LUKOIL

# OAO LUKOIL

## CONSOLIDATED FINANCIAL STATEMENTS

**(prepared in accordance with US GAAP)**

**As of December 31, 2011 and 2010
and for each of the years in the three-year period
ended December 31, 2011**

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# Independent Auditors' Report

The Board of Directors
OAO LUKOIL:

We have audited the accompanying consolidated balance sheets of OAO LUKOIL and subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three year period ended December 31, 2011. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of OAO LUKOIL and subsidiaries as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the years in the three year period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

U.S. generally accepted accounting principles require that the Supplementary Information on Oil and Gas Exploration and Production Activities on pages 42 through 48 be presented to supplement the basic consolidated financial statements. Such information, although not a part of the basic consolidated financial statements, is required by the Financial Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic consolidated financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic consolidated financial statements, and other knowledge we obtained during our audit of the basic consolidated financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

ZAO KPMG

ZAO KPMG
Moscow, Russian Federation
February 24, 2012

**OAO LUKOIL**
**Consolidated Balance Sheets**
**As of December 31, 2011 and 2010**
**(Millions of US dollars, unless otherwise noted)**

| | Note | 2011 | 2010 |
|---|---|---|---|
| **Assets** | | | |
| **Current assets** | | | |
| Cash and cash equivalents | 3 | 2,753 | 2,368 |
| Short-term investments | | 157 | 168 |
| Accounts receivable, net | 5 | 8,921 | 8,219 |
| Inventories | 6 | 7,533 | 6,231 |
| Prepaid taxes and other expenses | | 3,219 | 2,934 |
| Other current assets | | 946 | 697 |
| **Total current assets** | | **23,529** | **20,617** |
| Investments | 7 | 5,952 | 5,637 |
| Property, plant and equipment | 8, 9 | 56,803 | 54,629 |
| Deferred income tax assets | 13 | 591 | 676 |
| Goodwill and other intangible assets | 10 | 1,344 | 1,446 |
| Other non-current assets | | 2,973 | 1,012 |
| **Total assets** | | **91,192** | **84,017** |
| **Liabilities and Equity** | | | |
| **Current liabilities** | | | |
| Accounts payable | | 5,995 | 5,607 |
| Short-term borrowings and current portion of long-term debt | 11 | 1,792 | 2,125 |
| Taxes payable | | 2,271 | 2,099 |
| Other current liabilities | | 1,050 | 944 |
| **Total current liabilities** | | **11,108** | **10,775** |
| Long-term debt | 12, 16 | 7,300 | 9,069 |
| Deferred income tax liabilities | 13 | 2,790 | 2,417 |
| Asset retirement obligations | 8 | 2,120 | 1,788 |
| Other long-term liabilities | | 408 | 360 |
| **Total liabilities** | | **23,726** | **24,409** |
| **Equity** | 15 | | |
| **OAO LUKOIL stockholders' equity** | | | |
| Common stock | | 15 | 15 |
| Treasury stock, at cost | | (4,081) | (3,683) |
| Equity-linked notes | | (980) | (980) |
| Additional paid-in capital | | 4,798 | 4,700 |
| Retained earnings | | 67,940 | 59,212 |
| Accumulated other comprehensive loss | | (54) | (67) |
| **Total OAO LUKOIL stockholders' equity** | | **67,638** | **59,197** |
| Non-controlling interests | | (172) | 411 |
| **Total equity** | | **67,466** | **59,608** |
| **Total liabilities and equity** | | **91,192** | **84,017** |

President of OAO LUKOIL
Alekperov V.Y.

Vice-president – Chief accountant of OAO LUKOIL
Khoba L.N.

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

**OAO LUKOIL**
**Consolidated Statements of Income**
**For the years ended December 31, 2011, 2010 and 2009**
**(Millions of US dollars, unless otherwise noted)**

| | Note | 2011 | 2010 | 2009 |
|---|---|---|---|---|
| **Revenues** | | | | |
| Sales (including excise and export tariffs) | 21 | 133,650 | 104,956 | 81,083 |
| | | | | |
| **Costs and other deductions** | | | | |
| Operating expenses | | (9,055) | (8,298) | (7,340) |
| Cost of purchased crude oil, gas and products | | (59,694) | (43,250) | (31,761) |
| Transportation expenses | | (6,121) | (5,608) | (4,830) |
| Selling, general and administrative expenses | | (3,822) | (3,558) | (3,306) |
| Depreciation, depletion and amortization | | (4,473) | (4,154) | (3,937) |
| Taxes other than income taxes | 13 | (12,918) | (8,978) | (6,474) |
| Excise and export tariffs | | (22,217) | (18,878) | (13,058) |
| Exploration expenses | | (532) | (336) | (218) |
| Loss on disposals and impairments of assets | | (1,663) | (363) | (381) |
| **Income from operating activities** | | **13,155** | **11,533** | **9,778** |
| Interest expense | | (694) | (712) | (667) |
| Interest and dividend income | | 211 | 174 | 134 |
| Equity share in income of affiliates | 7 | 690 | 472 | 351 |
| Currency translation loss | | (301) | (122) | (520) |
| Other non-operating income (expense) | | 58 | 125 | (13) |
| **Income before income taxes** | | **13,119** | **11,470** | **9,063** |
| Current income taxes | | (2,678) | (2,104) | (1,922) |
| Deferred income taxes | | (615) | (247) | (72) |
| **Total income tax expense** | 13 | **(3,293)** | **(2,351)** | **(1,994)** |
| **Net income** | | **9,826** | **9,119** | **7,069** |
| Net loss (net income) attributable to non-controlling interests | | 531 | (113) | (58) |
| **Net income attributable to OAO LUKOIL** | | **10,357** | **9,006** | **7,011** |
| | | | | |
| Earnings per share of common stock attributable to OAO LUKOIL (US dollars): | | | | |
| Basic | 15 | 13.30 | 10.95 | 8.28 |
| Diluted | 15 | 13.04 | 10.94 | 8.28 |

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

**OAO LUKOIL**
**Consolidated Statements of Stockholders' Equity and Comprehensive Income**
**For the years ended December 31, 2011, 2010 and 2009**
**(Millions of US dollars, unless otherwise noted)**

| | 2011 | | 2010 | | 2009 | |
|---|---|---|---|---|---|---|
| | Stockholders' equity | Comprehensive income | Stockholders' equity | Comprehensive income | Stockholders' equity | Comprehensive income |
| Common stock | | | | | | |
| Balance as of January 1 | 15 | | 15 | | 15 | |
| **Balance as of December 31** | **15** | | **15** | | **15** | |
| Treasury stock | | | | | | |
| Balance as of January 1 | (3,683) | | (282) | | (282) | |
| Stock purchased | (398) | | (3,664) | | - | |
| Stock disposed | - | | 263 | | - | |
| **Balance as of December 31** | **(4,081)** | | **(3,683)** | | **(282)** | |
| Equity-linked notes | | | | | | |
| Balance as of January 1 | (980) | | - | | - | |
| Equity-linked notes purchased | - | | (980) | | - | |
| **Balance as of December 31** | **(980)** | | **(980)** | | **-** | |
| Additional paid-in capital | | | | | | |
| Balance as of January 1 | 4,700 | | 4,699 | | 4,694 | |
| Premium on non-outstanding shares issued | - | | 1 | | - | |
| Effect of stock compensation plan | 98 | | 98 | | 20 | |
| Convertible bonds issue | - | | 113 | | - | |
| Changes in non-controlling interests | - | | (141) | | (15) | |
| Treasury stock disposed | - | | (70) | | - | |
| **Balance as of December 31** | **4,798** | | **4,700** | | **4,699** | |
| Retained earnings | | | | | | |
| Balance as of January 1 | 59,212 | | 51,634 | | 45,983 | |
| Net income | 10,357 | 10,357 | 9,006 | 9,006 | 7,011 | 7,011 |
| Dividends on common stock | (1,629) | | (1,428) | | (1,360) | |
| **Balance as of December 31** | **67,940** | | **59,212** | | **51,634** | |
| Accumulated other comprehensive loss, net of tax | | | | | | |
| Balance as of January 1 | (67) | | (75) | | (70) | |
| Pension benefits: | | | | | | |
| Prior service cost | 22 | 22 | 12 | 12 | (4) | (4) |
| Actuarial (loss) gain | (9) | (9) | (4) | (4) | 1 | 1 |
| Unrecognized loss on available-for-sale securities | - | - | - | - | (2) | (2) |
| **Balance as of December 31** | **(54)** | | **(67)** | | **(75)** | |
| Total comprehensive income | | 10,370 | | 9,014 | | 7,006 |
| **Total OAO LUKOIL stockholders' equity as of December 31** | **67,638** | | **59,197** | | **55,991** | |
| Non-controlling interests | | | | | | |
| Balance as of January 1 | 411 | | 388 | | 670 | |
| (Net loss) net income attributable to non-controlling interests | (531) | | 113 | | 58 | |
| Changes in non-controlling interests | (52) | | (90) | | (340) | |
| **Balance as of December 31** | **(172)** | | **411** | | **388** | |
| **Total equity as of December 31** | **67,466** | | **59,608** | | **56,379** | |

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

| | Share activity | | |
|---|---|---|---|
| | 2011 | 2010 | 2009 |
| | (thousands of shares) | (thousands of shares) | (thousands of shares) |
| Common stock, issued | | | |
| Balance as of January 1 | 850,563 | 850,563 | 850,563 |
| **Balance as of December 31** | **850,563** | **850,563** | **850,563** |
| Treasury stock | | | |
| Balance as of January 1 | (69,208) | (3,836) | (3,836) |
| Purchase of treasury stock | (6,893) | (68,912) | - |
| Disposal of treasury stock | - | 3,540 | - |
| **Balance as of December 31** | **(76,101)** | **(69,208)** | **(3,836)** |

**OAO LUKOIL**
**Consolidated Statements of Cash Flows**
**For the years ended December 31, 2011, 2010 and 2009**
**(Millions of US dollars)**

| | Note | 2011 | 2010 | 2009 |
|---|---|---|---|---|
| **Cash flows from operating activities** | | | | |
| **Net income attributable to OAO LUKOIL** | | **10,357** | **9,006** | **7,011** |
| Adjustments for non-cash items: | | | | |
| Depreciation, depletion and amortization | | 4,473 | 4,154 | 3,937 |
| Equity share in income of affiliates, net of dividends received | | 185 | 316 | (213) |
| Dry hole write-offs | | 417 | 225 | 117 |
| Loss on disposals and impairments of assets | | 1,663 | 363 | 381 |
| Deferred income taxes | | 615 | 247 | 72 |
| Non-cash currency translation gain | | (214) | (44) | (57) |
| Non-cash investing activities | | (6) | (67) | (20) |
| All other items – net | | (447) | 167 | 138 |
| Changes in operating assets and liabilities: | | | | |
| Trade accounts receivable | | (758) | (2,285) | (1,171) |
| Inventories | | (1,420) | (813) | (1,719) |
| Accounts payable | | 885 | 1,508 | 96 |
| Taxes payable | | 177 | 274 | 292 |
| Other current assets and liabilities | | (413) | 490 | 19 |
| **Net cash provided by operating activities** | | **15,514** | **13,541** | **8,883** |
| **Cash flows from investing activities** | | | | |
| Acquisition of licenses | | (25) | (15) | (40) |
| Capital expenditures | | (8,249) | (6,596) | (6,483) |
| Proceeds from sale of property, plant and equipment | | 156 | 128 | 91 |
| Purchases of investments | | (101) | (137) | (216) |
| Proceeds from sale of investments | | 79 | 126 | 478 |
| Sale of subsidiaries and equity method affiliates, net of cash disposed | | 227 | 130 | 92 |
| Acquisitions of subsidiaries and equity method affiliates (including advances related to acquisitions), net of cash acquired | | (2,860) | (932) | (2,473) |
| **Net cash used in investing activities** | | **(10,773)** | **(7,296)** | **(8,551)** |
| **Cash flows from financing activities** | | | | |
| Net movements of short-term borrowings | | (633) | (213) | (1,281) |
| Proceeds from issuance of long-term debt | | 1 | 2,515 | 5,467 |
| Principal repayments of long-term debt | | (1,372) | (2,267) | (2,697) |
| Dividends paid on Company common stock | | (1,714) | (1,471) | (1,337) |
| Dividends paid to non-controlling interest stockholders | | (116) | (85) | (85) |
| Financing received from non-controlling interest stockholders | | 3 | 18 | 20 |
| Purchase of Company's stock | | (398) | (3,664) | - |
| Sale of Company's stock | | - | 193 | - |
| Purchase of equity-linked notes | | - | (980) | - |
| Purchases of non-controlling interest (including advances related to acquisitions) | | (34) | (192) | (372) |
| **Net cash used in financing activities** | | **(4,263)** | **(6,146)** | **(285)** |
| Effect of exchange rate changes on cash and cash equivalents | | (93) | (5) | (12) |
| **Net increase in cash and cash equivalents** | | **385** | **94** | **35** |
| Cash and cash equivalents at beginning of year | | 2,368 | 2,274 | 2,239 |
| **Cash and cash equivalents at end of year** | 3 | **2,753** | **2,368** | **2,274** |

| | | | |
|---|---|---|---|
| Supplemental disclosures of cash flow information | | | |
| Interest paid | 683 | 718 | 520 |
| Income taxes paid | 2,508 | 2,126 | 1,575 |

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

## Note 1. Organization and environment

The primary activities of OAO LUKOIL (the "Company") and its subsidiaries (together, the "Group") are oil exploration, production, refining, marketing and distribution. The Company is the ultimate parent entity of this vertically integrated group of companies.

The Group was established in accordance with Presidential Decree 1403, issued on November 17, 1992. Under this decree, on April 5, 1993, the Government of the Russian Federation transferred to the Company 51% of the voting shares of fifteen enterprises. Under Government Resolution 861 issued on September 1, 1995, a further nine enterprises were transferred to the Group during 1995. Since 1995, the Group has carried out a share exchange program to increase its shareholding in each of the twenty-four founding subsidiaries to 100%.

From formation, the Group has expanded substantially through consolidation of its interests, acquisition of new companies and establishment of new businesses.

### *Business and economic environment*

The accompanying financial statements reflect management's assessment of the impact of the business environment in the countries in which the Group operates on the operations and the financial position of the Group. The future business environments may differ from management's assessment.

### *Basis of preparation*

These consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America ("US GAAP").

## Note 2. Summary of significant accounting policies

### *Principles of consolidation*

These consolidated financial statements include the financial position and results of the Company, controlled subsidiaries of which the Company directly or indirectly owns more than 50% of the voting interest, unless minority stockholders have substantive participating rights, and variable interest entities where the Group is determined to be the primary beneficiary. Other significant investments in companies of which the Company directly or indirectly owns between 20% and 50% of the voting interest and over which it exercises significant influence but not control, are accounted for using the equity method of accounting. Investments in companies of which the Company directly or indirectly owns more than 50% of the voting interest but where minority stockholders have substantive participating rights are accounted for using the equity method of accounting. Undivided interests in oil and gas joint ventures are accounted for using the proportionate consolidation method. Investments in other companies are recorded at cost. Equity investments and investments in other companies are included in "Investments" in the consolidated balance sheet.

### *Use of estimates*

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities 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. Significant items subject to such estimates and assumptions include the carrying value of oil and gas properties and other property, plant and equipment, goodwill impairment assessment, asset retirement obligations, deferred income taxes, valuation of financial instruments, and obligations related to employee benefits. Eventual actual amounts could differ from those estimates.

## Note 2. Summary of significant accounting policies (continued)

### *Revenue*

Revenues are recognized when title passes to customers at which point the risks and rewards of ownership are assumed by the customer and the price is fixed or determinable. Revenues include excise on petroleum products sales and duties on export sales of crude oil and petroleum products.

Revenues from non-cash sales are recognized at the fair market value of the crude oil and petroleum products sold.

### *Foreign currency translation*

The Company maintains its accounting records in Russian rubles. The Company's functional currency is the US dollar and the Group's reporting currency is the US dollar.

For the majority of operations in the Russian Federation and outside the Russian Federation, the US dollar is the functional currency. Where the US dollar is the functional currency, monetary assets and liabilities have been translated into US dollars at the rate prevailing at each balance sheet date. Non-monetary assets and liabilities have been translated into US dollars at historical rates. Revenues, expenses and cash flows have been translated into US dollars at rates which approximate actual rates at the date of the transaction. Translation differences resulting from the use of these rates are included in the consolidated statement of income.

For certain other operations, where the US dollar is not the functional currency and the economy is not highly inflationary, assets and liabilities are translated into US dollars at year-end exchange rates and revenues and expenses are translated at average exchange rates for the year. Resulting translation adjustments are reflected as a separate component of comprehensive income.

In all cases, foreign currency transaction gains and losses are included in the consolidated statement of income.

As of December 31, 2011, 2010 and 2009, exchange rates of 32.20, 30.48 and 30.24 Russian rubles to the US dollar, respectively, have been used for translation purposes.

### *Cash and cash equivalents*

Cash and cash equivalents include all highly liquid investments with an original maturity of three months or less.

### *Cash with restrictions on immediate use*

Cash funds for which restrictions on immediate use exist are accounted for within other non-current assets.

### *Accounts receivable*

Accounts receivable are recorded at their transaction amounts less provisions for doubtful debts. Provisions for doubtful debts are recorded to the extent that there is a likelihood that any of the amounts due will not be collected. Non-current receivables are discounted to the present value of expected cash flows in future periods using the original discount rate.

### *Inventories*

The cost of finished goods and purchased products is determined using the first-in, first-out cost method (FIFO). The cost of all other inventory categories is determined using an "average cost" method.

**Note 2. Summary of significant accounting policies (continued)**

***Investments***

Debt and equity securities are classified into one of three categories: trading, available-for-sale, or held-to-maturity.

Trading securities are bought and held principally for the purpose of selling in the near term. Held-to-maturity securities are those securities in which a Group company has the ability and intent to hold until maturity. All securities not included in trading or held-to-maturity are classified as available-for-sale.

Trading and available-for-sale securities are recorded at fair value. Held-to-maturity securities are recorded at cost, adjusted for the amortization or accretion of premiums or discounts. Unrealized holding gains and losses on trading securities are included in the consolidated statement of income. Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are reported as a separate component of comprehensive income until realized. Realized gains and losses from the sale of available-for-sale securities are determined on a specific identification basis. Dividends and interest income are recognized in the consolidated statement of income when earned.

A permanent decline in the market value of any available-for-sale or held-to-maturity security below cost is accounted for as a reduction in the carrying amount to fair value. The impairment is charged to the consolidated statement of income and a new cost base for the security is established. Premiums and discounts are amortized or accreted over the life of the related held-to-maturity or available-for-sale security as an adjustment to yield using the effective interest method and such amortization and accretion is recorded in the consolidated statement of income.

***Property, plant and equipment***

Oil and gas properties are accounted for using the successful efforts method of accounting whereby property acquisitions, successful exploratory wells, all development costs (including development dry holes and the Group’s share of operators’ expenses during the development stage of production sharing and risk service contracts), and support equipment and facilities are capitalized. Unsuccessful exploratory wells are expensed when a well is determined to be non-productive. Other exploratory expenditures, including geological and geophysical costs are expensed as incurred.

The Group continues to capitalize costs of exploratory wells and exploratory-type stratigraphic wells for more than one year after the completion of drilling if the well has found a sufficient quantity of reserves to justify its completion as a producing well and the Company is making sufficient progress towards assessing the reserves and the economic and operating viability of the project. If these conditions are not met or if information that raises substantial doubt about the economic or operational viability of the project is obtained, the well would be assumed impaired, and its costs, net of any salvage value, would be charged to expense.

Depreciation, depletion and amortization of capitalized costs of oil and gas properties is calculated using the unit-of-production method based upon proved reserves for the cost of property acquisitions and proved developed reserves for exploration and development costs.

Production and related overhead costs are expensed as incurred.

Depreciation of assets not directly associated with oil production is calculated on a straight-line basis over the economic lives of such assets, estimated to be in the following ranges:

| | | |
|---|---|---|
| Buildings and constructions | 5 – 40 | Years |
| Machinery and equipment | 5 – 20 | Years |

**Note 2. Summary of significant accounting policies (continued)**

In addition to production assets, certain Group companies also maintain and construct social assets for the use of local communities. Such assets are capitalized only to the extent that they are expected to result in future economic benefits to the Group. If capitalized, they are depreciated over their estimated economic lives.

Significant unproved properties are assessed for impairment individually on a regular basis and any estimated impairment is charged to expense.

***Asset retirement obligations***

The Group records the fair value of liabilities related to its legal obligations to abandon, dismantle or otherwise retire tangible long-lived assets in the period in which the liability is incurred. A corresponding increase in the carrying amount of the related long-lived asset is also recorded. Subsequently, the liability is accreted for the passage of time and the related asset is depreciated using the unit-of-production method.

***Goodwill and other intangible assets***

Goodwill represents the excess of the cost of an acquired entity over the net of the fair value amounts assigned to assets acquired and liabilities assumed. It is assigned to reporting units as of the acquisition date. Goodwill is not amortized, but is tested for impairment at least on an annual basis and between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. The impairment test requires estimating the fair value of a reporting unit and comparing it with its carrying amount, including goodwill assigned to the reporting unit. If the estimated fair value of the reporting unit is less than its net carrying amount, including goodwill, then the goodwill is written down to its implied fair value.

Intangible assets with indefinite useful lives are tested for impairment at least annually. Intangible assets that have limited useful lives are amortized on a straight-line basis over the shorter of their useful or legal lives.

***Impairment of long-lived assets***

Long-lived assets, such as oil and gas properties (other than unproved properties), other property, plant, and equipment, and purchased intangibles subject to amortization, are assessed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset group to the estimated undiscounted future cash flows expected to be generated by that group. If the carrying amount of an asset group exceeds its estimated undiscounted future cash flows, an impairment charge is recognized by writing down the carrying amount to the estimated fair value of the asset group, generally determined as discounted future net cash flows. Assets to be disposed of are separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale are presented separately in the appropriate asset and liability sections of the balance sheet.

***Income taxes***

Deferred income tax assets and liabilities are recognized in respect of future tax consequences attributable to temporary differences between the carrying amounts of existing assets and liabilities for the purposes of the consolidated financial statements and their respective tax bases and in respect of operating loss and tax credit carryforwards. Deferred income tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse and the assets to be recovered and liabilities settled. The effect on deferred income tax assets and liabilities of a change in tax rates is recognized in the consolidated statement of income in the reporting period which includes the enactment date.

**Note 2. Summary of significant accounting policies (continued)**

The ultimate realization of deferred income tax assets is dependent upon the generation of future taxable income in the reporting periods in which the originating expenditure becomes deductible. In assessing the realizability of deferred income tax assets, management considers whether it is more likely than not that the deferred income tax assets will be realized. In making this assessment, management considers the scheduled reversal of deferred income tax liabilities, projected future taxable income, and tax planning strategies.

An income tax position is recognized only if the uncertain position is more likely than not of being sustained upon examination, based on its technical merits. A recognized income tax position is measured at the largest amount that is greater than 50% likely of being realized. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs. The Company records interest and penalties relating to income tax in income tax expense in the consolidated statements of income.

***Interest-bearing borrowings***

Interest-bearing borrowings from third parties (except convertible notes) are initially recorded at the value of net proceeds received. Any difference between the net proceeds and the redemption value is amortized at a constant rate over the term of the borrowing. Amortization is included in the consolidated statement of income and the carrying amounts are adjusted as amortization accumulates.

For borrowings from related parties (except convertible notes) issued with an interest rate lower than the market interest rate, the Group determines book value using market interest rate. The resulting difference is allocated to additional paid-in capital and is amortized at a constant rate over the term of the borrowings. Amortization is included in the consolidated statement of income each year and the carrying amounts are adjusted as amortization accumulates.

For convertible notes issued with a cash conversion option, the Group allocates the proceeds from issuance between a liability component and an equity component. The Group records the equity component at an amount equal to the difference between the proceeds received and the fair value of the liability component, measured as the fair value of a similar liability that does not have an associated equity component. The Group recognizes the interest cost in subsequent periods at its borrowing rate for non-convertible debt.

If borrowings are repurchased or settled before maturity, any difference between the amount paid and the carrying amount is recognized in the consolidated statement of income in the period in which the repurchase or settlement occurs.

***Pension benefits***

The expected costs in respect of pension obligations of Group companies are determined by an independent actuary. Obligations in respect of each employee are accrued over the reporting periods during which the employee renders service in the Group.

The Group recognizes the funded status of the postretirement defined benefit plan in the consolidated balance sheet with corresponding adjustments to accumulated other comprehensive income. The adjustment to accumulated other comprehensive income represents the net unrecognized actuarial gains and unrecognized prior service costs. These amounts are subsequently recognized as net periodic benefit cost. Further, actuarial gains and losses that arise in subsequent periods and are not recognized as net periodic benefit cost in the same periods are recognized as a component of other comprehensive income. These amounts are subsequently recognized as a component of net periodic benefit cost on the same basis as the amounts recognized in accumulated other comprehensive income.

***Treasury stock***

Purchases by Group companies of the Company’s outstanding stock are recorded at cost and classified as treasury stock within Stockholders’ equity. Shares shown as Authorized and Issued include treasury stock. Shares shown as Outstanding do not include treasury stock.

**Note 2. Summary of significant accounting policies (continued)**

***Earnings per share***

Basic earnings per share is computed by dividing net income available to common stockholders of the Company by the weighted-average number of shares of common stock outstanding during the reporting period. A calculation is carried out to establish if there is potential dilution in earnings per share if convertible securities were to be converted into shares of common stock or contracts to issue shares of common stock were to be exercised. If there is such dilution, diluted earnings per share is presented.

***Contingencies***

Certain conditions may exist as of the balance sheet date, which may result in losses to the Group but the impact of which will only be resolved when one or more future events occur or fail to occur.

If a Group company's assessment of a contingency indicates that it is probable that a material loss has been incurred and the amount of the liability can be estimated, then the estimated liability is accrued and charged to the consolidated statement of income. If the assessment indicates that a potentially material loss is not probable, but is reasonably possible, or is probable, but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss, is disclosed in the notes to the consolidated financial statements. Loss contingencies considered remote or related to unasserted claims are generally not disclosed unless they involve guarantees, in which case the nature of the guarantee is disclosed.

***Environmental expenditures***

Estimated losses from environmental remediation obligations are generally recognized no later than completion of remedial feasibility studies. Group companies accrue for losses associated with environmental remediation obligations when such losses are probable and reasonably estimable. Such accruals are adjusted as further information becomes available or circumstances change. Costs of expected future expenditures for environmental remediation obligations are not discounted to their present value.

***Use of derivative instruments***

The Group's derivative activity is limited to certain petroleum products marketing and trading operations and hedging of commodity price risks. Currently this activity involves the use of futures and swaps contracts together with purchase and sale contracts that qualify as derivative instruments. The Group accounts for these activities under the mark-to-market methodology in which the derivatives are revalued each accounting period. Resulting realized and unrealized gains or losses are presented in the consolidated statement of income on a net basis. Unrealized gains and losses are carried as assets or liabilities on the consolidated balance sheet.

***Share-based payments***

The Group accounts for liability classified share-based payment awards to employees at fair value on the date of grant and as of each reporting date. Expenses are recognized over the vesting period. Equity classified share-based payment awards to employees are valued at fair value on the date of grant and expensed over the vesting period.

***Comparative amounts***

Certain prior period amounts have been reclassified to conform with the current period's presentation.

**Note 2. Summary of significant accounting policies (continued)**

***Changes in accounting policy***

In April 2011, the FASB issued Accounting Standards Update ("ASU") No. 2011-02, *"A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring,"* which amends Topic 310 of the Codification. This ASU provides additional guidance in considering whether a restructuring constitutes a troubled debt restructuring and helps creditors in determining whether a creditor has granted a concession and whether a debtor is experiencing financial difficulties. ASU No. 2011-02 is effective starting from the first interim or annual period beginning on or after June 15, 2011. The Group adopted the requirements of ASU No. 2011-02 starting from the third quarter of 2011. This adoption did not have a material impact on the Group's results of operations, financial position or cash flows and did not require additional disclosures.

In January 2010, the FASB issued ASU No. 2010-06, *"Improving Disclosures about Fair Value Measurements,"* which requires reporting entities to make new disclosures about recurring or nonrecurring fair-value measurements including significant transfers into and out of Level 1 and Level 2 fair-value measurements and to present separately information about purchases, sales, issuances, and settlements on a gross basis in the reconciliation of Level 3 fair-value measurements. This ASU also clarifies existing fair-value measurement disclosure guidance about the level of disaggregation, inputs, and valuation techniques. The Group fully adopted the requirements of ASU No. 2010-06 starting from the first quarter of 2011. This adoption did not have a material impact on the Group's results of operations, financial position or cash flows.

***Recent accounting pronouncements***

In December 2011, the FASB issued ASU No. 2011-12, *"Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05."* This ASU defers changes that relate to the presentation to reclassification adjustments out of accumulated other comprehensive income in ASU No. 2011-05, *"Presentation of Comprehensive Income,"* until the FASB is able to reconsider those paragraphs. Entities should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU No. 2011-05. ASU No. 2011-12 is effective at the same time as the ASU No. 2011-05: for public entities for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively. The Group will apply the provisions of ASU No. 2011-12 starting from the first quarter of 2012 and does not expect any material impact on its results of operations, financial position or cash flows.

In December 2011, the FASB issued ASU No. 2011-11, *"Disclosures about Offsetting Assets and Liabilities."* This ASU requires entities to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The scope includes derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. ASU No. 2011-11 is effective for annual reporting periods on or after January 1, 2013, and interim periods within those annual periods, and should be applied retrospectively. The Group is evaluating the effect of the adoption of ASU No. 2011-11 and does not expect any material impact on its results of operations, financial position or cash flows.

In September 2011, the FASB issued ASU No. 2011-08, *"Testing Goodwill for Impairment,"* which allows an entity to use a qualitative approach to test goodwill for impairment. This ASU permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount and hence whether it is necessary to perform the two-step goodwill impairment test as required by the provisions of Topic 350 of the Codification. ASU No. 2011-08 is effective for annual and interim goodwill impairment tests performed for the fiscal years beginning after December 15, 2011. The Group will apply the provisions of ASU No. 2011-08 starting from the first quarter of 2012 and does not expect any material impact on its results of operations, financial position or cash flows.

**(Millions of US dollars, except as indicated)**

## Note 2. Summary of significant accounting policies (continued)

In June 2011, the FASB issued ASU No. 2011-05, *"Presentation of comprehensive income,"* which amends Topic 220 of the Codification. This ASU increases the prominence of other comprehensive income in financial statements. Under this ASU, an entity will have the option to present the components of net income and comprehensive income in either one or two statements. The ASU eliminates the option in US GAAP to present other comprehensive income in the statement of changes in equity. ASU No. 2011-05 is effective for public entities for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively. The Group will apply the provisions of ASU No. 2011-05 starting from the first quarter of 2012.

In May 2011, the FASB issued ASU No. 2011-04, *"Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in US GAAP and IFRSs,"* which amends Topic 820 of the Codification. This ASU provides guidance for fair value measurements and disclosure requirements and clarifies the Board's intent about the application of existing fair value measurement requirements. The new standard does not extend the use of fair value but, rather, provides guidance about how fair value should be applied where it already is required or permitted under US GAAP. ASU No. 2011-04 is effective for public entities during interim and annual periods beginning after December 15, 2011 and should be applied prospectively. The Group will apply the provisions of ASU No. 2011-04 starting from the first quarter of 2012 and does not expect any material impact on its results of operations, financial position or cash flows.

## Note 3. Cash and cash equivalents

| | **As of December 31, 2011** | **As of December 31, 2010** |
|---|---|---|
| Cash held in Russian rubles | 1,152 | 367 |
| Cash held in US dollars | 1,224 | 1,259 |
| Cash held in other currencies | 271 | 418 |
| Cash held in related party banks in Russian rubles | 83 | 320 |
| Cash held in related party banks in other currencies | 23 | 4 |
| **Total cash and cash equivalents** | **2,753** | **2,368** |

## Note 4. Non-cash transactions

The consolidated statement of cash flows excludes the effect of non-cash transactions, which are described in the following table:

| | **Year ended December 31, 2011** | **Year ended December 31, 2010** | **Year ended December 31, 2009** |
|---|---|---|---|
| Non-cash investing activity | 6 | 67 | 20 |
| Non-cash acquisitions | - | - | 100 |
| **Total non-cash transactions** | **6** | **67** | **120** |

The following table shows the effect of non-cash transactions on investing activity:

| | **Year ended December 31, 2011** | **Year ended December 31, 2010** | **Year ended December 31, 2009** |
|---|---|---|---|
| Net cash used in investing activity | 10,773 | 7,296 | 8,551 |
| Non-cash acquisitions | - | - | 100 |
| Non-cash investing activity | 6 | 67 | 20 |
| **Total investing activity** | **10,779** | **7,363** | **8,671** |

**(Millions of US dollars, except as indicated)**

## Note 5. Accounts receivable, net

| | As of December 31, 2011 | As of December 31, 2010 |
|---|---|---|
| Trade accounts receivable (net of provisions of $179 million and $182 million as of December 31, 2011 and 2010, respectively) | 7,209 | 6,748 |
| Current VAT and excise recoverable | 1,333 | 1,149 |
| Other current accounts receivable (net of provisions of $54 million and $50 million as of December 31, 2011 and 2010, respectively) | 379 | 322 |
| **Total accounts receivable, net** | **8,921** | **8,219** |

## Note 6. Inventories

| | As of December 31, 2011 | As of December 31, 2010 |
|---|---|---|
| Crude oil and petroleum products | 6,265 | 5,093 |
| Materials for extraction and drilling | 321 | 356 |
| Materials and supplies for refining | 57 | 37 |
| Other goods, materials and supplies | 890 | 745 |
| **Total inventories** | **7,533** | **6,231** |

## Note 7. Investments

| | As of December 31, 2011 | As of December 31, 2010 |
|---|---|---|
| Investments in equity method affiliates and joint ventures | 4,887 | 4,529 |
| Long-term loans to equity method affiliates and joint ventures | 1,001 | 990 |
| Other long-term investments | 64 | 118 |
| **Total long-term investments** | **5,952** | **5,637** |

### *Investments in "equity method" affiliates and joint ventures*

The summarized financial information below is in respect of equity method affiliates and corporate joint ventures. The companies are primarily engaged in crude oil exploration, production, marketing and distribution operations in the Russian Federation, crude oil production and marketing in Kazakhstan, and refining operations in Europe.

| | **Year ended December 31, 2011** | | **Year ended December 31, 2010** | | **Year ended December 31, 2009** | |
|---|---|---|---|---|---|---|
| | Total | Group's share | Total | Group's share | Total | Group's share |
| Revenues | 32,770 | 4,777 | 24,348 | 3,672 | 5,139 | 2,275 |
| Income before income taxes | 13,832 | 1,005 | 9,187 | 675 | 1,305 | 478 |
| Less income taxes | (4,241) | (315) | (2,682) | (203) | (407) | (127) |
| **Net income** | **9,591** | **690** | **6,505** | **472** | **898** | **351** |

**(Millions of US dollars, except as indicated)**

## Note 7. Investments (continued)

| | As of December 31, 2011 | | As of December 31, 2010 | |
|---|---|---|---|---|
| | Total | Group's Share | Total | Group's share |
| Current assets | 7,379 | 1,406 | 7,462 | 1,359 |
| Property, plant and equipment | 19,064 | 5,587 | 18,053 | 5,099 |
| Other non-current assets | 1,454 | 462 | 989 | 350 |
| Total assets | 27,897 | 7,455 | 26,504 | 6,808 |
| Short-term debt | 1,100 | 223 | 701 | 57 |
| Other current liabilities | 3,703 | 668 | 2,844 | 551 |
| Long-term debt | 7,461 | 1,069 | 7,809 | 1,079 |
| Other non-current liabilities | 1,581 | 608 | 1,805 | 592 |
| **Net assets** | **14,052** | **4,887** | **13,345** | **4,529** |

In April 2011, the Company and OAO ANK Bashneft signed an agreement to establish a joint venture and to develop two oil fields named after R.Trebs and A.Titov, located in the Nenets Autonomous District of Russia. According to the agreement, the mineral rights for the development of the fields were re-issued by OAO ANK Bashneft in favor of its 100% subsidiary OOO Bashneft-Polus. In December 2011, the Company acquired 25.1% of OOO Bashneft-Polus for approximately $153 million, and OOO Bashneft-Polus acquired 29 exploration wells located on these fields from a Group company for $60 million. The parties agreed to transport oil extracted from the fields via the Group's transportation infrastructure and to consider the exploitation of certain other nearby infrastructure owned by the Group.

In April 2011, the Group acquired an additional 11% interest in the joint venture which operates the ISAB refining complex (Priolo, Italy) for approximately €241 million ($342 million). The acquisition was based on an option, which was partially executed in accordance with the initial agreement on the establishment of the joint venture signed in 2008. This agreement gave the second investor – ERG S.p.A. ("ERG") a step-by-step put option to sell its remaining share in the joint venture to the Group. As a result the Group's interest in the joint venture was increased from 49% to 60%. Based on the agreement, ERG and the Company still have equal participation rights. Therefore the Group continues to use the equity method of accounting for this joint venture. In January 2012, the Group received a notice that the Board of Directors of ERG decided to exercise its option to sell to the Group a further 20% interest in the joint venture. The transaction is expected to be finalized in the second quarter of 2012 in the amount of €400 million ($526 million), excluding inventory. Thus, the Group's stake in the joint venture will be increased from 60% to 80% and the Group will then obtain control.

## Note 8. Property, plant and equipment and asset retirement obligations

| | At cost | | Net | |
|---|---|---|---|---|
| | **As of December 31, 2011** | **As of December 31, 2010** | **As of December 31, 2011** | **As of December 31, 2010** |
| Exploration and Production: | | | | |
| Russia | 54,269 | 51,797 | 34,415 | 32,973 |
| International | 8,138 | 7,114 | 6,376 | 5,624 |
| Total | 62,407 | 58,911 | 40,791 | 38,597 |
| Refining, Marketing, Distribution and Chemicals: | | | | |
| Russia | 12,133 | 11,062 | 7,395 | 7,208 |
| International | 6,903 | 6,883 | 4,282 | 4,511 |
| Total | 19,036 | 17,945 | 11,677 | 11,719 |

**(Millions of US dollars, except as indicated)**

## Note 8. Property, plant and equipment and asset retirement obligations (continued)

| | At cost | | Net | |
|---|---|---|---|---|
| | As of December 31, 2011 | As of December 31, 2010 | As of December 31, 2011 | As of December 31, 2010 |
| Power generation and other: | | | | |
| Russia | 4,890 | 4,589 | 4,026 | 3,970 |
| International | 406 | 440 | 309 | 343 |
| Total | 5,296 | 5,029 | 4,335 | 4,313 |
| **Total property, plant and equipment** | **86,739** | **81,885** | **56,803** | **54,629** |

The Company performs a regular annual impairment test of its assets. The test is based on geological models and development programs, which are revised on a regular basis at least annually. The fair value of tested assets is determined using the present value of the expected cash flows. Fair value measurements models used in the impairment tests were Level 3 (unobservable inputs) fair value measurements.

In 2005, the Company and ConocoPhillips formed a joint venture on the basis of OOO Narianmarneftegaz ("NMNG"), a Group subsidiary. The purpose of the joint venture is to develop oil reserves in the Timan-Pechora region of the Russian Federation (refer to Note 17. Consolidation of Variable Interest Entity). In 2008, NMNG started crude oil production on the Yuzhnoye Khylchuyu oil field, the major field of the joint venture. As of December 31, 2008, proved oil reserves on this oil field were estimated to be approximately 505 million barrels. During 2010, oil production started to fall below expected levels due to a number of unanticipated geological reasons. As of December 31, 2011, proved oil reserves were estimated to be approximately 142 million barrels. During the year ended December 31, 2011, the Company recognized an impairment loss on NMNG's exploration and production assets in the total amount of $1,175 million.

Additionally during the year ended December 31, 2011, the Company recognized an impairment loss of $175 million for assets related to international refining, marketing and distribution segment.

During the year ended December 31, 2010, the Company recognized an impairment loss of $164 million for its exploration and production assets in the Western Siberia, Timan-Pechora and Central European regions of Russia and $29 million for international marketing and distribution assets.

The following tables set out values of property, plant and equipment measured at fair value on a nonrecurring basis in periods subsequent to their initial recognition:

| | Fair value | Level 3 fair value measurements | Before-tax loss |
|---|---|---|---|
| **Year ended December 31, 2011** | | | |
| Property, plant and equipment | 1,195 | 1,195 | 1,350 |
| **Year ended December 31, 2010** | | | |
| Property, plant and equipment | 120 | 120 | 193 |

As of December 31, 2011 and 2010, the asset retirement obligations amounted to $2,126 million and $1,798 million, respectively, of which $6 million and $10 million was included in "Other current liabilities" in the consolidated balance sheets as of each balance sheet date.

**(Millions of US dollars, except as indicated)**

## Note 8. Property, plant and equipment and asset retirement obligations (continued)

During 2011 and 2010, asset retirement obligations changed as follows:

| | 2011 | 2010 |
|---|---|---|
| Asset retirement obligations as of January 1 | 1,798 | 1,199 |
| Accretion expense | 158 | 124 |
| New obligations | 172 | 190 |
| Changes in estimates of existing obligations | 173 | 314 |
| Spending on existing obligations | (5) | (6) |
| Property dispositions | (5) | (4) |
| Foreign currency translation and other adjustments | (165) | (19) |
| **Asset retirement obligations as of December 31** | **2,126** | **1,798** |

The asset retirement obligations incurred during 2011 and 2010 were Level 3 (unobservable inputs) fair value measurements.

## Note 9. Suspended wells

Net changes in capitalized exploratory suspended wells during 2011, 2010 and 2009 were as follows:

| | 2011 | 2010 | 2009 |
|---|---|---|---|
| Balance as of January 1 | 405 | 406 | 337 |
| Additions pending the determination of proved reserves | 97 | 156 | 124 |
| Charged to expenses | - | (94) | (36) |
| Reclassification to proved properties | (33) | (63) | (19) |
| **Balance as of December 31** | **469** | **405** | **406** |

Aging of capitalized suspended exploratory well costs were as follows:

| | As of December 31, 2011 | As of December 31, 2010 | As of December 31, 2009 |
|---|---|---|---|
| **Exploratory well costs capitalized** | | | |
| for a period of one year or less | 78 | 148 | 124 |
| for two years | 144 | 72 | 122 |
| for three years | 72 | 89 | 86 |
| for four years | 82 | 82 | 58 |
| for five years or more | 93 | 14 | 16 |
| for a period of greater than one year | 391 | 257 | 282 |
| **Total exploratory well costs capitalized** | **469** | **405** | **406** |
| Number of projects that have exploratory well costs capitalized for a period greater than one year | 14 | 11 | 15 |

**(Millions of US dollars, except as indicated)**

## Note 9. Suspended wells (continued)

Aging of the exploratory wells that have been capitalized for more than one year since completion of drilling as of December 31, 2011:

| **Project name (field name)** | **Location** | **As of December 31, 2011** | **Years wells drilled** |
|---|---|---|---|
| Block A | Saudi Arabia | 255 | 2007-2010 |
| Cape Three Points Deep Water | Ghana | 92 | 2010 |
| Aral | Uzbekistan | 5 | 2010 |
| Vinnikovskoe | European Russia | 7 | 2008-2010 |
| Centralno-Astrakhanskoe | European Russia | 6 | 2008-2009 |
| Gabishevskoe | European Russia | 5 | 2008-2009 |
| 8 projects of less than $4 million each | European Russia | 21 | 2004-2010 |
| **Total of 14 projects** | | **391** | |

Capitalized exploratory well costs of $255 million are related to two fields in the Block A area in Saudi Arabia, represented by four wells drilled in 2007-2010. The wells were suspended pending final assessment of the operational and economic viability of the project. During 2011, to assess the required technology for the development and extraction of the tight gas reservoirs, the Group engaged an international engineering survey company to evaluate recompletion options for the wells, to prove the commercialization potential of the appraisal area and to optimize the stimulation technology for its development. These evaluations were completed in December 2011. As a result of these evaluations, the Group will submit an implementation plan for consideration and approval by the Saudi Arabian Government. A decision is expected during 2012.

Capitalized exploratory well costs of $92 million related to block “Cape Three Points Deep Water” in Ghana are represented by one exploratory well. During 2011, an appraisal well was drilled, but it was found unsuccessful and was written off. Currently the Group plans to continue evaluating the development plan for this project and the second appraisal well will be drilled in 2012.

The Company is evaluating the development plans for other projects.

## Note 10. Goodwill and other intangible assets

The carrying value of goodwill and other intangible assets as of December 31, 2011 and 2010 was as follows:

| | **As of December 31, 2011** | **As of December 31, 2010** |
|---|---|---|
| Amortized intangible assets | | |
| Software | 389 | 391 |
| Licenses and other assets | 343 | 409 |
| Goodwill | 612 | 646 |
| **Total goodwill and other intangible assets** | **1,344** | **1,446** |

During the year ended December 31, 2011, the Company recognized an impairment of goodwill related to the refining, marketing and distribution segment.

## Note 11. Short-term borrowings and current portion of long-term debt

| | **As of December 31, 2011** | **As of December 31, 2010** |
|---|---|---|
| Short-term borrowings from third parties | 118 | 728 |
| Short-term borrowings from related parties | 30 | 66 |
| Current portion of long-term debt | 1,644 | 1,331 |
| **Total short-term borrowings and current portion of long-term debt** | **1,792** | **2,125** |

**(Millions of US dollars, except as indicated)**

## Note 11. Short-term borrowings and current portion of long-term debt (continued)

Short-term borrowings from third parties are unsecured and include amounts repayable in US dollars of $56 million and $609 million, amounts repayable in Euros of $17 million and $29 million, amounts repayable in other currencies of $45 million and $90 million as of December 31, 2011 and 2010, respectively. The weighted-average interest rate on short-term borrowings from third parties was 4.93% and 1.87% per annum as of December 31, 2011 and 2010, respectively.

## Note 12. Long-term debt

| | As of December 31, 2011 | As of December 31, 2010 |
|---|---|---|
| Long-term loans and borrowings from third parties (including loans from banks in the amount of $1,120 million and $2,071 million as of December 31, 2011 and 2010, respectively) | 2,652 | 3,764 |
| 6.375% non-convertible US dollar bonds, maturing 2014 | 897 | 896 |
| 2.625% convertible US dollar bonds, maturing 2015 | 1,412 | 1,388 |
| 6.356% non-convertible US dollar bonds, maturing 2017 | 500 | 500 |
| 7.250% non-convertible US dollar bonds, maturing 2019 | 596 | 595 |
| 6.125% non-convertible US dollar bonds, maturing 2020 | 998 | 998 |
| 6.656% non-convertible US dollar bonds, maturing 2022 | 500 | 500 |
| 7.10% Russian ruble bonds, maturing 2011 | - | 262 |
| 13.35% Russian ruble bonds, maturing 2012 | 776 | 820 |
| 9.20% Russian ruble bonds, maturing 2012 | 311 | 328 |
| 7.40% Russian ruble bonds, maturing 2013 | 186 | 197 |
| Capital lease obligations | 116 | 152 |
| Total long-term debt | 8,944 | 10,400 |
| Current portion of long-term debt | (1,644) | (1,331) |
| **Total non-current portion of long-term debt** | **7,300** | **9,069** |

### *Long-term loans and borrowings*

Long-term loans and borrowings from third parties include amounts repayable in US dollars of $834 million and $1,707 million, amounts repayable in Euros of $284 million and $369 million, amounts repayable in Russian rubles of $1,514 million and $1,667 million, and amounts repayable in other currencies of $20 million and $21 million as of December 31, 2011 and 2010, respectively. This debt has maturity dates from 2012 through 2038. The weighted-average interest rate on long-term loans and borrowings from third parties was 5.39% and 4.50% per annum as of December 31, 2011 and 2010, respectively. A number of long-term loan agreements contain certain financial covenants which are being met by the Group. Approximately 10% of total long-term loans and borrowings from third parties are secured by export sales and property, plant and equipment.

A Group company has an unsecured syndicated loan agreement with an outstanding amount of $315 million as of December 31, 2011, with maturity dates up to 2013. The loan was arranged by ABN AMRO Bank, Banco Bilbao Vizcaya Argentaria, BNP Paribas, The Bank of Tokyo-Mitsubishi UFJ, ING Bank, Mizuho Corporate Bank and WestLB. Borrowings under this agreement bear interest from three month LIBOR plus 0.85% to three month LIBOR plus 0.95% per annum.

The Company has an unsecured syndicated loan agreement with the European Bank for Reconstruction and Development with an outstanding amount of $173 million as of December 31, 2011, maturing up to 2017. Borrowings under this agreement bear interest from six month LIBOR plus 0.45% to six month LIBOR plus 0.65% per annum.

## Note 12. Long-term debt (continued)

A Group company has a secured loan agreement, arranged by Credit Suisse, supported by an Overseas Private Investment Corporation guarantee, with an outstanding amount of $136 million as of December 31, 2011. Borrowings under this agreement bear interest at six month LIBOR plus 4.8% per annum and have maturity dates up to 2015.

A Group company has an unsecured loan agreement with Citibank with an outstanding amount of $102 million as of December 31, 2011, maturing up to 2019. Borrowings under this agreement bear interest at euribor plus 0.125% per annum.

Group companies have a number of loan agreements denominated in Russian rubles with ConocoPhillips, the Group’s former related party, with an outstanding amount of $1,508 million as of December 31, 2011. This amount includes $1,335 million loaned by ConocoPhillips to NMNG (refer to Note 17. Consolidation of Variable Interest Entity). Borrowings under these agreements bear interest at fixed rates ranging from 6.8% to 8.0% per annum and have maturity dates up to 2038. Financing under these agreements is used to develop oil production and distribution infrastructure in the Timan-Pechora region of the Russian Federation.

As of December 31, 2011, the Group has a number of other loan agreements with fixed rates with a number of banks and other organizations totaling $78 million, maturing from 2012 to 2017. The weighted average interest rate under these loans was 4.17% per annum.

As of December 31, 2011, the Group has a number of other floating rate loan agreements with a number of banks and other organizations totaling $340 million, maturing from 2012 to 2018. The weighted average interest rate under these loans was 1.78% per annum.

***US dollar convertible bonds***

In December 2010, a Group company issued unsecured convertible bonds totaling $1.5 billion with a coupon yield of 2.625% and maturity in June 2015. The bonds were placed at face value. The bonds are convertible into LUKOIL ADRs (each representing one ordinary share of the Company) and have a conversion price of $73.3912 per ADR. Bondholders have the right to convert the bonds into LUKOIL ADRs during the period starting from 40 days after the issue date and ending 6 dealing days before the maturity date. The issuer has the right to redeem the bonds after December 31, 2013.

***US dollar non-convertible bonds***

In November 2010, a Group company issued two tranches of non-convertible bonds totaling $1.0 billion with a coupon yield of 6.125% and maturity in 2020. The first tranche totaling $800 million was placed at a price of 99.081% of the bond’s face value with a resulting yield to maturity of 6.250%. The second tranche totaling $200 million was placed at a price of 102.44% of the bond’s face value with a resulting yield to maturity of 5.80%. These tranches have a half year coupon period.

In November 2009, a Group company issued two tranches of non-convertible bonds totaling $1.5 billion. The first tranche totaling $900 million with a coupon yield of 6.375% per annum was placed with a maturity of 5 years at a price of 99.474% of the bond’s face value with a resulting yield to maturity of 6.500%. The second tranche totaling $600 million with a coupon yield of 7.250% per annum was placed with a maturity of 10 years at a price of 99.127% of the bond’s face value with a resulting yield to maturity of 7.375%. These tranches have a half year coupon period.

In June 2007, a Group company issued non-convertible bonds totaling $1 billion. $500 million were placed with a maturity of 10 years and a coupon yield of 6.356% per annum. Another $500 million were placed with a maturity of 15 years and a coupon yield of 6.656% per annum. All bonds were placed at their face value and have a half year coupon period.

## Note 12. Long-term debt (continued)

### *Russian ruble bonds*

In December 2009, the Company issued 10 million stock exchange bonds with a face value of 1,000 Russian rubles each. The bonds were placed at face value with a maturity of 1,092 days. The bonds have a 182 days' coupon period and bear interest at 9.20% per annum.

In August 2009, the Company issued 25 million stock exchange bonds with a face value of 1,000 Russian rubles each. The bonds were placed at face value with a maturity of 1,092 days. The bonds have a 182 days' coupon period and bear interest at 13.35% per annum.

In December 2006, the Company issued 14 million non-convertible bonds with a face value of 1,000 Russian rubles each. Eight million bonds were placed with a maturity of 5 years and a coupon yield of 7.10% per annum and six million bonds were placed with a maturity of 7 years and a coupon yield of 7.40% per annum. All bonds were placed at their face value and have a half year coupon period. In December 2011, the Company redeemed all issued bonds with a maturity of five years in accordance with the conditions of bond issue.

### *Maturities of long-term debt*

Annual maturities of total long-term debt during the next five years, including the portion classified as current, are $1,644 million in 2012, $512 million in 2013, $1,092 million in 2014, $1,551 million in 2015, $95 million in 2016 and $4,050 million thereafter.

## Note 13. Taxes

The Group is taxable in a number of jurisdictions within and outside of the Russian Federation and, as a result, is subject to a variety of taxes as established under the statutory provisions of each jurisdiction.

The total cost of taxation to the Group is reported in the consolidated statement of income as "Total income tax expense" for income taxes, as "Excise and export tariffs" for excise taxes, export tariffs and petroleum products sales taxes and as "Taxes other than income taxes" for other types of taxation. In each category taxation is made up of taxes levied at various rates in different jurisdictions.

Starting on January 1, 2009, operations in the Russian Federation are subject to a Federal income tax rate of 2.0% and a regional income tax rate that varies from 13.5% to 18.0% at the discretion of the individual regional administration. The Group's foreign operations are subject to taxes at the tax rates applicable to the jurisdictions in which they operate.

As of January 1, 2011 and 2010, and during 2011, 2010 and 2009, the Group did not have any unrecognized tax benefits and thus, no interest and penalties related to unrecognized tax benefits were accrued. The Group's policy is to record interest and penalties related to unrecognized tax benefits as components of income tax expense. In addition, the Group does not expect that the amount of unrecognized tax benefits will change significantly within the next 12 months.

The Company and its Russian subsidiaries file standalone income tax returns in Russia. With a few exceptions, income tax returns in Russia are open to examination by the Russian tax authorities for tax years beginning in 2009.

Until January 1, 2012, there were no provisions in the tax legislation of the Russian Federation to permit the Group to reduce taxable profits of a Group company by offsetting tax losses of another Group company against such profits. Tax losses may be fully or partially used to offset taxable profits in the same company in any of the ten years following the year of loss.

Starting from January 1, 2012, if certain conditions are met, taxpayers will be able to pay income tax as a consolidated taxpayers' group ("CTG"). This allows taxpayers to offset taxable losses generated by certain participants of a CTG against taxable profits of other participants of the CTG. During 2012, certain Group companies are going to meet the legislative requirements and pay income tax as a CTG.

**(Millions of US dollars, except as indicated)**

## Note 13. Taxes (continued)

Losses generated by a taxpayer before joining a CTG are not available for offset against taxable profits of other participants of the CTG. However, if a taxpayer leaves a CTG, such losses again become available for offset against future profits generated by the same taxpayer. The expiration period of the losses is extended to take account of any time spent within a CTG when the losses were unavailable for use.

Domestic and foreign components of income before income taxes were:

| | Year ended December 31, 2011 | Year ended December 31, 2010 | Year ended December 31, 2009 |
|---|---|---|---|
| Domestic | 12,561 | 10,569 | 9,013 |
| Foreign | 558 | 901 | 50 |
| **Income before income taxes** | **13,119** | **11,470** | **9,063** |

Domestic and foreign components of income taxes were:

| | Year ended December 31, 2011 | Year ended December 31, 2010 | Year ended December 31, 2009 |
|---|---|---|---|
| Current | | | |
| Domestic | 2,159 | 1,693 | 1,677 |
| Foreign | 519 | 411 | 245 |
| Current income tax expense | 2,678 | 2,104 | 1,922 |
| Deferred | | | |
| Domestic | 581 | 299 | 98 |
| Foreign | 34 | (52) | (26) |
| Deferred income tax expense | 615 | 247 | 72 |
| **Total income tax expense** | **3,293** | **2,351** | **1,994** |

The following table is a reconciliation of the amount of income tax expense that would result from applying the Russian combined statutory income tax rate of 20% applicable to the Company to income before income taxes to total income taxes:

| | Year ended December 31, 2011 | Year ended December 31, 2010 | Year ended December 31, 2009 |
|---|---|---|---|
| Income before income taxes | 13,119 | 11,470 | 9,063 |
| Notional income tax at the Russian statutory rate | 2,624 | 2,294 | 1,813 |
| Increase (reduction) in income tax due to: | | | |
| Non-deductible items, net | 693 | 266 | 252 |
| Foreign rate differences | 169 | (4) | 68 |
| Domestic regional rate differences | (328) | (226) | (251) |
| Change in valuation allowance | 135 | 21 | 112 |
| **Total income tax expense** | **3,293** | **2,351** | **1,994** |

Taxes other than income taxes were:

| | Year ended December 31, 2011 | Year ended December 31, 2010 | Year ended December 31, 2009 |
|---|---|---|---|
| Mineral extraction tax | 11,594 | 7,864 | 5,452 |
| Social taxes and contributions | 587 | 429 | 399 |
| Property tax | 573 | 518 | 470 |
| Other taxes and contributions | 164 | 167 | 153 |
| **Taxes other than income taxes** | **12,918** | **8,978** | **6,474** |

**(Millions of US dollars, except as indicated)**

## Note 13. Taxes (continued)

Deferred income taxes are included in the consolidated balance sheets as follows:

| | As of December 31, 2011 | As of December 31, 2010 |
|---|---|---|
| Other current assets | 127 | 77 |
| Deferred income tax assets – non-current | 591 | 676 |
| Other current liabilities | (216) | (85) |
| Deferred income tax liabilities – non-current | (2,790) | (2,417) |
| **Net deferred income tax liability** | **(2,288)** | **(1,749)** |

The following tables set out the tax effects of each type of temporary differences which give rise to deferred income tax assets and liabilities:

| | As of December 31, 2011 | As of December 31, 2010 |
|---|---|---|
| Accounts receivable | 5 | 42 |
| Long-term liabilities | 398 | 387 |
| Inventories | 13 | 1 |
| Property, plant and equipment | 207 | 263 |
| Accounts payable | 5 | 14 |
| Operating loss carry forwards | 646 | 527 |
| Other | 229 | 161 |
| Total gross deferred income tax assets | 1,503 | 1,395 |
| Less valuation allowance | (553) | (418) |
| **Deferred income tax assets** | **950** | **977** |
| Property, plant and equipment | (2,870) | (2,513) |
| Accounts payable | (39) | (2) |
| Accounts receivable | (91) | (30) |
| Long-term liabilities | (38) | (61) |
| Inventories | (63) | (57) |
| Investments | (33) | (15) |
| Other | (104) | (48) |
| **Deferred income tax liabilities** | **(3,238)** | **(2,726)** |
| **Net deferred income tax liability** | **(2,288)** | **(1,749)** |

As a result of acquisitions during 2011 the Group recognized a net deferred tax liability of $34 million.

As of December 31, 2011, retained earnings of foreign subsidiaries included $17,398 million for which deferred taxation has not been provided because remittance of the earnings has been indefinitely postponed through reinvestment and, as a result, such amounts are considered to be indefinitely invested. It is not practicable to estimate the amount of additional taxes that might be payable on such undistributed earnings.

In accordance with Topic 830, *"Foreign currency matters"* of the Codification and Topic 740, "*Income Taxes*" of the Codification deferred tax assets and liabilities are not recognized for the changes in exchange rate effects resulting from the translation of transactions and balances from the Russian ruble to the US dollar using historical exchange rates. Also, in accordance with Topic 740 of the Codification, no deferred tax assets or liabilities are recognized for the effects of the related statutory indexation of property, plant and equipment.

Based upon the levels of historical taxable income and projections for future taxable income over the periods in which the deferred income tax assets are deductible, management believes it is more likely than not that Group companies will realize the benefits of the deductible temporary differences and loss carry forwards, net of existing valuation allowances as of December 31, 2011 and 2010.

**(Millions of US dollars, except as indicated)**

## Note 13. Taxes (continued)

As of December 31, 2011, the Group had operating loss carry forwards of $2,189 million of which $24 million expire during 2012, $124 million expire during 2013, $2 million expire during 2014, $3 million expire during 2015, $250 million expire during 2016, $22 million expire during 2017, $80 million expire during 2018, $3 million expire during 2019, $3 million expire during 2020, $682 million expire during 2021, $882 million expire during 2035 and $114 million have an indefinite carry forward.

## Note 14. Pension benefits

The Company sponsors a postretirement benefits program. The primary component of the post employment and post retirement benefits program is a defined benefit pension plan that covers the majority of the Group's employees. This plan is administered by a non-state pension fund, LUKOIL-GARANT, and provides pension benefits primarily based on years of service and final remuneration levels. The Company also provides several long-term employee benefits such as a death-in-service benefit and lump-sum payments upon retirement of a defined benefit nature and other defined benefits to certain old age and disabled pensioners who have not vested any pensions under the pension plan.

The Company's pension plan primarily consists of a defined benefit plan enabling employees to contribute a portion of their salary to the plan and at retirement to receive a lump sum amount from the Company equal to all past contributions made by the employee (up to 2% of annual salary up to October 1, 2010 and up to 4% of annual salary in further periods). Employees also have the right to receive upon retirement the benefits accumulated under the previous pension plan that was replaced in December 2003. These benefits have been fixed and included in the benefit obligation as of December 31, 2011 and 2010. The amount was determined primarily based on a formula including past pensionable service and relative salaries as of December 31, 2003.

The Company uses December 31 as the measurement date for its post employment and post retirement benefits program. An independent actuary has assessed the benefit obligations as of December 31, 2011 and 2010.

The following table provides information about the benefit obligations and plan assets as of December 31, 2011 and 2010. The benefit obligations below represent the projected benefit obligation of the pension plan.

| | **2011** | **2010** |
|---|---|---|
| **Benefit obligations** | | |
| Benefit obligations as of January 1 | 296 | 291 |
| Effect of exchange rate changes | (14) | (2) |
| Service cost | 15 | 16 |
| Interest cost | 22 | 23 |
| Plan amendments | (4) | 6 |
| Actuarial loss | - | 2 |
| Acquisitions | - | 3 |
| Benefits paid | (52) | (40) |
| Curtailment gain | (3) | (3) |
| **Benefit obligations as of December 31** | **260** | **296** |

**(Millions of US dollars, except as indicated)**

## Note 14. Pension benefits (continued)

| | 2011 | 2010 |
|---|---|---|
| **Plan assets** | | |
| Fair value of plan assets as of January 1 | 112 | 108 |
| Effect of exchange rate changes | (6) | (1) |
| Return on plan assets | 2 | 6 |
| Employer contributions | 49 | 39 |
| Benefits paid | (52) | (40) |
| **Fair value of plan assets as of December 31** | **105** | **112** |
| Funded status | (155) | (184) |
| **Amounts recognized in the consolidated balance sheet as of December 31, 2011 and 2010** | | |
| Accrued benefit liabilities included in “Other long-term liabilities” | (128) | (144) |
| Accrued benefit liabilities included in “Other current liabilities” | (27) | (40) |

Weighted average assumptions used to determine benefit obligations as of December 31, 2011 and 2010:

| | 2011 | 2010 |
|---|---|---|
| Discount rate | 7.80% | 7.80% |
| Rate of compensation increase | 7.30% | 7.70% |

Weighted average assumptions used to determine net periodic benefit costs for the year ended December 31, 2011 and 2010:

| | 2011 | 2010 |
|---|---|---|
| Discount rate | 7.80% | 8.70% |
| Rate of compensation increase | 7.70% | 8.10% |
| Expected rate of return on plan assets | 8.95% | 10.07% |

Included in accumulated other comprehensive loss as of December 31, 2011 and 2010, are the following before-tax amounts that have not yet been recognized in net periodic benefit cost:

| | 2011 | 2010 |
|---|---|---|
| Unamortized prior service cost | 61 | 84 |
| Unrecognized actuarial gain | 4 | (6) |
| **Total costs** | **65** | **78** |

Amounts recognized in other comprehensive loss during the year ended December 31, 2011 and 2010:

| | 2011 | 2010 |
|---|---|---|
| Additional loss arising during the period | 9 | 4 |
| Additional prior service cost from plan amendment | (4) | 6 |
| Re-classified prior service cost amortization | (18) | (18) |
| **Net amount recognized for the period** | **(13)** | **(8)** |

The real returns on bonds and equities are based on what is observed in the international markets over extended periods of time. In the calculation of the expected return on assets no use is made of the historical returns LUKOIL-GARANT has achieved.

In addition to the plan assets, LUKOIL-GARANT holds assets in the form of an insurance reserve. The purpose of this insurance reserve is to satisfy pension obligations should the plan assets not be sufficient to meet pension obligations. The Group’s contributions to the pension plan are determined without considering the assets in the insurance reserve.

**(Millions of US dollars, except as indicated)**

## Note 14. Pension benefits (continued)

The plans are funded on a discretionary basis through a solidarity account, which is held in trust with LUKOIL-GARANT. LUKOIL-GARANT does not allocate separately identifiable assets to the Group or its other third party clients. All funds of plan assets and other individual pension accounts are managed as a pool of investments.

The asset allocation of the investment portfolio maintained by LUKOIL-GARANT for the Group and its clients was as follows:

| Type of assets | As of December 31, 2011 | As of December 31, 2010 |
|---|---|---|
| Eurobonds | 4% | - |
| Russian corporate bonds | 28% | 37% |
| Russian municipal bonds | - | 2% |
| Bank deposits | 44% | 41% |
| Equity securities of Russian issuers | 6% | 5% |
| Shares of OAO LUKOIL | 2% | 1% |
| Shares in investment funds | 13% | 13% |
| Other assets | 3% | 1% |
| | 100% | 100% |

The investment strategy employed by LUKOIL-GARANT includes an overall goal to attain a maximum investment return, while guaranteeing the principal amount invested. The strategy is to invest with a medium-term perspective while maintaining a level of liquidity through proper allocation of investment assets. Investment policies include rules and limitations to avoid concentrations of investments.

The investment portfolio is primarily comprised of investments: bank deposits, securities with fixed yield and equity securities. The securities with fixed yield include mainly high yield corporate bonds with low and medium risk ratings. Maturities range from one to three years.

Components of net periodic benefit cost were as follows:

| | Year ended December 31, 2011 | Year ended December 31, 2010 | Year ended December 31, 2009 |
|---|---|---|---|
| Service cost | 15 | 16 | 17 |
| Interest cost | 22 | 23 | 23 |
| Less expected return on plan assets | (10) | (11) | (10) |
| Amortization of prior service cost | 17 | 18 | 2 |
| Curtailment gain | (2) | (3) | (11) |
| **Total net periodic benefit cost** | **42** | **43** | **21** |

Total employer contributions for 2012 are expected to be $38 million. An amount of $13 million before-tax is included in other comprehensive income and expected to be recognized in the net periodic benefit cost in 2012.

The following benefit payments, which reflect expected future services, as appropriate, are expected to be paid:

| | 2012 | 2013 | 2014 | 2015 | 2016 | 5-year period 2012-2016 | 5-year period 2017-2021 |
|---|---|---|---|---|---|---|---|
| Pension benefits | 56 | 13 | 14 | 15 | 13 | 111 | 53 |
| Other long-term employee benefits | 26 | 14 | 14 | 14 | 14 | 82 | 62 |
| **Total expected benefits to be paid** | **82** | **27** | **28** | **29** | **27** | **193** | **115** |

## Note 15. Stockholders' equity

### *Common stock*

| | As of December 31, 2011 (thousands of shares) | As of December 31, 2010 (thousands of shares) |
|---|---|---|
| Authorized and issued common stock, par value of 0.025 Russian rubles each | 850,563 | 850,563 |
| Treasury stock | (76,101) | (69,208) |
| Outstanding common stock | **774,462** | **781,355** |

### *Dividends and dividend limitations*

Profits available for distribution to common stockholders in respect of any reporting period are determined by reference to the statutory financial statements of the Company prepared in accordance with the laws of the Russian Federation and denominated in Russian rubles. Under Russian Law, dividends are limited to the net profits of the reporting year as set out in the statutory financial statements of the Company. These laws and other legislative acts governing the rights of shareholders to receive dividends are subject to various interpretations.

The Company's net profits were 139,853 million Russian rubles, 45,148 million Russian rubles and 66,926 million Russian rubles respectively for 2010, 2009 and 2008, pursuant to the statutory financial statements, which at the US dollar exchange rates as of December 31, 2010, 2009 and 2008, amounted to $4,589 million, $1,493 million and $2,278 million, respectively.

At the annual stockholders' meeting on June 23, 2011, dividends were declared for 2010 in the amount of 59.00 Russian rubles per common share, which at the date of the meeting was equivalent to $2.11. Dividends payable of $10 million and $13 million are included in "Other current liabilities" in the consolidated balance sheets as of December 31, 2011 and 2010, respectively.

At the annual stockholders' meeting on June 24, 2010, dividends were declared for 2009 in the amount of 52.00 Russian rubles per common share, which at the date of the meeting was equivalent to $1.68.

At the annual stockholders' meeting on June 25, 2009, dividends were declared for 2008 in the amount of 50.00 Russian rubles per common share, which at the date of the meeting was equivalent to $1.61.

### *Earnings per share*

The calculation of diluted earnings per share for these years was as follows:

| | Year ended December 31, 2011 | Year ended December 31, 2010 | Year ended December 31, 2009 |
|---|---|---|---|
| Net income | 10,357 | 9,006 | 7,011 |
| Add back interest and accretion on 2.625% convertible US dollar bonds, maturing 2015 (net of tax at effective rate) | 63 | 3 | - |
| Total diluted net income | 10,420 | 9,009 | 7,011 |
| Weighted average number of outstanding common shares (thousands of shares) | 778,964 | 822,359 | 846,645 |
| Add back treasury shares held in respect of convertible debt (thousands of shares) | 20,383 | 892 | - |
| Weighted average number of outstanding common shares, after dilution (thousands of shares) | 799,347 | 823,251 | 846,645 |
| Earnings per share of common stock attributable to OAO LUKOIL (US dollars): | | | |
| Basic | 13.30 | 10.95 | 8.28 |
| Diluted | 13.04 | 10.94 | 8.28 |

**(Millions of US dollars, except as indicated)**

## Note 16. Financial and derivative instruments

### *Fair value*

The fair values of cash and cash equivalents, current accounts receivable, long-term receivables and liquid securities are approximately equal to their value as disclosed in the consolidated financial statements. The fair value of long-term receivables was determined by discounting with estimated market interest rates for similar financing arrangements.

The fair value of long-term debt differs from the amount disclosed in the consolidated financial statements. The estimated fair value of long-term debt as of December 31, 2011 and 2010 was $8,666 million and $10,225 million, respectively, as a result of discounting using estimated market interest rates for similar financing arrangements. These amounts include all future cash outflows associated with the long-term debt repayments, including the current portion and interest. Market interest rates mean the rates of raising long-term debt by companies with a similar credit rating for similar tenors, repayment schedules and similar other main terms. During the year ended December 31, 2011, the Group did not have significant transactions or events that would result in nonfinancial assets and liabilities measured at fair value on a nonrecurring basis.

### *Derivative instruments*

The Group uses financial and commodity-based derivative contracts to manage exposures to fluctuations in foreign currency exchange rates, commodity prices, or to exploit market opportunities. Since the Group is not currently using hedge accounting, defined by Topic 815, *"Derivative and hedging,"* of the Codification, all gains and losses, realized or unrealized, from derivative contracts have been recognized in the consolidated income statement.

Topic 815 of the Codification requires purchase and sales contracts for commodities that are readily convertible to cash (e.g., crude oil, natural gas and gasoline) to be recorded on the balance sheet as derivatives unless the contracts are for quantities the Group expects to use or sell over a reasonable period in the normal course of business (i.e., contracts eligible for the normal purchases and normal sales exception). The Group does apply the normal purchases and normal sales exception to certain long-term contracts to sell oil products. This normal purchases and normal sales exception is applied to eligible crude oil and refined product commodity purchase and sales contracts; however, the Group may elect not to apply this exception (e.g., when another derivative instrument will be used to mitigate the risk of the purchase or sale contract but hedge accounting will not be applied, in which case both the purchase or sales contract and the derivative contract mitigating the resulting risk will be recorded on the balance sheet at fair value).

The fair value hierarchy for the Group's derivative assets and liabilities accounted for at fair value on a recurring basis was:

| | **As of December 31, 2011** | | | | **As of December 31, 2010** | | | |
|---|---|---|---|---|---|---|---|---|
| | **Level 1** | **Level 2** | **Level 3** | **Total** | **Level 1** | **Level 2** | **Level 3** | **Total** |
| Assets | | | | | | | | |
| Commodity derivatives | - | 575 | - | **575** | - | 226 | - | **226** |
| **Total assets** | - | **575** | - | 575 | - | **226** | - | 226 |
| Liabilities | | | | | | | | |
| Commodity derivatives | - | (599) | - | **(599)** | - | (264) | - | **(264)** |
| **Total liabilities** | **-** | **(599)** | - | **(599)** | **-** | **(264)** | - | **(264)** |
| **Net liabilities** | **-** | **(24)** | - | **(24)** | **-** | **(38)** | - | **(38)** |

The derivative values above are based on an analysis of each contract as the fundamental unit of account as required by Topic 820, *"Fair Value Measurements and Disclosures,"* of the Codification; therefore, derivative assets and liabilities with the same counterparty are not reflected net where the legal right of offset exists. Gains or losses from contracts in one level may be offset by gains or losses on contracts in another level or by changes in values of physical contracts or positions that are not reflected in the table above.

**(Millions of US dollars, except as indicated)**

## Note 16. Financial and derivative instruments (continued)

### *Commodity derivative contracts*

The Group operates in the worldwide crude oil, refined product, natural gas and natural gas liquids markets and is exposed to fluctuations in the prices for these commodities. These fluctuations can affect the Group's revenues as well as the cost of operating, investing and financing activities. Generally, the Group's policy is to remain exposed to the market prices of commodities. However, the Group uses futures, forwards, swaps and options in various markets to balance physical systems, meet customer needs, manage price exposures on specific transactions, and do a limited, immaterial amount of trading not directly related to the Group's physical business. These activities may move the Group's profile away from market average prices.

The fair value of commodity derivative assets and liabilities as of December 31, 2011 was:

| | As of December 31, 2011 |
|---|---|
| **Assets** | |
| Accounts receivable | 575 |
| **Liabilities** | |
| Accounts payable | (599) |

Hedge accounting has not been used for items in the table.

As required under Topic 815 of the Codification the amounts shown in the preceding table are presented gross (i.e., without netting assets and liabilities with the same counterparty where the right of offset and intent to net exist). Derivative assets and liabilities resulting from eligible commodity contracts have been netted in the consolidated balance sheet and are recorded as accounts receivable in the amount of $39 million and accounts payable in the amount of $63 million.

Financial results from commodity derivatives were included in the consolidated income statements in "Cost of purchased crude oil, gas and products". Realized losses were $667 million and unrealized gains were $10 million for the year ended December 31, 2011 and realized losses were $235 million and unrealized gains were $3 million for the year ended December 31, 2010.

As of December 31, 2011, the net position of outstanding commodity derivative contracts, primarily to manage price exposure on underlying operations, was not significant.

### *Currency exchange rate derivative contracts*

The Group has foreign currency exchange rate risk resulting from its international operations. The Group does not comprehensively hedge the exposure to currency rate changes, although the Group selectively hedges certain foreign currency exchange rate exposures, such as firm commitments for capital projects or local currency tax payments and dividends.

The fair value of foreign currency derivatives assets and liabilities open at December 31, 2011 was not significant.

The impact from foreign currency derivatives during the year ended December 31, 2011 on the consolidated income statement was not significant. The net position of outstanding foreign currency swap contracts as of December 31, 2011 also was not significant.

### *Credit risk*

The Group's financial instruments that are potentially exposed to concentrations of credit risk consist primarily of cash equivalents, over-the-counter derivative contracts and trade receivables. Cash equivalents are placed in high-quality commercial paper, money market funds and time deposits with major international banks and financial institutions.

**Note 16. Financial and derivative** instruments **(continued)**

The credit risk from the Group's over-the-counter derivative contracts, such as forwards and swaps, derives from the counterparty to the transaction, typically a major bank or financial institution. Individual counterparty exposure is managed within predetermined credit limits and includes the use of cash-call margins when appropriate, thereby reducing the risk of significant non-performance. The Group also uses futures contracts, but futures have a negligible credit risk because they are traded on the New York Mercantile Exchange or the ICE Futures.

Certain of the Group's derivative instruments contain provisions that require the Group to post collateral if the derivative exposure exceeds a threshold amount. The Group has contracts with fixed threshold amounts and other contracts with variable threshold amounts that are contingent on the Group's credit rating. The variable threshold amounts typically decline for lower credit ratings, while both the variable and fixed threshold amounts typically revert to zero if the Group falls below investment grade. Cash is the primary collateral in all contracts; however, many contracts also permit the Group to post letters of credit as collateral.

There were no derivative instruments with such credit-risk-related contingent features that were in a liability position on December 31, 2011. The Group posted $35 million in collateral in the normal course of business for the over-the-counter derivatives. If the Group's credit rating were lowered one level from its "BBB-" rating (per Standard and Poors) on December 31, 2011, and it would be below investment grade, the Group would be required to post additional collateral of $5 million to the Group's counterparties for the over-the-counter derivatives, either with cash or letters of credit. The maximum additional collateral based on the lowest downgrade would be $14 million in total.

**Note 17. Consolidation of Variable Interest Entity**

The Group and ConocoPhillips have a joint venture NMNG which develops oil reserves in the Timan-Pechora region of the Russian Federation. The Group and ConocoPhillips have equal voting rights over the joint venture's activity and effective ownership interests of 70% and 30%, respectively.

The Group originally determined that NMNG is a variable interest entity ("VIE") as the Group's voting rights are not proportionate to its ownership rights and all of NMNG's activities are conducted on behalf of the Group and ConocoPhillips, its former related party. Based on the requirements of Topic 810, *"Consolidation,"* of the Codification, the Group performs a regular qualitative analysis as to whether it is the primary beneficiary of this VIE. As a result the Group is still considered to be the primary beneficiary of NMNG and consolidated it.

NMNG's total assets were approximately $3.3 billion and $5.5 billion as of December 31, 2011 and 2010, respectively.

**Note 18. Commitments and contingencies**

***Capital expenditure, exploration and investment programs***

Under the terms of existing exploration and production license agreements in Russia the Group has to fulfill certain obligations: oil and gas exploration, wells drilling, fields development, etc., and the Group also has commitments to reach a defined level of extraction on the fields. Management believes that the Group's approved annual capital expenditure budgets fully cover all the requirements of the described license obligations.

Group companies have commitments for capital expenditure contributions in the amount of $406 million related to various production sharing agreements over the next 26 years.

**(Millions of US dollars, except as indicated)**

**Note 18. Commitments and contingencies (continued)**

The Company signed a three-year agreement for the years 2010-2012 for drilling services with OOO Eurasia Drilling Company. The volume of these services is based on the Group's capital construction program, which is re-evaluated on an annual basis. The Group estimates the amount of capital commitment under this agreement for 2012 to be approximately $1,521 million.

The Company signed a strategic agreement for the ongoing provision of construction, engineering and technical services with ZAO Globalstroy-Engineering. The volume of these services is based on the Group's capital construction program, which is re-evaluated on an annual basis. The Group estimates the amount of capital commitment under this agreement for 2012 to be approximately $225 million.

The Group signed a number of agreements for the years 2012-2015 for construction of offshore platforms in the Caspian region. The Group estimates the amount of this capital commitment to be approximately $866 million.

The Group has a commitment to execute the capital construction program of its power generation segment and under the terms of this program power plants with a total capacity of 890 MW should be constructed. Currently the Group is approving certain amendments to the capital construction program, including its extension to the end of 2014. As of December 31, 2011, the Group estimates the amount of this commitment to be approximately $594 million.

***Operating lease obligations***

Group companies have commitments of $507 million primarily for the lease of vessels and petroleum distribution outlets. Operating lease expenses were $175 million and $155 million during the years ended December 31, 2011 and 2010, respectively. Commitments for minimum rentals under these leases as of December 31, 2011 are as follows:

| | As of December 31, 2011 |
|---|---|
| 2012 | 145 |
| 2013 | 83 |
| 2014 | 74 |
| 2015 | 46 |
| 2016 | 54 |
| beyond | 105 |

***Insurance***

The insurance industry in the Russian Federation and certain other areas where the Group has operations is in the course of development. Management believes that the Group has adequate property damage coverage for its main production assets. In respect of third party liability for property and environmental damage arising from accidents on Group property or relating to Group operations, the Group has insurance coverage that is generally higher than insurance limits set by the local legal requirements. Management believes that the Group has adequate insurance coverage of the risks, which could have a material effect on the Group's operations and financial position.

***Environmental liabilities***

Group companies and their predecessor entities have operated in the Russian Federation and other countries for many years and, within certain parts of the operations, environmental related problems have developed. Environmental regulations are currently under consideration in the Russian Federation and other areas where the Group has operations. Group companies routinely assess and evaluate their obligations in response to new and changing legislation.

**Note 18. Commitments and contingencies (continued)**

As liabilities in respect of the Group's environmental obligations are able to be determined, they are charged against income. The likelihood and amount of liabilities relating to environmental obligations under proposed or any future legislation cannot be reasonably estimated at present and could become material. Under existing legislation, however, management believes that there are no significant unrecorded liabilities or contingencies, which could have a materially adverse effect on the operating results or financial position of the Group.

***Social assets***

Certain Group companies contribute to Government sponsored programs, the maintenance of local infrastructure and the welfare of their employees within the Russian Federation and elsewhere. Such contributions include assistance with the construction, development and maintenance of housing, hospitals and transport services, recreation and other social needs. The funding of such assistance is periodically determined by management and is appropriately capitalized or expensed as incurred.

***Taxation environment***

The taxation systems in the Russian Federation and other emerging markets where Group companies operate are relatively new and are characterized by numerous taxes and frequently changing legislation, which is often unclear, contradictory, and subject to interpretation. Often, differing interpretations exist among different tax authorities within the same jurisdictions and among taxing authorities in different jurisdictions. Taxes are subject to review and investigation by a number of authorities, which are enabled by law to impose severe fines, penalties and interest charges. In the Russian Federation a tax year remains open for review by the tax authorities during the three subsequent calendar years; however, under certain circumstances a tax year may remain open longer. Recent events within the Russian Federation suggest that the tax authorities are taking a more assertive position in their interpretation and enforcement of tax legislation. Such factors may create taxation risks in the Russian Federation and other emerging markets where Group companies operate substantially more significant than those in other countries where taxation regimes have been subject to development and clarification over long periods.

The tax authorities in each region may have a different interpretation of similar taxation issues which may result in taxation issues successfully defended by the Group in one region being unsuccessful in another region. There is some direction provided from the central authority based in Moscow on particular taxation issues.

The Group has implemented tax planning and management strategies based on existing legislation at the time of implementation. The Group is subject to tax authority audits on an ongoing basis, as is normal in the Russian environment and other republics of the former Soviet Union, and, at times, the authorities have attempted to impose additional significant taxes on the Group. Management believes that it has adequately met and provided for tax liabilities based on its interpretation of existing tax legislation. However, the relevant tax authorities may have differing interpretations and the effects on the financial statements, if the authorities were successful in enforcing their interpretations, could be significant.

***Litigation and claims***

On November 27, 2001, Archangel Diamond Corporation ("ADC"), a Canadian diamond development company, filed a lawsuit in the Denver District Court, Colorado against OAO Arkhangelskgeoldobycha ("AGD"), a Group company, and the Company (together the "Defendants"). ADC alleged that the Defendants interfered with the transfer of a diamond exploration license to Almazny Bereg, a joint venture between ADC and AGD. ADC claimed compensatory damages of $1.2 billion and punitive damages of $3.6 billion. On October 15, 2002, the District Court dismissed the lawsuit for lack of personal jurisdiction. This ruling was upheld by the Colorado Court of Appeals on March 25, 2004. On November 21, 2005, the Colorado Supreme Court affirmed the lower courts' ruling that no specific jurisdiction exists over the Defendants.

## Note 18. Commitments and contingencies (continued)

By virtue of this finding, AGD (the holder of the diamond exploration license) was dismissed from the lawsuit. The Colorado Supreme Court found, however, that the trial court made a procedural error by failing to hold an evidentiary hearing before making its ruling concerning general jurisdiction regarding the Company and remanded the case to the Colorado Court of Appeals to consider whether the lawsuit should have been dismissed on alternative grounds (i.e., forum non conveniens). The Colorado Court of Appeals declined to dismiss the case based on forum non conveniens and the case was remanded to the District Court. In June 2009, three creditors of ADC filed an Involuntary Bankruptcy Petition putting ADC into bankruptcy. In November 2009, after adding a claim, ADC removed the case from the District Court to the US Bankruptcy Court. On October 28, 2010, the Bankruptcy Court granted the Company's Motion for Remand and Abstention and remanded the case to the Denver District Court. On October 20, 2011, the Denver District Court dismissed all claims in the lawsuit against the Company. ADC has filed a notice of appeal. No briefing schedule has been established. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

On January 6, 2012, ADC filed a lawsuit in the US District Court for the District of Colorado (federal court) reasserting almost identical claims asserted in the aforementioned lawsuit and dismissed by the Denver District Court (state court) notwithstanding ADC's appeal of the state court's decision. The time within which the Company is required to respond has not expired. The Company plans to seek dismissal of the case and vigorously defend the matter. Management does not believe that the ultimate resolution of this matter will have a material adverse effect on the Group's financial condition.

As of the date the financial statements were available to be issued approximately 100 claims in relation to a violation of the anti-monopoly regulation were initiated against several Group companies in Russia and abroad. The Group companies were accused of violations primarily involving abuse of their dominant market position and execution of coordinated actions in oil products retail markets.

On February 9, 2011, the Federal Anti-monopoly Service of the Russian Federation ("FAS of Russia") filed a case against the three largest Russian oil companies, including the Company, accusing them of abuse of their dominant position in the oil products market. The decision accusing the Company in establishing monopolistically high prices on diesel fuel during the period October 2010 – December 2010 was issued on August 9, 2011. The case in establishing monopolistically high prices on jet fuel was separated into an individual proceeding and its hearing is scheduled for March 20, 2012. On December 28, 2011, FAS of Russia defined fines against the Company and the Group's refinery plants in the amount of $19 million. The decision was not contested and the fines were paid on February 17, 2012. The Group accrued a provision for this amount in the consolidated financial statements as of December 31, 2011.

The Group is involved in cost recovery disputes with the Republic of Kazakhstan. The Group's share of the claim is approximately $295 million. Management is of the view that substantially all of the amounts subject to dispute are in fact recoverable under the Final Production Sharing Agreement. Management believes that the ultimate resolution of the claim will not have a material adverse impact on the Group's operating results or financial condition.

The Group is involved in various other claims and legal proceedings arising in the normal course of business. While these claims may seek substantial damages against the Group and are subject to uncertainty inherent in any litigation, management does not believe that the ultimate resolution of such matters will have a material adverse impact on the Group's operating results or financial condition.

## Note 19. Related party transactions

In the rapidly developing business environment in the Russian Federation, companies and individuals have frequently used nominees and other forms of intermediary companies in transactions. The senior management of the Company believes that the Group has appropriate procedures in place to identify and properly disclose transactions with related parties in this environment and has disclosed all of the relationships identified which it deemed to be significant. Related party sales and purchases of oil and oil products were primarily to and from affiliated companies and the Company's shareholder ConocoPhillips. Related party processing services were provided by affiliated refineries. As a result of the purchase of the Company's shares by a Group company from ConocoPhillips in September 2010, ConocoPhillips ceased to be a related party of the Group by the end of the third quarter of 2010.

Below are related party transactions not disclosed elsewhere in the financial statements. Refer also to Notes 3, 7, 11, 14, 17 and 20 for other transactions with related parties.

Sales of oil and oil products to related parties were $1,298 million, $2,383 million and $1,152 million for the years ended December 31, 2011, 2010 and 2009, respectively.

Other sales to related parties were $54 million, $134 million and $69 million for the years ended December 31, 2011, 2010 and 2009, respectively.

Purchases of oil and oil products from related parties were $374 million, $521 million and $862 million for the years ended December 31, 2011, 2010 and 2009, respectively.

Purchases of processing services from related parties were $901 million, $719 million and $539 million for the years ended December 31, 2011, 2010 and 2009, respectively.

Other purchases from related parties were $73 million, $39 million and $28 million for the years ended December 31, 2011, 2010 and 2009, respectively.

Amounts receivable from related parties, including advances, were $415 million and $419 million as of December 31, 2011 and 2010, respectively. Amounts payable to related parties were $115 million and $114 million as of December 31, 2011 and 2010, respectively.

## Note 20. Compensation plan

Since December 2009, the Company has a compensation plan to certain members of management for the period from 2010 to 2012, which is based on assigned shares and provides compensation consisting of two parts. The first part represents annual bonuses that are based on the number of assigned shares and the amount of dividend per share. The payment of these bonuses is contingent on the Group meeting certain financial KPIs in each financial year. The second part is based upon the Company's common stock appreciation from 2010 to 2012, with rights vesting after the date of the compensation plan's termination. The number of assigned shares is approximately 17.3 million.

For the first part of the share plan the Group recognizes a liability based on expected dividends and the number of assigned shares.

The second part of the share plan is classified as equity settled. The grant date fair value of the plan was estimated at $295 million using the Black-Scholes-Merton option-pricing model, assuming a risk-free interest rate of 8.0% per annum, an expected dividend yield of 3.09% per annum, an expected term of three years and a volatility factor of 34.86%. The expected volatility factor was estimated based on the historical volatility of the Company's shares for the previous five year period up to January 2010.

As of December 31, 2011, there was $98 million of total unrecognized compensation cost related to unvested benefits. This cost is expected to be recognized periodically by the Group up to December 2012.

**(Millions of US dollars, except as indicated)**

## Note 20. Compensation plan (continued)

During the period from 2007 to 2009, the Company had a compensation plan available to certain members of management. Its conditions were similar to the conditions of the new compensation plan introduced in December 2009. The number of assigned shares was approximately 15.5 million shares. Because of an unfavorable market situation the conditions for exercising the second part of this share plan were not met and therefore no payments or share transfers to employees took place by the end of the compensation plan.

Related to these plans the Group recorded $137 million, $129 million and $105 million of compensation expenses during 2011, 2010 and 2009, respectively, of which $98 million, $98 million and $20 million, respectively, are recognized as an increase in additional paid-in capital. As of December 31, 2011 and 2010, $28 million and $33 million related to these plans are included in “Other current liabilities” of the consolidated balance sheets, respectively. The total recognized tax benefits related to these accruals were $20 million, $21 million and $21 million during the years ended December 31, 2011, 2010 and 2009.

## Note 21. Segment information

Presented below is information about the Group’s operating and geographical segments for the years ended December 31, 2011, 2010 and 2009, in accordance with Topic 280, “*Segment reporting,*” of the Codification.

The Group has the following operating segments – exploration and production; refining, marketing and distribution; chemicals; power generation and other business segments. These segments have been determined based on the nature of their operations. Management on a regular basis assesses the performance of these operating segments. The exploration and production segment explores for, develops and produces primarily crude oil. The refining, marketing and distribution segment processes crude oil into refined products and purchases, sells and transports crude oil and refined petroleum products. The chemicals segment refines and sells chemical products. The power generation segment produces steam and electricity, distributes them and provides related services. The activities of the other business operating segment include businesses beyond the Group’s traditional operations.

Geographical segments are based on the area of operations and include two segments: Russia and International. Geographical segments presentation has been changed starting from the three-month period ended March 31, 2011, due to a change in the Company’s management reporting system.

### Operating segments

| **2011** | **Exploration and production** | **Refining, marketing and distribution** | **Chemicals** | **Power generation** | **Other** | **Elimination** | **Consolidated** |
|---|---|---|---|---|---|---|---|
| Sales | | | | | | | |
| Third parties | 3,449 | 126,665 | 1,944 | 1,472 | 120 | - | 133,650 |
| Inter-segment | 41,409 | 1,884 | 500 | 1,520 | 2,467 | (47,780) | - |
| Total sales | 44,858 | 128,549 | 2,444 | 2,992 | 2,587 | (47,780) | 133,650 |
| Operating expenses | 4,347 | 3,975 | 459 | 2,098 | 2,029 | (3,853) | 9,055 |
| Depreciation, depletion and amortization | 2,865 | 1,248 | 63 | 224 | 129 | (56) | 4,473 |
| Interest expense | 732 | 709 | 20 | 47 | 505 | (1,319) | 694 |
| Income tax expense | 2,106 | 1,060 | 43 | (5) | 10 | 79 | 3,293 |
| Net income (net loss) | 6,665 | 3,687 | (27) | (127) | (370) | 529 | 10,357 |
| Total assets | 60,311 | 62,173 | 1,488 | 4,220 | 21,201 | (58,201) | 91,192 |
| Capital expenditures | 6,629 | 1,354 | 89 | 196 | 224 | - | 8,492 |

**(Millions of US dollars, except as indicated)**

## Note 21. Segment information (continued)

| **2010** | **Exploration and production** | **Refining, marketing and distribution** | **Chemicals** | **Power generation** | **Other** | **Elimination** | **Consolidated** |
|---|---|---|---|---|---|---|---|
| Sales | | | | | | | |
| Third parties | 3,012 | 99,064 | 1,331 | 1,416 | 133 | - | 104,956 |
| Inter-segment | 33,511 | 1,182 | 271 | 1,277 | 1,937 | (38,178) | - |
| Total sales | 36,523 | 100,246 | 1,602 | 2,693 | 2,070 | (38,178) | 104,956 |
| Operating expenses | 3,965 | 3,771 | 294 | 1,901 | 1,628 | (3,261) | 8,298 |
| Depreciation, depletion and amortization | 2,773 | 1,033 | 40 | 183 | 126 | (1) | 4,154 |
| Interest expense | 806 | 859 | 26 | 38 | 405 | (1,422) | 712 |
| Income tax expense | 1,449 | 874 | 37 | (14) | 4 | 1 | 2,351 |
| Net income (net loss) | 6,139 | 3,330 | 101 | (167) | (317) | (80) | 9,006 |
| Total assets | 57,280 | 56,908 | 1,249 | 4,338 | 15,390 | (51,148) | 84,017 |
| Capital expenditures | 4,908 | 1,320 | 76 | 420 | 120 | - | 6,844 |

| **2009** | **Exploration and production** | **Refining, marketing and distribution** | **Chemicals** | **Power generation** | **Other** | **Elimination** | **Consolidated** |
|---|---|---|---|---|---|---|---|
| Sales | | | | | | | |
| Third parties | 2,257 | 76,096 | 1,576 | 1,087 | 67 | - | 81,083 |
| Inter-segment | 22,096 | 955 | 162 | 1,065 | 725 | (25,003) | - |
| Total sales | 24,353 | 77,051 | 1,738 | 2,152 | 792 | (25,003) | 81,083 |
| Operating expenses | 3,266 | 3,472 | 515 | 1,475 | 452 | (1,840) | 7,340 |
| Depreciation, depletion and amortization | 2,612 | 936 | 41 | 198 | 150 | - | 3,937 |
| Interest expense | 886 | 1,205 | 14 | 52 | 381 | (1,871) | 667 |
| Income tax expense | 1,221 | 821 | 12 | (7) | 6 | (59) | 1,994 |
| Net income (net loss) | 5,456 | 2,268 | (74) | (162) | (147) | (330) | 7,011 |
| Total assets | 55,033 | 56,286 | 1,371 | 4,041 | 14,250 | (51,962) | 79,019 |
| Capital expenditures | 4,626 | 1,316 | 113 | 283 | 196 | - | 6,534 |

## Geographical segments

| | **2011** | **2010** | **2009** |
|---|---|---|---|
| Sales of crude oil within Russia | 1,571 | 956 | 735 |
| Export of crude oil and sales of crude oil by foreign subsidiaries | 32,522 | 26,342 | 19,914 |
| Sales of petroleum products within Russia | 15,242 | 10,928 | 8,101 |
| Export of petroleum products and sales of petroleum products by foreign subsidiaries | 76,335 | 60,018 | 46,888 |
| Sales of chemicals within Russia | 914 | 728 | 514 |
| Export of chemicals and sales of chemicals by foreign subsidiaries | 1,095 | 642 | 574 |
| Other sales within Russia | 3,213 | 2,881 | 2,235 |
| Other export sales and other sales by foreign subsidiaries | 2,758 | 2,461 | 2,122 |
| **Total sales** | **133,650** | **104,956** | **81,083** |

**(Millions of US dollars, except as indicated)**

## Note 21. Segment information (continued)

| **2011** | **Russia** | **International** | **Elimination** | **Consolidated** |
|---|---|---|---|---|
| Sales | | | | |
| Third parties | 24,674 | 108,976 | - | 133,650 |
| Inter-segment | 39,567 | 143 | (39,710) | - |
| Total sales | 64,241 | 109,119 | (39,710) | 133,650 |
| Operating expenses | 6,999 | 2,094 | (38) | 9,055 |
| Depletion, depreciation and amortization | 3,692 | 781 | - | 4,473 |
| Interest expense | 338 | 477 | (121) | 694 |
| Income taxes | 2,715 | 554 | 24 | 3,293 |
| Net income | 9,769 | 4 | 584 | 10,357 |
| Total assets | 73,150 | 34,384 | (16,342) | 91,192 |
| Capital expenditures | 6,516 | 1,976 | - | 8,492 |

| **2010** | **Russia** | **International** | **Elimination** | **Consolidated** |
|---|---|---|---|---|
| Sales | | | | |
| Third parties | 17,615 | 87,341 | - | 104,956 |
| Inter-segment | 34,599 | 37 | (34,636) | - |
| Total sales | 52,214 | 87,378 | (34,636) | 104,956 |
| Operating expenses | 6,334 | 2,005 | (41) | 8,298 |
| Depletion, depreciation and amortization | 3,393 | 761 | - | 4,154 |
| Interest expense | 415 | 427 | (130) | 712 |
| Income taxes | 1,993 | 359 | (1) | 2,351 |
| Net income | 8,542 | 542 | (78) | 9,006 |
| Total assets | 74,033 | 30,225 | (20,241) | 84,017 |
| Capital expenditures | 5,333 | 1,511 | - | 6,844 |

| **2009** | **Russia** | **International** | **Elimination** | **Consolidated** |
|---|---|---|---|---|
| Sales | | | | |
| Third parties | 13,880 | 67,203 | - | 81,083 |
| Inter-segment | 26,897 | 18 | (26,915) | - |
| Total sales | 40,777 | 67,221 | (26,915) | 81,083 |
| Operating expenses | 5,434 | 1,952 | (46) | 7,340 |
| Depletion, depreciation and amortization | 3,186 | 751 | - | 3,937 |
| Interest expense | 448 | 406 | (187) | 667 |
| Income taxes | 1,834 | 219 | (59) | 1,994 |
| Net income (net loss) | 7,511 | (168) | (332) | 7,011 |
| Total assets | 58,461 | 28,038 | (7,480) | 79,019 |
| Capital expenditures | 5,064 | 1,470 | - | 6,534 |

## Note 21. Segment information (continued)

The Group's international sales to third parties include sales in Switzerland of $66,884 million, $53,245 million and $37,724 million for the years ended December 31, 2011, 2010 and 2009, respectively. The Group's international sales to third parties include sales in the USA of $9,496 million, $8,595 million and $8,144 million for the years ended December 31, 2011, 2010 and 2009, respectively. These amounts are attributed to individual countries based on the jurisdiction of subsidiaries making the sale.

## Note 22. Subsequent events

In accordance with the requirements of Topic 855, "*Subsequent events,*" of the Codification, the Group evaluated subsequent events through the date the financial statements were available to be issued. Therefore subsequent events were evaluated by the Group up to February 24, 2012.

**(Millions of US dollars, except as indicated)**

This section provides unaudited supplemental information on oil and gas exploration and production activities in accordance with Topic 932, *"Disclosures About Oil and Gas Producing Activities,"* of the Codification in six separate tables:

I. Capitalized costs relating to oil and gas producing activities
II. Costs incurred in oil and gas property acquisition, exploration, and development activities
III. Results of operations for oil and gas producing activities
IV. Reserve quantity information
V. Standardized measure of discounted future net cash flows
VI. Principal sources of changes in the standardized measure of discounted future net cash flows

Amounts shown for equity companies represent the Group's share in its exploration and production affiliates, which are accounted for using the equity method of accounting.

### *I. Capitalized costs relating to oil and gas producing activities*

| **As of December 31, 2011** | **International** | **Russia** | **Total consolidated companies** | **Group's share in equity companies** |
|---|---|---|---|---|
| Unproved oil and gas properties | 659 | 583 | 1,242 | 166 |
| Proved oil and gas properties | 7,479 | 52,939 | 60,418 | 2,315 |
| Accumulated depreciation, depletion, and amortization | (1,762) | (19,527) | (21,289) | (718) |
| Net capitalized costs | 6,376 | 33,995 | 40,371 | 1,763 |

| **As of December 31, 2010** | **International** | **Russia** | **Total consolidated companies** | **Group's share in equity companies** |
|---|---|---|---|---|
| Unproved oil and gas properties | 536 | 302 | 838 | 274 |
| Proved oil and gas properties | 6,578 | 50,662 | 57,240 | 2,111 |
| Accumulated depreciation, depletion, and amortization | (1,490) | (18,530) | (20,020) | (597) |
| Net capitalized costs | 5,624 | 32,434 | 38,058 | 1,788 |

| **As of December 31, 2009** | **International** | **Russia** | **Total consolidated companies** | **Group's share in equity companies** |
|---|---|---|---|---|
| Unproved oil and gas properties | 545 | 305 | 850 | 285 |
| Proved oil and gas properties | 5,826 | 47,237 | 53,063 | 1,998 |
| Accumulated depreciation, depletion, and amortization | (1,201) | (16,460) | (17,661) | (454) |
| Net capitalized costs | 5,170 | 31,082 | 36,252 | 1,829 |

**(Millions of US dollars, except as indicated)**

## *II. Costs incurred in oil and gas property acquisition, exploration, and development activities*

| Year ended December 31, 2011 | International | Russia | Total consolidated companies | Group's share in equity companies |
|---|---|---|---|---|
| Acquisition of properties - proved | - | 41 | 41 | - |
| Acquisition of properties - unproved | 70 | 164 | 234 | - |
| Exploration costs | 507 | 358 | 865 | 8 |
| Development costs | 968 | 4,726 | 5,694 | 123 |
| Total costs incurred | 1,545 | 5,289 | 6,834 | 131 |

| Year ended December 31, 2010 | International | Russia | Total consolidated companies | Group's share in equity companies |
|---|---|---|---|---|
| Acquisition of properties - proved | 113 | - | 113 | - |
| Acquisition of properties - unproved | - | 15 | 15 | 122 |
| Exploration costs | 199 | 220 | 419 | 16 |
| Development costs | 685 | 3,686 | 4,371 | 115 |
| Total costs incurred | 997 | 3,921 | 4,918 | 253 |

| Year ended December 31, 2009 | International | Russia | Total consolidated companies | Group's share in equity companies |
|---|---|---|---|---|
| Acquisition of properties - proved | - | 17 | 17 | 1,154 |
| Acquisition of properties - unproved | - | 23 | 23 | 97 |
| Exploration costs | 221 | 162 | 383 | 11 |
| Development costs | 549 | 3,726 | 4,275 | 146 |
| Total costs incurred | 770 | 3,928 | 4,698 | 1,408 |

**(Millions of US dollars, except as indicated)**

### *III. Results of operations for oil and gas producing activities*

The Group's results of operations for oil and gas producing activities are presented below. In accordance with Topic 932 of the Codification, sales and transfers to Group companies are based on market prices. Income taxes are based on statutory rates. The results of operations exclude corporate overhead and interest costs.

| **Year ended December 31, 2011** | **International** | **Russia** | **Total consolidated companies** | **Group's share in equity companies** |
|---|---|---|---|---|
| Revenue | | | | |
| Sales | 2,656 | 25,232 | 27,888 | 1,924 |
| Transfers | - | 13,981 | 13,981 | 14 |
| Total revenues | 2,656 | 39,213 | 41,869 | 1,938 |
| Production costs (excluding production taxes) | (242) | (3,298) | (3,540) | (93) |
| Exploration expense | (439) | (93) | (532) | (2) |
| Depreciation, depletion, and amortization, and valuation provision | (324) | (2,511) | (2,835) | (125) |
| Taxes other than income taxes | (460) | (23,817) | (24,277) | (640) |
| Related income taxes | (531) | (1,817) | (2,348) | (407) |
| Total results of operations for producing activities | 660 | 7,677 | 8,337 | 671 |

| **Year ended December 31, 2010** | **International** | **Russia** | **Total consolidated companies** | **Group's share in equity companies** |
|---|---|---|---|---|
| Revenue | | | | |
| Sales | 1,926 | 19,956 | 21,882 | 1,350 |
| Transfers | - | 12,278 | 12,278 | 13 |
| Total revenues | 1,926 | 32,234 | 34,160 | 1,363 |
| Production costs (excluding production taxes) | (218) | (3,023) | (3,241) | (113) |
| Exploration expense | (240) | (96) | (336) | (2) |
| Depreciation, depletion, and amortization, and valuation provision | (306) | (2,504) | (2,810) | (127) |
| Taxes other than income taxes | (257) | (17,872) | (18,129) | (321) |
| Related income taxes | (314) | (1,813) | (2,127) | (275) |
| Total results of operations for producing activities | 591 | 6,926 | 7,517 | 525 |

| **Year ended December 31, 2009** | **International** | **Russia** | **Total consolidated companies** | **Group's share in equity companies** |
|---|---|---|---|---|
| Revenue | | | | |
| Sales | 1,472 | 13,870 | 15,342 | 824 |
| Transfers | - | 11,850 | 11,850 | 17 |
| Total revenues | 1,472 | 25,720 | 27,192 | 841 |
| Production costs (excluding production taxes) | (195) | (2,592) | (2,787) | (98) |
| Exploration expense | (147) | (71) | (218) | (10) |
| Depreciation, depletion, and amortization, and valuation provision | (323) | (2,278) | (2,601) | (105) |
| Taxes other than income taxes | (206) | (12,830) | (13,036) | (186) |
| Related income taxes | (198) | (1,399) | (1,597) | (203) |
| Total results of operations for producing activities | 403 | 6,550 | 6,953 | 239 |

**(Millions of US dollars, except as indicated)**

### *IV. Reserve quantity information*

Proved reserves are the estimated quantities of oil and gas reserves which geological and engineering data demonstrate will be recoverable with reasonable certainty in future years from known reservoirs under existing economic and operating conditions. In accordance with Topic 932 of the Codification existing economic and operating conditions are based on the 12-months average price and the year-end costs. Proved reserves do not include additional quantities of oil and gas reserves that may result from applying secondary or tertiary recovery techniques not yet tested and determined to be economic.

Proved developed reserves are the quantities of proved reserves expected to be recovered through existing wells with existing equipment and operating methods.

Due to the inherent uncertainties and the necessarily limited nature of reservoir data, estimates of reserves are inherently imprecise, require the application of judgment and are subject to change as additional information becomes available.

Management has included within proved reserves significant quantities which the Group expects to produce after the expiry dates of certain of its current production licenses in the Russian Federation. The Subsoil Law of the Russian Federation states that, upon expiration, a license is subject to renewal at the initiative of the license holder provided that further exploration, appraisal, production or remediation activities are necessary and provided that the license holder has not violated the terms of the license. Since the law applies both to newly issued and old licenses and the Group has currently renewed nearly 50% of its licenses, management believes that licenses will be renewed upon their expiration for the remainder of the economic life of each respective field.

Estimated net proved oil and gas reserves and changes thereto for the years ended December 31, 2011, 2010 and 2009, are shown in the tables set out below.

| Millions of barrels | **Consolidated subsidiaries** | | | **Group's share in equity companies** |
|---|---|---|---|---|
| | International | Russia | Total | |
| **Crude oil** | | | | |
| January 1, 2009 | 404 | 13,838 | 14,242 | 216 |
| Revisions of previous estimates | (85) | (636) | (721) | 15 |
| Purchase of hydrocarbons in place | - | 39 | 39 | 102 |
| Extensions and discoveries | 37 | 503 | 540 | - |
| Production | (27) | (673) | (700) | (20) |
| Sales of reserves | - | (17) | (17) | - |
| December 31, 2009 | 329 | 13,054 | 13,383 | 313 |
| Revisions of previous estimates | (4) | (292) | (296) | (5) |
| Purchase of hydrocarbons in place | 62 | - | 62 | - |
| Extensions and discoveries | 10 | 550 | 560 | 10 |
| Production | (26) | (658) | (684) | (24) |
| December 31, 2010 | 371 | 12,654 | 13,025 | 294 |
| Revisions of previous estimates | (12) | 233 | 221 | 7 |
| Purchase of hydrocarbons in place | - | 7 | 7 | - |
| Extensions and discoveries | 4 | 515 | 519 | 1 |
| Production | (26) | (623) | (649) | (22) |
| **December 31, 2011** | **337** | **12,786** | **13,123** | **280** |
| Proved developed reserves | | | | |
| December 31, 2009 | 186 | 8,442 | 8,628 | 199 |
| December 31, 2010 | 207 | 8,401 | 8,608 | 182 |
| **December 31, 2011** | **197** | **8,397** | **8,594** | **178** |

**(Millions of US dollars, except as indicated)**

The minority interest share included in the above total proved reserves was 163 million barrels, 187 million barrels and 242 million barrels as of December 31, 2011, 2010 and 2009, respectively. The minority interest share included in the above proved developed reserves was 96 million barrels, 132 million barrels and 135 million barrels as of December 31, 2011, 2010 and 2009, respectively. Substantially all minority interests relate to the reserves in the Russian Federation.

| Billions of cubic feet | **Consolidated subsidiaries** | | | **Group's share in equity companies** |
|---|---|---|---|---|
| | International | Russia | Total | |
| **Natural gas** | | | | |
| January 1, 2009 | 6,806 | 22,273 | 29,079 | 174 |
| Revisions of previous estimates | (294) | (6,081) | (6,375) | (3) |
| Purchase of hydrocarbons in place | - | 13 | 13 | 130 |
| Extensions and discoveries | 294 | 164 | 458 | - |
| Production | (175) | (436) | (611) | (15) |
| December 31, 2009 | 6,631 | 15,933 | 22,564 | 286 |
| Revisions of previous estimates | (35) | 1,214 | 1,179 | 11 |
| Extensions and discoveries | 98 | 226 | 324 | 4 |
| Production | (187) | (540) | (727) | (26) |
| December 31, 2010 | 6,507 | 16,833 | 23,340 | 275 |
| Revisions of previous estimates | (487) | 273 | (214) | 25 |
| Purchase of hydrocarbons in place | - | 1 | 1 | - |
| Extensions and discoveries | 240 | 309 | 549 | 1 |
| Production | (189) | (565) | (754) | (27) |
| **December 31, 2011** | **6,071** | **16,851** | **22,922** | **274** |
| | | | | |
| Proved developed reserves: | | | | |
| December 31, 2009 | 2,002 | 5,636 | 7,638 | 157 |
| December 31, 2010 | 2,715 | 6,024 | 8,739 | 143 |
| **December 31, 2011** | **3,250** | **6,065** | **9,315** | **163** |

The minority interest share included in the above total proved reserves was 32 billion cubic feet, 31 billion cubic feet and 36 billion cubic feet as of December 31, 2011, 2010 and 2009, respectively. The minority interest share included in the above proved developed reserves was 22 billion cubic feet, 21 billion cubic feet and 23 billion cubic feet as of December 31, 2011, 2010 and 2009, respectively. Substantially all minority interests relate to the reserves in the Russian Federation.

### *V. Standardized measure of discounted future net cash flows*

The standardized measure of discounted future net cash flows, related to the above oil and gas reserves, is calculated in accordance with the requirements of Topic 932 of the Codification. Estimated future cash inflows from production are computed by applying the 12-months average price for oil and gas to year-end quantities of estimated net proved reserves. Adjustments in this calculation for future price changes are limited to those required by contractual arrangements in existence at the end of each reporting year. Future development and production costs are those estimated future expenditures necessary to develop and produce year-end estimated proved reserves based on year-end cost indices, assuming continuation of year-end economic conditions. Estimated future income taxes are calculated by applying appropriate year-end statutory tax rates. These rates reflect allowable deductions and tax credits and are applied to estimated future pre-tax net cash flows, less the tax bases of related assets. Discounted future net cash flows have been calculated using a ten percent discount factor. Discounting requires a year-by-year estimate of when future expenditures will be incurred and when reserves will be produced.

**(Millions of US dollars, except as indicated)**

The information provided in the tables set out below does not represent management's estimate of the Group's expected future cash flows or of the value of the Group's proved oil and gas reserves. Estimates of proved reserve quantities are imprecise and change over time as new information becomes available. Moreover, probable and possible reserves, which may become proved in the future, are excluded from the calculations. The arbitrary valuation, prescribed under Topic 932 of the Codification, requires assumptions as to the timing and amount of future development and production costs. The calculations should not be relied upon as an indication of the Group's future cash flows or of the value of its oil and gas reserves.

| | International | Russia | Total consolidated companies | Group's share in equity companies |
|---|---|---|---|---|
| **As of December 31, 2011** | | | | |
| Future cash inflows | 51,665 | 616,290 | 667,955 | 25,773 |
| Future production and development costs | (26,242) | (416,403) | (442,645) | (12,897) |
| Future income tax expenses | (6,056) | (35,768) | (41,824) | (2,896) |
| Future net cash flows | 19,367 | 164,119 | 183,486 | 9,980 |
| Discount for estimated timing of cash flows (10% p.a.) | (10,930) | (97,394) | (108,324) | (5,145) |
| Discounted future net cash flows | 8,437 | 66,725 | 75,162 | 4,835 |
| Minority share in discounted future net cash flows | - | 937 | 937 | - |

| | International | Russia | Total consolidated companies | Group's share in equity companies |
|---|---|---|---|---|
| **As of December 31, 2010** | | | | |
| Future cash inflows | 40,871 | 432,401 | 473,272 | 18,629 |
| Future production and development costs | (23,193) | (313,375) | (336,568) | (9,503) |
| Future income tax expenses | (3,843) | (19,775) | (23,618) | (2,107) |
| Future net cash flows | 13,835 | 99,251 | 113,086 | 7,019 |
| Discount for estimated timing of cash flows (10% p.a.) | (8,641) | (60,808) | (69,449) | (3,656) |
| Discounted future net cash flows | 5,194 | 38,443 | 43,637 | 3,363 |
| Minority share in discounted future net cash flows | - | 963 | 963 | - |

| | International | Russia | Total consolidated companies | Group's share in equity companies |
|---|---|---|---|---|
| **As of December 31, 2009** | | | | |
| Future cash inflows | 31,025 | 385,266 | 416,291 | 14,816 |
| Future production and development costs | (18,778) | (254,811) | (273,589) | (7,692) |
| Future income tax expenses | (2,337) | (22,285) | (24,622) | (1,489) |
| Future net cash flows | 9,910 | 108,170 | 118,080 | 5,635 |
| Discount for estimated timing of cash flows (10% p.a.) | (6,468) | (66,015) | (72,483) | (3,013) |
| Discounted future net cash flows | 3,442 | 42,155 | 45,597 | 2,622 |
| Minority share in discounted future net cash flows | - | 1,370 | 1,370 | - |

**(Millions of US dollars, except as indicated)**

## *VI. Principal sources of changes in the standardized measure of discounted future net cash flows*

| **Consolidated companies** | **2011** | **2010** | **2009** |
|---|---|---|---|
| Discounted present value as at January 1 | 43,637 | 45,597 | 42,570 |
| Net changes due to purchases and sales of minerals in place | 39 | (193) | 86 |
| Sales and transfers of oil and gas produced, net of production costs | (13,520) | (12,454) | (11,151) |
| Net changes in prices and production costs estimates | 69,089 | 22,241 | 36,633 |
| Net changes in mineral extraction taxes | (32,678) | (23,976) | (27,376) |
| Extensions and discoveries, less related costs | 3,492 | 1,886 | 1,878 |
| Previously estimated development cost incurred during the period | 6,182 | 5,565 | 3,201 |
| Revisions of previous quantity estimates | 620 | (433) | (4,495) |
| Net change in income taxes | (7,467) | 407 | (1,104) |
| Other changes | 229 | (141) | 70 |
| Accretion of discount | 5,539 | 5,138 | 5,285 |
| **Discounted present value at December 31** | **75,162** | **43,637** | **45,597** |

| **Group's share in equity companies** | **2011** | **2010** | **2009** |
|---|---|---|---|
| Discounted present value as at January 1 | 3,363 | 2,622 | 1,006 |
| Net changes due to purchases and sales of minerals in place | - | - | 1,182 |
| Sales and transfers of oil and gas produced, net of production costs | (1,203) | (927) | (547) |
| Net changes in prices and production costs estimates | 3,820 | 2,296 | 2,129 |
| Net changes in mineral extraction taxes | (1,720) | (985) | (1,086) |
| Extensions and discoveries, less related costs | 8 | 53 | 3 |
| Previously estimated development cost incurred during the period | 66 | 120 | 31 |
| Revisions of previous quantity estimates | 179 | (56) | 137 |
| Net change in income taxes | (365) | (294) | (442) |
| Other changes | 267 | 234 | 95 |
| Accretion of discount | 420 | 300 | 114 |
| **Discounted present value at December 31** | **4,835** | **3,363** | **2,622** |