**OPEN JOINT STOCK COMPANY**
**NOVOLIPETSK IRON AND STEEL CORPORATION**

**US GAAP**
**CONSOLIDATED FINANCIAL STATEMENTS**

**AS AT AND FOR THE YEARS ENDED**
**DECEMBER 31, 2003 AND 2002**

**(WITH REPORT OF INDEPENDENT AUDITORS THEREON)**

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# REPORT OF INDEPENDENT AUDITORS

**To the Board of Directors of open joint stock company Novolipetsk Iron and Steel Corporation**

We have audited the accompanying consolidated balance sheet of open joint stock company Novolipetsk Iron and Steel Corporation and its subsidiaries (the "Group") as of December 31, 2003, and the related consolidated statements of income, cash flows and stockholders' equity and comprehensive income for the year then ended. These consolidated financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The consolidated financial statements of the Group as of December 31, 2002 and for the year then ended were audited by other independent auditors whose report dated June 9, 2003 expressed an unqualified opinion on those financial statements.

We conducted our audit 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 9 to the consolidated financial statements, the cost of certain property, plant and equipment was determined with the assistance of an independent appraiser, who provided US dollar estimates of historical cost and depreciated historical cost of the Group's property, plant and equipment.

In our opinion, except for the effects of using the valuation to determine the historical cost and depreciated historical cost for certain property, plant and equipment as discussed in the preceding paragraph, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Group as of December 31, 2003 and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Moscow, Russian Federation
May 1, 2004

*(All amounts in thousands of US dollars, except for share data)*

| | Note | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|---|
| **ASSETS** | | | |
| **Current assets** | | | |
| Cash and cash equivalents | 4 | 789,492 | 390,472 |
| Short-term investments | 5 | 180,797 | 44,487 |
| Accounts receivable, net | 6 | 377,746 | 266,199 |
| Inventories, net | 7 | 301,303 | 210,628 |
| Other current assets, net | 8 | 63,336 | 32,242 |
| | | **1,712,674** | **944,028** |
| **Non-current assets** | | | |
| Long-term investments | 5 | 54,925 | 71,164 |
| Property, plant and equipment, net | 9 | 1,280,832 | 1,167,714 |
| Other non-current assets | | 36,834 | 16,080 |
| | | **1,372,591** | **1,254,958** |
| **Total assets** | | **3,085,265** | **2,198,986** |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | | |
| **Current liabilities** | | | |
| Short-term borrowings | | 2,803 | 3,346 |
| Accounts payable and other liabilities | 10 | 253,739 | 151,759 |
| Current income tax liability | | 23,032 | 17,106 |
| Short-term capital lease liability | 18 | 6,114 | 1,727 |
| | | **285,688** | **173,938** |
| **Non-current liabilities** | | | |
| Long-term borrowings | | 1,738 | 2,988 |
| Long-term capital lease liability | 18 | 11,563 | 2,468 |
| Deferred income tax liability | 14 | 159,716 | 15,523 |
| | | **173,017** | **20,979** |
| **Total liabilities** | | **458,705** | **194,917** |
| **Commitments and contingencies** | 21 | - | - |
| **Minority interest** | | **16,652** | **12,891** |
| **Stockholders' equity** | | | |
| Common stock, 1 RUB par value – 5,987,240 shares issued and outstanding at December 31, 2003 and 2002 | | 14,440 | 14,440 |
| Additional paid-in capital | | 680 | 680 |
| Other comprehensive income | | 27,672 | 3,723 |
| Retained earnings | | 2,567,116 | 1,972,335 |
| | | **2,609,908** | **1,991,178** |
| **Total liabilities and stockholders' equity** | | **3,085,265** | **2,198,986** |

The consolidated financial statements as set out on pages 4 to 30 were approved on May 1, 2004.

**General Director**
**Frantsenjuk I.V.**

**Chief accountant**
**Sokolov A.A.**

The accompanying notes constitute an integral part of these consolidated financial statements

*(All amounts in thousands of US dollars, except for earnings per share amounts)*

| | Note | For the year ended December 31, 2003 | For the year ended December 31, 2002 |
|---|---|---|---|
| Sales revenue | | 2,468,022 | 1,711,657 |
| Cost of sales | 12 | (1,451,139) | (1,096,385) |
| **Gross profit** | | **1,016,883** | **615,272** |
| Selling, general and administrative expenses | 13 | (125,708) | (103,359) |
| **Operating income** | | **891,175** | **511,913** |
| Loss on disposals of property, plant and equipment and impairment | | (7,949) | (8,895) |
| Gain / (loss) on investments | | 12,136 | (2,675) |
| Net interest income | | 26,289 | 10,832 |
| Gain / (loss) on long-term loan given | 5(e) | 20,984 | (20,544) |
| Foreign currency exchange loss, net | | (42,999) | (18,247) |
| Other expense | | (17,902) | (5,510) |
| **Operating income before income tax and minority interest** | | **881,734** | **466,874** |
| Income tax | 14 | (223,035) | (129,699) |
| **Operating income before minority interest** | | **658,699** | **337,175** |
| Minority interest | | (2,243) | 1,243 |
| **Net income** | | **656,456** | **338,418** |
| **Income from continuing operations per share (US dollars)** | | | |
| basic and diluted | | 109.64 | 56.54 |
| **Net income per share (US dollars)** | | | |
| basic and diluted | 15 | 109.64 | 56.54 |

The accompanying notes constitute an integral part of these consolidated financial statements

*(thousands of US dollars)*

| | Note | For the year ended December 31, 2003 | For the year ended December 31, 2002 |
|---|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | | |
| **Net income** | | **656,456** | **338,418** |
| **Adjustments to reconcile net income to net cash provided by operating activities:** | | | |
| Minority interest | | 2,243 | (1,243) |
| Depreciation | | 157,809 | 146,327 |
| Loss on disposals of property, plant and equipment and impairment | | 7,949 | 8,895 |
| (Gain) / loss on investments | | (12,136) | 2,675 |
| Deferred income tax benefit | | (13,498) | (4,257) |
| (Gain) / loss on long-term loan given | 5(e) | (20,984) | 20,544 |
| Other movements | | 1,642 | (1,428) |
| **Changes in operating assets and liabilities** | | | |
| Increase in accounts receivables | | (86,853) | (25,098) |
| Increase in inventories | | (71,038) | (5,646) |
| Increase in other current and non-current assets | | (44,029) | (32,137) |
| Increase in accounts payable and other liabilities | | 86,360 | 43,524 |
| Increase in current income tax payable | | 4,390 | 6,840 |
| **Net cash provided by operating activities** | | **668,311** | **497,414** |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | | |
| Proceeds from sale of property, plant and equipment | | 15,677 | 846 |
| Purchase and construction of property, plant and equipment | | (187,532) | (153,632) |
| Loans given | 5(e) | - | (85,000) |
| Proceeds from loans given | 5(e) | 71,415 | 13,987 |
| Proceeds from sale of investments | | 55,754 | 15,121 |
| Purchase of long-term investments | | (37,419) | - |
| Purchase of short-term investments | | (165,171) | (7,106) |
| **Net cash used in investing activities** | | **(247,276)** | **(215,784)** |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | | |
| Proceeds from borrowings | | 470 | 3,576 |
| Repayment of borrowings | | (930) | (87,925) |
| Proceeds from issuance of additional stock by subsidiaries to minority stockholders | | 388 | 3,727 |
| Payments under capital lease | | (6,648) | (565) |
| Dividends to the stockholders | 11(b) | (61,675) | - |
| **Net cash used in financing activities** | | **(68,395)** | **(81,187)** |
| **Net increase in cash and cash equivalents** | | **352,640** | **200,443** |
| Effect of exchange rate changes on cash | | 46,380 | - |
| Cash and cash equivalents at beginning of the year | 4 | 390,472 | 190,029 |
| **Cash and cash equivalents at end of the year** | 4 | **789,492** | **390,472** |
| **Supplemental disclosures of cash flow information:** | | | |
| Income taxes paid | | 232,142 | 126,482 |
| Interest paid | | 3,934 | 2,475 |

*(thousands of US dollars)*

| | Note | Common stock | Preferred stock | Additional paid-in capital | Other comprehensive income | Retained earnings | Total stockholders' equity |
|---|---|---|---|---|---|---|---|
| **Balance at December 31, 2001** | | **14,435** | **5** | **680** | **2,986** | **1,633,917** | **1,652,023** |
| Net income | | - | - | - | - | 338,418 | 338,418 |
| Net unrealized gain on a change in valuation of investments | | - | - | - | 737 | - | 737 |
| Converting preferred shares into ordinary shares | | 5 | (5) | - | - | - | - |
| **Balance at December 31, 2002** | | **14,440** | **-** | **680** | **3,723** | **1,972,335** | **1,991,178** |
| Deferred income tax liability effect | 2(b) | - | - | - | (145,133) | - | (145,133) |
| Net income | | - | - | - | - | 656,456 | 656,456 |
| Net unrealized loss on a change in valuation of investments | | - | - | - | (2,390) | - | (2,390) |
| Cumulative translation adjustment | 2(b) | - | - | - | 171,472 | - | 171,472 |
| Dividends to the stockholders | 11(b) | - | - | - | - | (61,675) | (61,675) |
| **Balance at December 31, 2003** | | **14,440** | **-** | **680** | **27,672** | **2,567,116** | **2,609,908** |

## 1 BACKGROUND

Open joint stock company Novolipetsk Iron and Steel Corporation (the "Parent Company") and its subsidiaries (together – the "Group") is one of the largest iron and steel holdings in the Russian Federation with facilities that allow the Group to operate an integrated steel production cycle. The Parent Company is a Russian Federation open joint stock company in accordance with the Civil Code of the Russian Federation. The Parent Company was originally established as a State owned enterprise in 1934 and was privatized in the form of an open joint stock company on January 28, 1993. On August 12, 1998 the Parent Company's name was reregistered as an open joint stock company in accordance with the Law on Joint Stock Companies of the Russian Federation.

The Group's principal activity is the production and sale of ferrous metals, primarily consisting of pig iron, steel slabs, hot rolled steel, cold rolled steel, galvanized cold rolled sheet and cold rolled sheet with polymeric coatings. These products are sold both in the Russian Federation and abroad.

The Group's main operations are in the Lipetsk region of the Russian Federation and are subject to the legislative requirements of both the Russian Federation and the Lipetsk regional authorities.

The Group's primary subsidiaries, located in Lipetsk and other regions of the Russian Federation, comprise of:

- The commercial bank OJSC Lipetskcombank. The bank possesses a general banking license of the Central Bank of the Russian Federation, a license for foreign currency operations and a license for brokerage activity. The bank provides banking services to commercial and retail customers.
- Trading companies LLC Stahl, LLC Vimet and LLC Larmet. The principal activity of these companies is the purchase of raw materials for the Group's metallurgical production and the sale of metal products.
- Mining companies OJSC Combinat KMAruda, OJSC StAGDoK and OJSC Dolomite. The principal activity of these companies is mining, processing and the sale of iron-ore raw concentrate, fluxing limestone and metallurgical dolomite respectively.
- The insurance company LLC LIS Chance. The principal business activities of the company is corporate property insurance, voluntary medical insurance, vehicle insurance and public liability insurance.

## 2 BASIS OF PREPARATION

### (a) Statement of compliance

The Group maintains its accounting records in accordance with the legislative requirements of the Russian Federation. The accompanying consolidated financial statements have been prepared from those accounting records and adjusted as necessary to comply, in all material respects, with the requirements of accounting principles generally accepted in the United States of America ("US GAAP").

### (b) Functional and reporting currency

The accounting records of the Group are maintained in Russian rubles and the Parent Company prepares its statutory financial statements and reports in that currency to its stockholders in accordance with the laws of the Russian Federation.

The Group's functional currency is considered to be Russian ruble. The accompanying consolidated financial statements have been prepared using the US dollar as the Group's reporting currency. The translation into US dollars has been performed in accordance with the provisions of SFAS No. 52, *Foreign currency translation*.

## 2 BASIS OF PREPARATION (continued)

### (b) Functional and reporting currency (continued)

Prior to January 1, 2003, the Russian economy was considered hyperinflationary. In accordance with SFAS No. 52 requirements applicable to hyperinflationary market economics, monetary assets and liabilities originally denominated in US dollars were stated at their original US dollars amounts. Monetary assets and liabilities denominated in other currencies were translated into US dollars using the exchange rate ruling at the balance sheet date. Non-monetary assets and liabilities, which were denominated in currencies other than US dollars, were translated into US dollars at the exchange rates in effect as at the date of the transaction. Income and expenses, which were earned or incurred in currencies other than US dollars, were translated into US dollars using a basis that approximates the rate of exchange ruling at the date of the transaction. Gains and losses arising from the translation of assets and liabilities into US dollars were reflected in the consolidated statement of income as foreign currency exchange gains and losses.

The Russian economy ceased to be considered hyperinflationary as of January 1, 2003. At January 1, 2003, the monetary and non-monetary assets and liabilities of the Group as well as the related equity balance were translated into Russian rubles at the current exchange rate prevailing at January 1, 2003. This translation established a new functional currency basis for the Group. For periods subsequent to January 1, 2003, the functional currency consolidated financial statements (Russian rubles) are translated into the reporting currency (US dollars) utilizing period-end exchange rates for assets and liabilities, period average exchange rates for consolidated income statement accounts and historic rates for equity accounts in accordance with the relevant provisions of SFAS No. 52. As a result of these translation procedures, a cumulative translation adjustment of $171,472 which accounts for such translation gains and losses was recorded directly in stockholders' equity. The deferred income tax effect of $145,133 of the change in functional currency was also recorded directly in stockholders' equity. No cumulative translation adjustment was made for the period during which the Russian economy was considered hyperinflationary.

The Central Bank of the Russian Federation closing rates of exchange ruling at December 31, 2003 and 2002 were 1 US dollar to 29.4545 Russian rubles and 1 US dollar to 31.7844 Russian rubles, respectively. The annual weighted average exchange rates were 30.6877 and 31.3474 Russian rubles to 1 US dollar for the years ended December 31, 2003 and 2002, respectively.

### (c) Consolidation principles

Consolidated financial statements include all majority-owned and controlled subsidiaries of the Group. All significant intercompany accounts and transactions have been eliminated.

## 3 SIGNIFICANT ACCOUNTING POLICIES

The following significant accounting policies have been applied in the preparation of the consolidated financial statements. These accounting policies have been consistently applied by the Group year-on-year.

### (a) Use of estimates

The preparation of financial statements in accordance with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and revenue and expenses during the periods reported. Estimates are used when accounting for certain items such as allowances for doubtful accounts; employee compensation programs; depreciation and amortization lives; property, plant, and equipment valuation allowances; asset retirement obligations; legal and tax contingencies; inventory values; valuations of investments and determining when investment impairments are other than temporary; intangible assets, including fair value determinations; and deferred tax assets, including tax valuation allowances. Estimates are based on historical experience, where applicable, and other assumptions that management believes are reasonable under the circumstances. Actual results may differ from those estimates under different assumptions or conditions. Additionally, estimates are used when recording the fair values of assets and liabilities assumed in a purchase business combination.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (b) Cash and cash equivalents

Cash and cash equivalents comprise cash balances, cash on current and deposit accounts with banks and other highly liquid short-term investments with original maturities of less than three months.

### (c) Accounts receivable

Receivables are stated at cost less an allowance for doubtful debts. Management quantifies this allowance based on current information regarding the customers' ability to repay their obligations. Amounts previously written off which are subsequently collected are recognized as income.

### (d) Value added tax

Value added taxes related to sales and services rendered is payable to tax authorities upon collection of receivables from customers. Input VAT is reclaimable against sales VAT upon payment for purchases. The tax authorities permit the settlement of VAT on a net basis. VAT related to sales / purchases and services rendered / used which have not been settled at the balance sheet date (VAT deferred) is recognised in the balance sheet on a gross basis and disclosed separately as a current asset and liability. Where allowance has been made for doubtful debts, loss is recorded for the gross amount of the debtor, including VAT. The related VAT deferred liability is maintained until the debtor is written off for tax purposes.

### (e) Inventories

Inventories are stated at the lower of acquisition cost inclusive of completion expenses or market value. Inventories are released to production or written off otherwise at average cost. In the case of manufactured inventories and work in progress, cost includes an appropriate share of production overheads.

Provision for obsolescence is calculated on the basis of slow-moving and obsolete inventories analysis. Such items are provided for in full.

### (f) Investments in marketable debt and equity securities

Marketable debt and equity securities consist of investments in corporate debt and equity securities where the Group does not exert control or significant influence over the investee. The Group classifies marketable debt and equity securities using three categories: trading, held-to-maturity and available-for-sale. The specific identification method is used for determining the cost basis of all such securities.

***Trading securities***

Trading securities are bought and held principally for the purpose of selling them in the near term. Trading securities are carried in the consolidated balance sheet at their fair value. Unrealized holding gains and losses on trading securities are included in the consolidated statement of income.

***Held-to-maturity securities***

Held-to-maturity securities are those securities which the Group has the ability and intent to hold until maturity. Held-to-maturity securities are recorded at amortized cost.

Premiums and discounts are amortized and recorded in the consolidated statement of income over the life of the related security held-to-maturity, as an adjustment to yield using the effective interest method.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (f) Investments in marketable debt and equity securities (continued)

***Available-for-sale securities***

All marketable securities not included in trading or held-to-maturity are classified as available-for-sale.

Available-for-sale securities are recorded at their fair value. Unrealized holding gains and losses, net of the related tax effect, are excluded from earnings and reported as a separate component of accumulated other comprehensive income in the stockholders' equity until realized. Realized gains and losses from the sale of available for sale securities, less tax, are determined on a specific identification basis.

Premiums and discounts on available-for-sale securities are amortized to the consolidated statement of income over the life of the related available-for-sale security as an adjustment to yield using the effective interest method. Dividend and interest income are recognized when earned.

### (g) Investments in associates and non-marketable securities

***Investments in associates***

Associates are those enterprises in which the Group has significant influence, but not control, over the financial and operating policies. Investments in associates are accounted for using the equity method of accounting. The consolidated financial statements include the Group's share of the total recognized gains and losses of associates from the date that significant influence effectively commences until the date that significant influence effectively ceases.

***Investments in non-marketable securities***

Investments in non-marketable securities where the Group does not exercise control or significant influence over the investee are carried at cost less provisions for any permanent diminution in value. Provisions are calculated for the investments in companies which are experiencing significant financial difficulties for which recovery is not expected within a reasonable period in the future or under bankruptcy proceedings.

### (h) Property, plant and equipment

***Owned assets***

Items of property, plant and equipment are stated at acquisition cost less accumulated depreciation and impairment losses (Note 3(j)). The cost of self-constructed assets includes the cost of materials, direct labor and an appropriate proportion of production overheads.

Property, plant and equipment also includes assets under construction and plant and equipment for installation.

Where an item of property, plant and equipment comprises major components having different useful lives, they are accounted for as separate items of property, plant and equipment.

***Leased assets***

Leases that meet the definition of capital leases under the requirements of SFAS No. 13, *Accounting for Leases*, are classified accordingly. Plant and equipment acquired by way of capital lease are stated at the lower of its fair value or the present value of the minimum lease payments at inception of the lease, less accumulated depreciation (refer below) and impairment losses (Note 3(j)).

Payments for operating leases are expensed as incurred.

*(thousands of US dollars)*

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (h) Property, plant and equipment (continued)

***Subsequent expenditures***

Expenditures incurred to replace a component of an item of property, plant and equipment that is accounted for separately, are capitalized with the carrying amount of the component subject to depreciation. Other subsequent expenditures are capitalized only when they increase the future economic benefits embodied in an item of property, plant and equipment. All other expenditures are recognized as expenses in the consolidated statement of income as incurred.

***Capitalized interest***

Interest is capitalized in connection with the construction of major facilities. The capitalized interest is recorded as part of the asset to which it relates, and is depreciated over the asset's useful life.

***Depreciation***

Depreciation is charged on a straight-line basis over the estimated useful lives of the individual assets. Plant and equipment under capital leases and subsequent capitalized expenses are depreciated on a straight-line basis over the estimated useful life of the individual assets. Depreciation commences from the time an asset is put into operation. Depreciation is not charged on assets to be disposed of or land. The range of estimated useful lives is as follows:

| | |
|---|---|
| Buildings and land and buildings improvements | 20 – 45 years |
| Machinery and equipment | 2 – 40 years |
| Vehicles | 5 – 25 years |

### (i) Goodwill and intangible assets

Goodwill represents the excess of purchase price over the fair value of net assets acquired. The Group adopted provisions of SFAS No. 142, *Goodwill and Other Intangible Assets,* as of January 1, 2002. Under SFAS No. 142 goodwill and intangible assets with indefinite useful lives are no longer amortized as they were prior to 2002, but are instead subject to impairment test 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.

The Group does not have goodwill balances in its consolidated balance sheets as at December 31, 2003 and 2002.

### (j) Impairment

Long-lived assets, such as property, plant and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized for the amount by which the carrying amount of the asset exceeds the fair value of the asset, generally determined by reference to the discounted future cash flows. Assets to be disposed of are reported at the lower of the carrying amount or fair value less selling costs.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (k) Pension and post retirement benefits other than pensions

The Group follows the Pension and Social Insurance legislation of the Russian Federation, which requires contributions to the Russian Federation Pension Fund by the employer calculated as a percentage of current gross salaries. Such contributions are expensed as incurred.

The Parent Company also sponsors other post retirement benefits for its employees which are not provided for in law. All of these benefits are part of an annually negotiated Trade Union agreement. These benefits do not vest and may be cancelled when the Trade Union agreement is negotiated annually.

The Parent Company and some other Group companies have an agreement with a non-Government pension fund (the "Fund") in accordance with which contributions are made on a monthly basis. Contributions are calculated as a certain fixed percentage of the employees' salaries. These pension benefits are accumulated in the Fund during the employment period and distributed by the Fund subsequently. As such, all abovementioned benefits are considered as made under a defined contribution plan and are charged to expense as incurred. Accordingly, the Group has no long-term commitments to provide funding, guarantees, or other support to the Fund.

In addition, lump sum benefits are paid to employees on retirement depending on the employment period and the salary level of the individual employee. The expected future obligations to the employees are assessed by the Group's management and accrued in the consolidated financial statements. The scheme is considered as a defined benefit plan.

### (l) Asset retirement obligations

In July 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. This statement provides accounting and reporting standards for costs associated with the retirement of long-lived assets. This statement requires entities to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred. When the liability is initially recorded, the entity capitalizes a cost by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the estimated useful life of the related asset. Upon settlement of the liability, an entity either settles the obligation for its recorded amount or incurs a gain or loss upon settlement.

The Group's land, buildings and equipment are subject to the provisions of this statement. Based on the current requirements under the laws of the Russian Federation and various contractual agreements associated with these assets, the Group has no commitments related to the retirement of its long-lived assets.

### (m) Long-term borrowings

Long-term borrowings are recognized initially at cost, net of any transaction costs incurred. Subsequent to initial recognition, long-term borrowings are stated at amortized cost with any difference between cost and redemption value being recognized in the consolidated statement of income over the period of the borrowings.

When borrowings are repurchased or settled before maturity, any difference between the amount received and the carrying amount is recognized immediately in the consolidated statement of income.

### (n) Commitments and contingencies

Contingent liabilities, including environmental remediation costs, arising from claims, assessments, litigation, fines, penalties and other sources are recorded when it is probable that a liability can be assessed and the amount of the assessment and / or remediation can be reasonably estimated.

Estimated losses from environmental remediation obligations are generally recognized no later than completion of remedial feasibility studies. Group companies accrue expenses associated with environmental remediation obligations when such expenses 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.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (o) Income tax

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to be applied to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period when a different tax rate is enacted.

Pursuant to the provisions of SFAS No. 109, *Accounting For Income Taxes*, the Group provides valuation allowances for deferred tax assets for which it does not consider realization of such assets to be more likely than not.

### (p) Stockholders' equity

***Treasury stock***

When shares are repurchased, the amount of the consideration paid, including directly attributable costs, is recognized as a change in the stockholders' equity in the consolidated balance sheet. Repurchased shares are presented as a deduction from the stockholders' equity.

***Dividends***

Dividends are recognized as a liability in the period in which they are declared.

### (q) Revenue recognition

***Goods sold***

Revenue from the sale of goods is recognized in the consolidated statement of income when there is a firm arrangement, the price is fixed and determinable, delivery has occurred, and collectibility is reasonably assured.

***Interest income***

Interest income is recognized in the consolidated statement of income as it is earned.

### (r) Expenses

***Operating lease payments***

Operating leases are recognized as an expense in the consolidated statement of income as incurred.

***Interest expense***

All interest and other costs incurred in connection with borrowings are expensed as incurred as part of interest expense, except for interest which is incurred on construction projects and capitalized (Note 3(h)).

### (s) Non-cash transactions

Non-cash settlements represent offset transactions between customers and suppliers, when exchange equivalent is defined and goods are shipped between the parties without exchange of cash.

The related sales and purchases are recorded in the same manner as cash transactions. The fair market value for such transactions is based on the value of similar transactions in which monetary consideration is exchanged with a third party.

Purchases of property, plant and equipment under capital lease arrangements are also recognized as non-cash transactions.

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (t) Related party transactions

The following are considered to be related parties:

- Associates of the Group;
- The Group's major stockholders and their immediate relatives;
- Enterprises and trusts created for the benefit of the employees, including pension funds, charity organizations, profit sharing trusts and investment funds that are managed by or under the trusteeship of the Group's management;
- Directors and officers of the Group and their immediate relatives;
- Enterprises in which principal stockholders, officers and directors and their immediate relatives have control or significant influence;
- Other parties with which the Group deals if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.

In considering each possible related party relationship, attention is directed to the nature and substance of the relationship, and not merely to the legal form.

### (u) Recent accounting pronouncements

On December 31, 2002, the Financial Accounting Standards Board issued SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*. This Statement amends SFAS No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Group does not use stock-based compensations and believes that the adoption of the standard has no material impact on its consolidated financial statements.

In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46 (FIN 46), *Consolidation of Variable Interest Entities*. In December 2003, the Financial Accounting Standards Board revised FIN 46 (FIN 46R). FIN 46R addresses consolidation and disclosure by business enterprises of variable interest entities. Application of FIN 46R is required in financial statements of nonpublic entities that have interests in the entities that are subject to this interpretation and those are created after December 31, 2003. Nonpublic entities should apply FIN 46R to all entities that are subject to this interpretation by the beginning of the first annual period beginning after December 15, 2004. The Group does not expect the adoption of FIN 46R to have a material impact on its consolidated financial statements.

In April 2003, the Financial Accounting Standards Board issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The Group does not use derivatives and believes that the adoption of the standard has no material impact on its consolidated financial statements.

In May 2003, the Financial Accounting Standards Board issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. The Group believes that the adoption of the standard has no material impact on its consolidated financial statements.

*(thousands of US dollars)*

## 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

### (u) Recent accounting pronouncements (continued)

In December 2003, the Financial Accounting Standards Board issued a revision to SFAS No. 132, *Employers' Disclosures about Pension and Other Postretirement Benefits*. The revised SFAS No. 132 included additional disclosures for employers concerning pension plans and other postretirement benefit plans, however, it did not change the measurement or recognition of those plans required by SFAS No. 87, *Employers' Accounting for Pensions*, No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. The revised SFAS No. 132 retains the disclosure requirements under the original SFAS No. 132, however, it also requires expanded disclosures about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans. The required information should be provided separately for pension plans and for other postretirement benefit plans. The Group believes that the adoption of the standard has no significant impact on the disclosures in the Group's consolidated financial statements.

### (v) Reclassifications

Certain amounts in previously issued consolidated financial statements have been reclassified to conform to the current period presentation.

## 4 CASH AND CASH EQUIVALENTS

| | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|
| Cash – Russian rubles | 26,927 | 38,056 |
| Cash – foreign currency | 164,659 | 841 |
| Deposits – Russian rubles | 98,457 | 13,552 |
| Deposits – US dollars | 435,601 | 128,500 |
| Deposits – Euro | 3,000 | - |
| Cash in trust – foreign currency | - | 197,900 |
| Other cash equivalents | 52,744 | 4,108 |
| Restrictive cash | 8,104 | 7,515 |
| | **789,492** | **390,472** |

Restricted cash as at December 31, 2003 and 2002 includes the amounts of obligatory reserve, placed with the Central Bank of the Russian Federation by the subsidiary bank in accordance with statutory requirements applicable to credit institutions of $8,104 and $7,515, respectively.

Other cash equivalents as at December 31, 2003 and 2002 include letters of credit amounting to $51,747 and $3,352, respectively.

Cash in trust as at December 31, 2002 represents surplus cash transferred by the Group into a cash management account with a Russian bank with international share in equity in 2002. This cash was available at the Group's call.

*(thousands of US dollars)*

## 5 INVESTMENTS

### (a) Trading securities

| | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|
| Shares of Russian listed companies | 158,280 | - |
| Corporate bonds | 3,378 | - |
| Eurobonds | 9,630 | - |
| Other | 1,146 | 1,232 |
| | **172,434** | **1,232** |

Group's return on such investments is affected by the operating environment of the Group (Note 19(a)).

### (b) Available-for-sale securities

| | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|
| Russian government bonds with annual coupon rate 3% of the face value | | |
| Acquisition cost | 905 | 921 |
| Gross unrealized gains | 1,718 | 3,723 |
| Deposit certificates with interest rates ranging from 10% p.a. to 20% p.a. | 29,304 | 6,844 |
| **Fair value** | **31,927** | **11,488** |

Maturities of debt securities classified as available-for-sale as at December 31, 2003 and 2002 are presented below.

| | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|
| Due within one year | 8,363 | 5,151 |
| Due in one to five years | 20,898 | 4,018 |
| Due after five years | 2,666 | 2,319 |
| | **31,927** | **11,488** |

Russian Government bonds with a face value of $2,908 as at December 31, 2003, and $3,180 as at December 31, 2002, are pledged to secure the redemption of the Parent Company's promissory notes issued in 2000 for the purchase of shares in CJSC Korpus. These promissory notes are denominated in Russian rubles and mature in 2008.

*(thousands of US dollars)*

## 5 INVESTMENTS (continued)

### (c) Investments in associates

| | As at December 31, 2003 Ownership | As at December 31, 2002 Ownership | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|---|---|
| CJSC Korpus | 40.00% | 40.00% | 3,232 | 3,042 |
| CJSC Stalconverst | 36.80% | 36.80% | 2,130 | 1,974 |
| OJSC AKB Lipetskcredit | 22.19% | 22.19% | 1,116 | 1,034 |
| OJSC Avron | 26.70% | 26.70% | 406 | 376 |
| OJSC Lipetsky Gipromez | 43.44% | 43.44% | 8 | 7 |
| | | | 6,892 | 6,433 |
| Provision for permanent diminution in value | | | (3,652) | (3,384) |
| | | | **3,240** | **3,049** |

### (d) Non-marketable securities

| | As at December 31, 2003 Ownership | As at December 31, 2002 Ownership | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|---|---|
| **Non-marketable securities, net of current portion:** | | | | |
| OJSC Lebedinsky GOK | 11.96% | 11.96% | 9,240 | 8,546 |
| OJSC Yakovlevsky rudnik | 9.48% | 9.48% | 5,797 | 5,372 |
| OJSC Lipetskenergo | 12.21% | 12.21% | 2,268 | 2,102 |
| OJSC Lipetskoblgaz | 19.40% | 19.40% | 695 | 644 |
| OJSC Almetievsky pipe plant | 14.53% | 14.53% | 557 | 516 |
| OJSC Moscow pipe plant Filit | 12.00% | 12.00% | 423 | 392 |
| Other | | | 708 | 1,659 |
| | | | 19,688 | 19,231 |
| Provision for permanent diminution in value | | | (6,567) | (6,144) |
| | | | **13,121** | **13,087** |
| **Current portion of non-marketable securities**: | | | | |
| OJSC Coal Mining Company Kuzbassugol | - | 17.70% | - | 39,787 |
| Provision for permanent diminution in value | | | - | (1,683) |
| | | | - | **38,104** |
| **Total non-marketable securities** | | | **13,121** | **51,191** |

*(thousands of US dollars)*

## 5 INVESTMENTS (continued)

### (e) Loans given

| | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|
| Long-term loan | - | 48,691 |
| | **-** | **48,691** |

The balance of the long-term loan as at December 31, 2002 represents the amortized cost of a Russian ruble denominated interest free loan payable before December 31, 2004. At the date of issue the long-term loan of $85,000 was accounted for at its fair value. The fair value of the loan was calculated based on an annual commercial interest rate of 19% at the date of issue and an assumption that the loan will be repaid at the end of 2004.

A difference between the face value and fair value of $56,348 in the amount of $28,652 (representing interest income to be recognized in future periods) and current period interest income of $8,108 were recognized in the consolidated statement of income for the year ended December 31, 2002. In 2002, a portion of the loan of $13,987 was repaid.

In 2003, the loan was fully repaid by the borrower. A gain on the early retirement of the loan in the amount of $20,984 was recognized in the consolidated statement of income for the year ended December 31, 2003.

### (f) Long-term bank deposits

| | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|
| Long-term bank deposit | 15,000 | - |
| | **15,000** | **-** |

The balance represents a US dollar denominated long-term 6.5% bank deposit with a maturity date of October 2006. The Group pledged this deposit as a guarantee for a third party obligation to another third party (Note 21(h)).

Balance sheet classification of investments:

| | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|
| Long-term investments | 54,925 | 71,164 |
| Short-term investments and current portion of long-term investments | 180,797 | 44,487 |
| **Total investments** | **235,722** | **115,651** |

*(thousands of US dollars)*

## 6 ACCOUNTS RECEIVABLE

| | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|
| Trade accounts receivable | 245,404 | 165,293 |
| Advances given to suppliers | 23,834 | 15,225 |
| Taxes receivable | 95,634 | 74,825 |
| Accounts receivable from employees | 896 | 968 |
| Other accounts receivable | 18,556 | 16,377 |
| | 384,324 | 272,688 |
| Allowance for doubtful debts | (6,578) | (6,489) |
| | **377,746** | **266,199** |

As at December 31, 2003 and 2002, the Group had accounts receivable from Steelco Mediterranian Trading Ltd., Cyprus, and Tuscany Intertrade, UK, each of which exceeded 10% of the gross accounts receivable balances. The outstanding balances owed by these debtors totaled $121,658 and $87,272 at December 31, 2003 and $47,093 and $54,290 at December 31, 2002, respectively.

In addition, current receivables from Moorfield Commodities Company, UK at December 31, 2002 exceeded 10% of the gross accounts receivable balances and totaled $28,590. At December 31, 2003, accounts receivable from this company do not exceed 10%.

## 7 INVENTORIES

| | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|
| Finished goods and goods for resale | 37,813 | 26,564 |
| Work in process | 64,326 | 54,475 |
| Raw materials | 201,610 | 130,735 |
| | 303,749 | 211,774 |
| Provision for obsolescence | (2,446) | (1,146) |
| | **301,303** | **210,628** |

*(thousands of US dollars)*

## 8 OTHER CURRENT ASSETS

| | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|
| Short-term loans provided by OJSC Lipetskcombank | 53,904 | 25,707 |
| Other current assets | 12,781 | 8,386 |
| | 66,685 | 34,093 |
| Allowance for doubtful loans | (3,349) | (1,851) |
| | **63,336** | **32,242** |

Short-term loans represent loans provided to customers and other banks by the subsidiary bank of the Group. The interest rates on such loans range from 12% p.a. to 28% p.a. for loans denominated in Russian rubles and from 8% p.a. to 18% p.a. for foreign currency loans.

## 9 PROPERTY, PLANT AND EQUIPMENT

| | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|
| Land | 35,442 | 32,844 |
| Buildings | 550,005 | 507,486 |
| Land and buildings improvements | 686,332 | 633,344 |
| Machinery and equipment | 3,831,976 | 3,485,774 |
| Vehicles | 105,027 | 99,531 |
| Construction in progress | 218,827 | 168,717 |
| Leased assets | 21,819 | 4,760 |
| Other | 7,011 | 6,099 |
| | 5,456,439 | 4,938,555 |
| Accumulated depreciation | (4,175,607) | (3,770,841) |
| | **1,280,832** | **1,167,714** |

According to US GAAP, the Group's property, plant and equipment should be reported at their actual historical depreciated cost. However, due to the absence of reliable US GAAP accounting records and impairment calculations, the book value of certain property, plant and equipment was determined with the assistance of an independent appraiser, which management considers provided the best basis for initial recognition and depreciation of such items. The appraiser provided US dollar estimates of historical cost and depreciated historical cost which the Group has applied to its property, plant and equipment balance as of January 1, 2000. As of December 31, 2003 and 2002, the net book value of this property, plant and equipment was $649,000 and $760,000, respectively.

*(thousands of US dollars)*

## 10 ACCOUNTS PAYABLE AND OTHER LIABILITIES

| | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|
| Trade accounts payable | 65,606 | 36,727 |
| Advances received | 81,447 | 52,917 |
| Customers' deposits in the subsidiary bank | 60,559 | 17,912 |
| Taxes payable other than income tax | 6,166 | 15,933 |
| Accrued liabilities | 7,339 | 2,492 |
| Accounts payable to employees | 26,017 | 18,441 |
| Other accounts payable | 6,605 | 7,337 |
| | **253,739** | **151,759** |

## 11 STOCKHOLDERS' EQUITY

### (a) Stock

As of December 31, 2003 and 2002, the Parent Company's share capital consisted of 5,987,240 issued common shares with par value of 1 Russian ruble. For each common share held, the stockholder has the right to one vote at the annual stockholders' meeting.

### (b) Dividends

Dividends are paid on common stock at the recommendation of the Board of Directors and approval at the annual stockholders' meeting, subject to certain limitations as determined by Russian legislation. Profits available for distribution to stockholders in respect of any reporting period are determined by reference to the statutory financial statements of the Parent Company. At December 31, 2003 and 2002 the retained earnings, in accordance with the legislative requirements of the Russian Federation, available for distribution amounted to $1,855,959 and $1,078,193, respectively, converted into US dollars using exchange rate at December 31, 2003 and 2002, respectively. The Parent Company paid dividends of 312.5 Russian rubles per share based on the results for 2002 for a total of $61,675. No dividends on common stock were declared or paid in 2002.

## 12 COST OF SALES

| | For the year ended December 31, 2003 | For the year ended December 31, 2002 |
|---|---|---|
| Production cost | 1,293,330 | 950,058 |
| Depreciation and amortization | 157,809 | 146,327 |
| | **1,451,139** | **1,096,385** |

*(thousands of US dollars)*

## 13 SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

| | For the year ended December 31, 2003 | For the year ended December 31, 2002 |
|---|---|---|
| Taxes other than income tax | 24,325 | 33,632 |
| Selling expenses | 40,760 | 32,072 |
| Employee costs | 23,611 | 13,638 |
| Net movement in the allowance for doubtful debts and loans | 3,134 | (1,747) |
| Other expenses | 33,878 | 25,764 |
| | **125,708** | **103,359** |

## 14 INCOME TAX

| | For the year ended December 31, 2003 | For the year ended December 31, 2002 |
|---|---|---|
| Current tax expense | 236,533 | 133,956 |
| Deferred tax benefit: | | |
| origination and reversal of temporary differences | (13,498) | (8,271) |
| foreign exchange differences | - | (976) |
| change in tax loss carryforwards | - | 4,990 |
| | (13,498) | (4,257) |
| **Total income tax expense** | **223,035** | **129,699** |

The corporate income tax rate in Russia applicable to the Group was 24% in 2003 and 2002.

Operating income before tax is reconciled to income tax expense as follows:

| | For the year ended December 31, 2003 | For the year ended December 31, 2002 |
|---|---|---|
| Profit before tax | 881,734 | 466,874 |
| Income tax at applicable tax rate | 211,616 | 112,050 |
| Increase in income tax resulting from: | | |
| non-deductible expenses and non-taxable income | 11,419 | 17,649 |
| **Total income tax expense** | **223,035** | **129,699** |

*(thousands of US dollars)*

## 14 INCOME TAX (continued)

The tax effects of temporary differences that give rise to the deferred tax assets and deferred tax liabilities are presented below:

| | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|
| *Deferred tax assets* | | |
| Accounts payable and other liabilities | 8,659 | 3,158 |
| Non-current liabilities | 2,455 | 541 |
| Accounts receivable | 1,572 | 2,573 |
| Investments | - | 5,332 |
| Other | - | 3 |
| Allowance | - | (1 830) |
| | 12,686 | 9,777 |
| *Deferred tax liabilities* | | |
| Property, plant and equipment | (160,021) | (18,602) |
| Inventories | (11,145) | (6,696) |
| Investments | (385) | - |
| Other | (851) | (2) |
| | (172,402) | (25,300) |
| **Total deferred tax liability** | **(159,716)** | **(15,523)** |

Deferred tax assets have not been recognized in respect of the temporary differences, where it is not probable that future taxable profit will be available and therefore realization of these tax assets is doubtful.

The deferred tax effect of establishing a new functional currency basis (Note 2(b)) is recorded within the cumulative translation adjustment directly in other comprehensive income.

## 15 EARNINGS PER SHARE

Basic net income per share of common stock is calculated by dividing net income by the weighted average number of shares of common stock outstanding during the reporting period.

Calculation of diluted net income per share of common stock takes into account the effect of additional liabilities, such as convertible preferred stock, considered to be potentially dilutive.

| | Income for the year ended December 31, 2003 | Shares in 2003 | Income for the year ended December 31, 2002 | Shares in 2002 |
|---|---|---|---|---|
| Net income | 656,456 | 5,987,240 | 338,418 | 5,985,657 |
| Preferred stock dividends | - | | - | |
| **Net income and shares** | **656,456** | **5,987,240** | **338,418** | **5,985,657** |
| **Basic and diluted net income per share ($)** | **109.64** | | **56.54** | |

*(thousands of US dollars)*

## 16 NON-CASH TRANSACTIONS

Approximately $3,000 and $2,000 of the Group's 2003 and 2002 revenues, respectively, were settled in the form of mutual offset, i.e. amounts receivable for goods dispatched were offset against the liability to pay for raw materials supplied.

Prices for goods sold and purchased through non-cash settlement arrangements are fixed in the respective contracts and generally reflect current market prices.

In 2003 and 2002, the Group acquired equipment and vehicles under capital lease arrangements with the right to buy out leased assets upon completion of the underlying agreements. The cost of property, plant and equipment obtained during the years ended December 31, 2003 and 2002, was $17,059 and $4,760, respectively (Note 18).

## 17 FAIR VALUE OF FINANCIAL INSTRUMENTS

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties.

Management believes, that the carrying amounts of financial assets and liabilities approximate to a reasonable estimate of their fair value.

The fair values of available-for-sale securities are based on quoted market prices for these or similar instruments.

## 18 LIABILITIES UNDER CAPITAL AND OPERATIONAL LEASES

| | **Capital leases** |
|---|---|
| *Future minimum lease payments* | |
| 2004 | 9,111 |
| 2005 | 6,470 |
| 2006 | 4,011 |
| 2007 | 2,652 |
| 2008 | 1,723 |
| Remainder | 1,128 |
| **Total minimum lease payments** | **25,095** |
| Less: amount representing estimated executory costs (including taxed payable by the lessor) and profit thereon, included in total minimum lease payments | (931) |
| **Net lease payments** | **24,164** |
| Less: amount representing interest | (6,487) |
| **Present value of minimum lease payments** | **17,677** |
| Less: short-term capital lease liability | (6,114) |
| **Long-term capital lease liability** | **11,563** |

The discount rate used for calculation of the present value of net minimum lease payments was 14% for assets received in 2003 and 19% for the assets received in 2002.

*(thousands of US dollars)*

## 18 LIABILITIES UNDER CAPITAL AND OPERATIONAL LEASES (continued)

Capital lease charges of $3,405 and $909 were recorded in the consolidated statement of income for the years ended December 31, 2003 and 2002, respectively.

At December 31, 2003 and 2002, net book value of the machinery, equipment and vehicles obtained under the capital lease arrangements was:

| | As at December 31, 2003 | As at December 31, 2002 |
|---|---|---|
| Machinery and equipment | 4,620 | 1,858 |
| Vehicles | 17,199 | 2,902 |
| | 21,819 | 4,760 |
| Accumulated depreciation | (1,067) | (160) |
| **Net value of property, plant and equipment obtained under capital lease arrangements** | **20,752** | **4,600** |

The Group has also incurred expenses in respect of operational leases of $6,701 and $6,626 in 2003 and 2002, respectively.

## 19 RISKS AND UNCERTAINTIES

### (a) Operating environment of the Group

The Russian Federation economy continues to display some characteristics of an emerging market. These characteristics include, but are not limited to, the existence of a currency that is not freely convertible in most countries outside of the Russian Federation, restrictive currency controls, and relatively high inflation. The tax, currency and customs legislation within the Russian Federation is subject to varying interpretations, and changes, which can occur frequently.

Whilst there have been improvements in the economic trends, the future economic direction of the Russian Federation is largely dependent upon the effectiveness of economic, financial and monetary measures undertaken by the Government, together with tax, legal, regulatory, and political developments.

### (b) Convertibility of Russian ruble

Exchange restrictions and controls exist relating to converting Russian rubles into other currencies. At present, the Russian ruble is not a convertible currency outside of the Russian Federation and, further, the Group is required to convert 25% of its hard currency earnings into Russian rubles. Future movements in the exchange rate between the Russian ruble and the US dollar will affect the carrying value of the Group's Russian ruble denominated monetary assets and liabilities. Such movements may also affect the Group's ability to realize non-monetary assets presented in US dollars in these consolidated financial statements. Accordingly, any translation of ruble amounts to US dollars should not be construed as a representation that such ruble amounts have been, could be, or will in the future be converted into US dollars at the exchange rate shown or at any other exchange rate.

## 19 RISKS AND UNCERTAINTIES (continued)

### (c) Commercial risks

The Group minimizes its sales risks by having a wide range of geographical zones for sales, which allows the Group to respond quickly to unexpected changes in the situation on one or more sales markets. The Group uses executive analysis of the existing and prospective markets.

The Group's exports in monetary terms in 2003 were 58% (2002: 61%) of the total metal products sales.

The Group's major export markets are Asia and Oceania – 35% (2002: 32%), the European Union – 28% (2002: 26%), Middle East countries including Turkey – 25% (2002: 17%) and North America – 3% (2002: 14%). The Group relies on export sales to generate foreign currency earnings. As the Group exports the significant portion of its production, it is exposed to foreign currency risk as well as global economic and political risks.

The Group has three international traders that account for the majority of its export sales. In 2003, Steelco Mediterranean Ltd., Tuscany Intertrade (UK), and Moorfield Commodities Company purchased 45%, 33% and 9% of the Group's export sales, respectively (in 2002, these companies purchased 25%, 55% and 11% of the Group's export sales, respectively). These companies were indirect shareholders of the Parent Company during the reporting period. The maximum shareholdings during 2003 were 7.59%, 9.99% and 7.59%, and at the year end were 4.16%, 4.11% and 4.16%, respectively. Price fluctuations of sales to these companies are in line with global prices fluctuations. The Group's export prices are comparable to the prices of Russian competitors.

LLC Insaur-Stal accounted for in excess of 10% of the Group's 2003 and 2002 domestic sales (in monetary terms). No other individual customer accounted for in excess of 10% of the Group's export or domestic sales during 2003 or 2002.

The price at which the Group can sell metal products is one of the primary drivers of the Group's revenue. The Group's prices are largely determined by prices set in the international metal trading market. International prices for products which the Group sells have been increasing during the two years ended December 31, 2003. The Group's future profitability and overall performance is strongly effected by the prices of metal products that are set in the international metal trading market.

## 20 RELATED PARTY TRANSACTIONS

Balances as at December 31, 2003 and 2002 and transactions for the years ended December 31, 2003 and 2002 with related parties of the Group consist of the following:

### (a) Sales to and purchases from related parties

***Sales***

Sales to a related party controlled by the Group's management were $25,303 and $12,821 for the years ended December 31, 2003 and 2002, respectively. Related accounts receivable equaled $527 and $898 as at December 31, 2003 and 2002, respectively.

***Purchases***

Purchases of raw materials, energy and transport services from the related parties controlled by the Group's management were $140,729 and $46,003 for the years ended December 31, 2003 and 2002, respectively. Accounts payable to the related parties were $7,689 and $5,362 as at December 31, 2003 and 2002, respectively.

### (b) Financial transactions

The subsidiary bank of the Group had short-term loans receivable from a related party controlled by the Group's management of $1,008 and $1,311 as at December 31, 2003 and 2002, respectively.

## 20 RELATED PARTY TRANSACTIONS (continued)

### (c) Contributions to non-governmental pension fund

Total contributions to a non-governmental pension fund amounted to $2,216 and $1,876 in 2003 and 2002, respectively. The Group has the right to appoint and dismiss a top manager of the fund as the major contributor to its charter capital. The Group has no long-term commitments to provide funding, guarantees, or other support to the fund.

## 21 COMMITMENTS AND CONTINGENCIES

### (a) Anti-dumping investigations

The Group's export trading activities are subject to from time to time compliance reviews of importers' regulatory authorities. The Group's export sales were considered within several anti-dumping investigation frameworks. The Group takes steps to address negative effects of the current and potential anti-dumping investigations and participates in the settlement efforts coordinated through the Russian authorities.

No provision arising from any possible agreements as a result of anti-dumping investigations has been made in the accompanying consolidated financial statements.

### (b) Litigation

The Group, in the ordinary course of business, is the subject of, or party to, various pending or threatened legal actions. The management of the Group believes that any ultimate liability resulting from these legal actions will not significantly affect its financial position or results of operations, and no amount has been accrued in the consolidated financial statements.

### (c) Environmental matters

The enforcement of environmental regulation in Russian Federation is evolving and the enforcement posture of government authorities is continually being reconsidered. The Group periodically evaluates its obligations under environmental regulations. As obligations are determined, they are recognised immediately. Potential liabilities, which might arise as a result of changes in existing regulations, civil litigation or legislation, cannot be estimated but could be material. In the current enforcement climate under existing legislation, management believes that the Group has met the Government's federal and regional requirements concerning environmental matters, therefore there are no significant liabilities for environmental damage or remediation.

The Parent Company was subject to an environmental audit performed by the Natural Resource Committee of Lipetsk Region in 2001. As a result, the Parent Company has committed itself to carrying out certain environmental activities in the period from 2002 to 2005. The Parent Company also acquires assets to decrease environmental pollution within the Technical Re-equipment and Development Program (Note 21(e)).

### (d) Insurance

The Russian insurance market is in a developing stage and some forms of insurance protection common in other parts of the world are not yet generally available in the Russian Federation.

The Group has entered into insurance contracts to insure property, plant and equipment, land transport; an aircraft and purchased accident and health insurance, inter-city motor vehicle passenger insurance and medical insurance for employees. Furthermore, the Group has purchased operating entities civil liability coverage for dangerous production units.

Management believes that the Group is insured against adverse effect that unfavorable developments may have on the Group's operating activities.

## 21 COMMITMENTS AND CONTINGENCIES (continued)

### (e) Capital, sale and purchase commitments

In the normal course of business the Group enters into long-term purchase contracts for raw materials and long-term sale contracts. These contracts allow for variations in the quantities and types of goods, as well as for periodic adjustments in prices dependent on prevalent market conditions.

To minimize financial losses resulting from disruption of supplies, the Group creates stocks of inventories and maintains relations with reliable suppliers only that ensures sustainability of shipments and proper quality of raw material purchases.

The Parent Company has been carrying out a Technical Re-equipment and Development Program since 2000. According to this Program, the projected investments from 2004 to 2005 in assets for the main production and environmental programs amount to approximately $460,000.

Management estimates the outstanding agreements in connection with equipment supply and construction works amounted to $ 6,000 and in connection with purchase of materials amounted to $ 26,000 at December 31, 2003.

### (f) Social commitments

The Group makes contributions to mandatory and voluntary social programs. The Group's social assets, as well as local social programs, benefit the community at large and are not normally restricted to the Group's employees. The Group has transferred certain social operations and assets to local authorities, however, management expects that the Group will continue to fund certain social programs through the foreseeable future. These costs are recorded in the year they are incurred.

### (g) Tax contingencies

Russian tax, currency and customs legislation is subject to varying interpretations, and changes, which can occur frequently. Management's interpretation of such legislation as applied to the transactions and activity of the Group may be challenged by the relevant regional and federal authorities. Recent events within the Russian Federation suggest that the tax authorities may be taking a more assertive position in their interpretation of the legislation and assessments. As a result, significant additional taxes, penalties and interest may be assessed. Fiscal periods remain open to review by the authorities in respect of taxes for three calendar years preceding the year of review. Under certain circumstances reviews may cover longer periods.

As at December 31, 2003 and 2002 management believes that its interpretation of the relevant legislation is appropriate and the Group's tax, currency and customs positions will be sustained. Where management believes it is probable that a position cannot be sustained, an appropriate amount has been accrued for in these financial statements.

### (h) Financial guarantees

As of December 31, 2003 and 2002, the Group had issued guarantees to third parties amounting to $38,980 and $7,649, respectively, in respect of borrowings from non-group companies. No amount has been accrued in the consolidated financial statements for the Group's obligation under these guarantees as the projected outflows from such guarantees will be immaterial.

## 22 SUBSEQUENT EVENTS

In February 2004, the Parent Company reached the decision to increase its share capital by cumulative retained earnings through an additional issue of 5,987,240,000 common stock with a par value of one Russian ruble each. These shares will be distributed to all existing shareholders of the Parent Company in proportion to their interest held at the date of additional shares distribution. One share held makes the shareholder eligible to 1,000 additional shares. At the date of these consolidated financial statements, the aforementioned decision was registered with the relevant governmental authorities, the distribution was pending. Share capital and earnings per share data for 2003 and 2002 has not been restated to reflect this share distribution (Note 15).

In March 2004 the Group acquired 59.8% of OJSC Stoilensky GOK for a consideration of $510,000. The transaction was carried out through three companies which were shareholders of the Parent Company at the date of the transaction. Management believes that the transaction was at a price close to a fair value. The agreement contains no future contingent payments or commitments.

This transaction was consummated to acquire one of the largest iron-ore concentrate and agglomerated ore producers in Russia in order to secure long-term supplies of raw materials for the Group. This entity will be consolidated for the first time as of the effective date of obtaining control which management considers to be March 2004.

The Board of Directors of the Parent Company proposed dividends for the year ended December 31, 2003 in the total amount of Russian rubles 3,622,906 thousand ($123,000 at the exchange rate as of December 31, 2003). The final amount of dividends is subject to the approval by the annual General Shareholders' Meeting.