non-governmental charity organisations. These expenses are presented in other non-operating income/(expense) in the interim condensed consolidated statements of comprehensive income.

Taxation

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

The Group's management believes that its interpretation of the relevant legislation is appropriate and is in accordance with the current industry practice and that the Group's tax, currency and customs positions will be sustained. However, the interpretations of the relevant authorities could differ.

As of 28 May 2014 the Group's management estimated the possible effect of additional taxes, before fines and interest, if any, on these interim condensed consolidated financial statements, if the authorities were successful in enforcing different interpretations, in the amount of up to approximately 845.

Litigation

The Group is not a party to any material litigation, although in the ordinary course of business, some of the Group’s subsidiaries may be party to various legal and tax proceedings, and subject to claims, certain of which relate to the developing markets and evolving fiscal and regulatory environments in which they operate. In the opinion of management, the Company’s and its subsidiaries’ liability, if any, in all pending litigation, other legal proceedings or other matters, will not have a material effect on the financial condition, financial performance or liquidity of the Group.

13. Events after the reporting date

Dividends

On 29 April 2014, the Board of Directors recommended payment of a dividend in the amount of 64.51 Rubles per ordinary share for the second, third and fourth quarters of 2013. If the recommended dividend is approved by the Company's shareholders at the Annual General Meeting to be held on 30 June 2014, and after taking into account the interim dividend for the first quarter of 2013 paid in 2013, total dividends for 2013 will amount to 74.85 Rubles per ordinary share. The total sum allocated to the recommended dividend payment is 36,972.

Ruble bonds

On 20 May 2014 the Group issued its Series BO-04 Ruble denominated exchange bonds, in an aggregate principal amount of 15,000. The bonds are due for repayment in full in May 2024. The coupon rate was set at 9.45% per annum, paid semiannually. The coupon rate is subject to revision on or about the first anniversary of the bonds placement, and bondholders electing not to accept the revised rate will have the right to put their bonds to the Group.