

OPEN JOINT STOCK COMPANY VSMPO

CONSOLIDATED FINANCIAL STATEMENTS

**PREPARED IN ACCORDANCE WITH ACCOUNTING PRINCIPLES
GENERALLY ACCEPTED IN THE UNITED STATES OF AMERICA**

**AS AT AND FOR THE YEARS ENDED
DECEMBER 31, 2004 AND 2003**

(WITH REPORT OF INDEPENDENT AUDITORS)

CONTENTS**PAGES**

| | |
|--|------|
| Report of Independent Auditors | - |
| Consolidated Balance Sheets | 4 |
| Consolidated Statements of Income and Comprehensive Income | 5 |
| Consolidated Statements of Cash Flows | 6 |
| Consolidated Statements of Changes in Shareholders' Equity | 7 |
| Notes to the Consolidated Financial Statements | 8-27 |

REPORT OF INDEPENDENT AUDITORS

To the Board of Directors of Open Joint Stock Company VSMPO

We have audited the accompanying consolidated balance sheets of Open Joint Stock Company VSMPO (the "Company") and its subsidiaries (collectively the "Group") as of December 31, 2004 and 2003, and the related consolidated statements of income and comprehensive income, of cash flows and changes in shareholders' equity for the years then ended. These consolidated financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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 statements presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Group as of December 31, 2004 and 2003 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

ZAO PricewaterhouseCoopers Audit

Moscow, Russian Federation
February 28, 2006

VSMPO
Consolidated Balance Sheets
(in thousands of US\$)

| | Notes | December 31, 2004 | December 31, 2003 |
|---|-------|----------------------|----------------------|
| ASSETS | | | |
| Current assets | | | |
| Cash and cash equivalents | 5 | 37,478 | 16,452 |
| Restricted cash | 5 | 2,400 | 5,200 |
| Short-term investments | | 601 | 2 |
| Short-term loans - related parties | 20 | 2,248 | - |
| Trade accounts receivable, net of provision of US\$ 841 (December 31, 2003: US\$ 1,028) | | 73,051 | 69,929 |
| Trade accounts receivable – related parties | 20 | 9,854 | 3,758 |
| Advances, net of provision of US\$ 330 (December 31, 2003: US\$ 721) | | 23,947 | 11,220 |
| Taxes and other receivables | 7 | 59,591 | 43,810 |
| Inventories, net | 8 | 215,957 | 157,302 |
| Other current assets | | 8,680 | 4,381 |
| Total current assets | | 433,807 | 312,054 |
| Non – current assets | | | |
| Property, plant and equipment, net | 9 | 272,485 | 261,327 |
| Investments | 6 | 4,078 | 540 |
| Loans to related parties | 20 | - | 32,771 |
| Other non-current receivables - related parties | 20 | 2,089 | - |
| Other non-current assets | | 995 | 1,000 |
| Total non-current assets | | 279,647 | 295,638 |
| Assets held for sale | 4 | 30,930 | - |
| Total assets | | 744,384 | 607,692 |
| LIABILITIES, SHAREHOLDERS' EQUITY AND MINORITY INTERESTS | | | |
| Current liabilities | | | |
| Borrowings from third parties | 10 | (88,957) | (89,527) |
| Trade accounts payable | | (48,500) | (20,103) |
| Trade accounts payable – related parties | 20 | (103) | - |
| Income and other taxes payable | 11 | (16,416) | (6,300) |
| Restructured taxes, current portion | 13 | (744) | (483) |
| Other current liabilities | 12 | (27,755) | (22,947) |
| Other current liabilities – related parties | 20 | (5,643) | - |
| Accrued pension cost | 14 | (1,602) | (645) |
| Dividends payable | 16 | (25) | - |
| Deferred income taxes | 15 | (14,449) | (16,130) |
| Total current liabilities | | (204,194) | (156,135) |
| Non-current liabilities | | | |
| Long-term borrowings from third parties | 10 | - | (925) |
| Long-term borrowings from related parties | 20 | (1,316) | - |
| Restructured taxes | 13 | (9,497) | (9,661) |
| Accrued pension cost | 14 | (14,399) | (13,127) |
| Deferred revenue | | (166) | (32) |
| Deferred income taxes | 15 | (21,411) | (22,013) |
| Total non-current liabilities | | (46,789) | (45,758) |
| Liabilities of operations held for sale | 4 | (358) | - |
| Total liabilities | | (251,341) | (201,893) |
| Minority interests | 18 | (52,058) | (35,523) |
| Commitments and contingencies | 22 | - | - |
| Shareholders' equity | | | |
| Share capital | 16 | (5,118) | (5,118) |
| Capital surplus | 16 | (4,014) | (3,596) |
| Treasury stock | 16 | 74 | - |
| Receivable for treasury stock | 16 | - | 2,641 |
| Net unrealized gain on a change in valuation of investments | | (480) | - |
| Cumulative translation adjustment | | (26,024) | (5,101) |
| Accumulated other comprehensive income | | (26,504) | (5,101) |
| Retained earnings | | (405,423) | (359,102) |
| Total shareholders' equity | | (440,985) | (370,276) |
| Total liabilities, shareholders' equity and minority interests | | (744,384) | (607,692) |

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

VSMPO
Consolidated Statements of Income and Comprehensive Income
(in thousands of US\$)

| | Notes | Year ended December 31, 2004 | Year ended December 31, 2003 |
|---|-------|------------------------------------|------------------------------------|
| Sales revenue | | | |
| Sales of titanium products | | 347,064 | 265,795 |
| Sales of titanium products - related parties | 20 | 33,314 | 3,320 |
| Sales of aluminium products | | 19,983 | 23,304 |
| Sales of magnesium and alloys | | 51,690 | 52,695 |
| Sales of ferrotitanium | | 17,575 | 11,931 |
| Other revenue | | 53,102 | 44,726 |
| Total revenue | | 522,728 | 401,771 |
| Production costs | | | |
| Materials and components used | | (137,787) | (93,380) |
| Repairs and maintenance expense | | (16,641) | (9,061) |
| Personnel costs | | (68,832) | (53,850) |
| Utilities | | (64,953) | (52,353) |
| Depreciation | | (21,302) | (18,310) |
| Other production costs | | (7,579) | (8,380) |
| Production costs | | (317,094) | (235,334) |
| Gross profit | | 205,634 | 166,437 |
| Operating costs | | | |
| Taxes other than on income | | (6,247) | (6,067) |
| Provision for taxes | | (3,868) | (1,089) |
| Selling, general and administrative expenses | 17 | (84,204) | (75,619) |
| Consulting expenses - related parties | 20 | (5,643) | - |
| Commission expenses - related parties | 20 | (872) | (25) |
| Social expenses | | (11,813) | (10,287) |
| Loss on disposal of interest in subsidiary | 18 | (4,771) | (252) |
| (Loss)/gain from investments | | (255) | 577 |
| Share in earnings/(loss) of joint venture | 6 | 2,861 | (210) |
| Other expenses | | (166) | (903) |
| Operating costs | | (114,978) | (93,875) |
| Operating income | | 90,656 | 72,562 |
| Income before income taxes and minority interest | | | |
| Interest expense | | (3,211) | (3,858) |
| Foreign exchange loss | | (1,845) | (3,265) |
| Income before income taxes and minority interest | | 85,600 | 65,439 |
| Income before minority interest | | | |
| Income tax | 15 | (27,662) | (21,007) |
| Income before minority interest | | 57,938 | 44,432 |
| Net income | | | |
| Minority interest | 18 | (7,651) | (642) |
| Net income | | 50,287 | 43,790 |
| Other comprehensive income, net of tax: | | | |
| Deferred income tax effect of the change in functional currency | 2 | - | (19,875) |
| Net unrealized gain on a change in valuation of investments | | 480 | - |
| Translation adjustment | | 20,923 | 24,976 |
| Comprehensive income | | 71,690 | 48,891 |

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

VSMPO
Consolidated Statements of Cash Flows
(in thousands of US\$)

| | Notes | Year ended December 31, 2004 | Year ended December 31, 2003 |
|--|-------|------------------------------------|------------------------------------|
| Net income | | 50,287 | 43,790 |
| Adjustments to reconcile net income to net cash generated by operating activities: | | | |
| Depreciation | | 21,734 | 18,468 |
| Loss on disposal of property, plant and equipment | | 455 | - |
| Loss on disposal of interest in subsidiary | | 4,771 | 252 |
| Share in earnings of joint venture | 6 | (2,861) | 210 |
| Change in deferred income taxes | 15 | (4,825) | 1,559 |
| Foreign exchange differences on non-operating balances | | 1,150 | (4,541) |
| Bad Debts | 17 | 179 | 1,344 |
| Inventory provisions | 17 | 725 | 6,724 |
| Loss on disposal of long-term promissory notes | | (694) | - |
| Minority interests | | 7,651 | 642 |
| Changes in operating assets and liabilities, excluding cash and debt: | | 78,572 | 68,448 |
| Trade accounts receivable | | (5,112) | (29,786) |
| Advances | | (11,175) | 4,556 |
| Taxes and other receivables | | (11,506) | (15,293) |
| Inventories | | (49,150) | (16,138) |
| Other current assets | | (574) | (60) |
| Trade accounts payable and accrued expenses | | 26,654 | 7,760 |
| Income and other taxes payable | | 3,005 | 1,842 |
| Repayment of restructured tax liabilities | | (507) | (386) |
| Other current liabilities | | 8,677 | 4,894 |
| Accrued pension cost | | 1,530 | 1,355 |
| Cash generated by operating activities | | 40,414 | 27,192 |
| Investing activities | | | |
| Capital expenditures | | (50,138) | (41,280) |
| Loans advanced to related parties | | (2,051) | (11,051) |
| Loans repaid by related parties | | 33,504 | 101 |
| Loans advanced to third parties | | (601) | 128 |
| Disposal of a share in subsidiary | | 3,744 | 724 |
| Purchase of additional share in subsidiary | | (526) | (3,832) |
| Acquisition of subsidiary | 4 | - | (27,876) |
| Change in restricted cash balance | | 2,993 | (4,902) |
| Net cash used in investing activities | | (13,075) | (87,988) |
| Financing activities | | | |
| Proceeds from short-term borrowings – third parties | | - | 34,111 |
| Repayment of short-term borrowings – third parties | | (5,921) | - |
| Repayment of short-term borrowings – related parties | | - | (194) |
| Proceeds from long-term borrowings – related parties | | 1,268 | - |
| Repayment of long-term borrowings – third parties | | (250) | - |
| Purchase of treasury stock | | (74) | - |
| Proceeds from sale of treasury stock | | 3,059 | 29,376 |
| Dividends paid to minority shareholders of subsidiary | | (582) | - |
| Dividends paid | 16 | (3,966) | - |
| Net cash generated (used) by (in) financing activities | | (6,466) | 63,293 |
| Effect of exchange rate changes on cash and cash equivalents | | 410 | 2,226 |
| Net change in cash and cash equivalents | | 21,283 | 4,723 |
| Cash and cash equivalents at December 31, 2003 (net of restricted cash of US\$ 5,200) and 2002 (net of restricted cash of US\$ 86) | 5 | 16,452 | 11,729 |
| Cash and cash equivalents at December 31, 2004 (net of restricted cash of US\$ 2,400) and 2003 (net of restricted cash of US\$ 5,200) | 5 | 37,735 | 16,452 |
| Supplemental cash flow information: | | | |
| Interest paid | | 4,134 | 4,750 |
| Income taxes paid | | 27,253 | 15,394 |

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

VSMPO
Consolidated Statements of Changes in Shareholders' Equity
(in thousands of US\$)

| | Notes | Share capital | Capital surplus | Treasury stock | Receivable for treasury stock | Cumulative translation adjustment | Net unrealized gain on a change in valuation of investments | Retained earnings | Total shareholders' equity |
|---|-------|---------------|-----------------|----------------|-------------------------------|-----------------------------------|---|-------------------|----------------------------|
| Balance at December 31, 2002 | | (5,118) | - | 24,301 | 4,120 | - | - | (315,312) | (292,009) |
| Net income | | - | - | - | - | - | - | (43,790) | (43,790) |
| Disposal of treasury stock | 16 | - | (3,843) | (24,301) | - | - | - | - | (28,144) |
| Receivable for treasury stock | 16 | - | 247 | - | (1,479) | - | - | - | (1,232) |
| Other comprehensive income: | | | | | | | | | |
| Translation adjustment | 2 | - | - | - | - | (5,101) | - | - | (5,101) |
| Balance at December 31, 2003 | | (5,118) | (3,596) | - | 2,641 | (5,101) | - | (359,102) | (370,276) |
| Net income | | - | - | - | - | - | - | (50,287) | (50,287) |
| Acquired own stock | 16 | - | - | 74 | - | - | - | - | 74 |
| Disposal of treasury stock | 16 | - | (255) | - | - | - | - | - | (255) |
| Receivable for treasury stock | 16 | - | (163) | - | (2,641) | - | - | - | (2,804) |
| Dividends to shareholders | 16 | - | - | - | - | - | - | 3,966 | 3,966 |
| Other comprehensive income: | | | | | | | | | |
| Net unrealized gain on a change in valuation of investments | | - | - | - | - | - | (480) | - | (480) |
| Translation adjustment | | - | - | - | - | (20,923) | - | - | (20,923) |
| Balance at December 31, 2004 | | (5,118) | (4,014) | 74 | - | (26,024) | (480) | (405,423) | (440,985) |

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

1 NATURE OF OPERATIONS

Open joint stock company VSMPO (“VSMPO” or the “Company”) and its subsidiaries (collectively the “Group”) is one of the world’s leading titanium producers. The Company was originally established as a state owned enterprise in 1933 in the Moscow region and re-allocated to Verkhnya Salda (Sverdlovsk region) in 1941. The Company was privatised in the form of a joint stock company in 1993. In 1993 the Company was registered as an open joint stock company in accordance with the Law on Joint Stock Companies of the Russian Federation.

The Company’s main operations are in Verkhnya Salda (Sverdlovsk region) of the Russian Federation and are subject to the legislative requirement of both the Russian Federation and the Sverdlovsk regional authorities. The Company’s main products are titanium melted and mill products and forgings for aerospace, industrial and other applications. It also produces ferrotitanium, aluminium extrusions and specialty steel mill products and forgings. These products are sold both in the Russian Federation and abroad.

On July 1, 2005 legal reorganisation of VSMPO and Open joint stock company Avisma (“Avisma”), its subsidiary and Russia’s largest titanium sponge producer, was carried out in the form of the accession of Avisma to VSMPO (Note 23).

Avisma’s main operations are in Berezniki (Perm region) of the Russian Federation and are subject to the legislative requirement of both the Russian Federation and the Perm regional authorities. Avisma’s main products are titanium sponge and primary magnesium. Titanium sponge is further processed by the Group to titanium.

VSMPO and its subsidiaries form a vertically integrated group.

The Group’s other revenue includes sales of steel and other metal products.

2 BASIS OF PREPARATION

The Company and its Russian subsidiaries maintain their accounting records in accordance with the legislative requirements of the Russian Federation. The accompanying 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”).

(a) Functional and reporting currency

The accounting records of the Company and its Russian subsidiaries are maintained in the Russian roubles (“rouble”) and the Company prepares its statutory financial statements and reports in that currency to its stockholders in accordance with the laws of the Russian Federation.

The functional currency of the Company and its Russian subsidiaries is considered to be the rouble. The functional currency of non-Russian subsidiaries is the US Dollar. The accompanying financial statements have been prepared using the US Dollar (“US\$”) as the Group’s reporting currency. The translation into US\$ has been performed in accordance with the provisions of SFAS No. 52, Foreign currency translation.

2 BASIS OF PREPARATION (continued)

(a) *Functional and reporting currency (continued)*

Prior to January 1, 2003, the Russian economy was considered hyperinflationary. In accordance with the relevant SFAS No. 52 requirements applicable to entities operating in hyperinflationary economies, monetary assets and liabilities originally denominated in US\$ were stated at their original US\$ amounts. Monetary assets and liabilities denominated in other currencies were translated into US\$ using the exchange rate ruling at the balance sheet date. Non-monetary assets and liabilities, which were denominated in currencies other than the US\$, were translated into US\$ 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\$, were translated into US\$ 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\$ were reflected in the consolidated statement of income and comprehensive income as foreign currency exchange gains and losses.

The Russian economy ceased to be considered hyperinflationary as of January 1, 2003. Accordingly, all monetary and non-monetary assets and liabilities of the Company as well as the related equity balance were translated into roubles at the current exchange rate prevailing at January 1, 2003. This translation established a new functional currency basis for the Company. For periods subsequent to January 1, 2003, the functional currency financial statements (rouble) are translated into the reporting currency (US\$) utilizing period-end exchange rates for assets and liabilities, period average exchange rates for income statement accounts and historic rates for equity accounts in accordance with the relevant provisions of SFAS No. 52. Translation gains and losses, net of applicable tax, are recorded as a separate component of other comprehensive income directly in shareholders' equity. The deferred income tax charge of US\$ 19,875 resulting from the change in the functional currency at the time when the economy ceased to be considered hyperinflationary was also recorded directly in shareholders' equity as at January 1, 2003, as an adjustment to the cumulative translation adjustment component of other comprehensive income.

The Central Bank of the Russian Federation's closing rates of exchange at December 31, 2004 and 2003 were US\$1 to 27.75 roubles and US\$1 to 29.45 roubles, respectively. The annual weighted average exchange rates were 28.81 and 30.69 roubles to US\$1 for each of the years ended December 31, 2004 and 2003. Prior to 1992, the State set the official exchange rate for the rouble. The rouble exchange rate in those periods may differ from rates that might have existed under market conditions. For the purposes of translating fixed assets acquired prior to 1992 into US\$, the Company has used the historic exchange rate of US\$ 1 to 110 roubles prior to denomination (US\$ 1 to 0.11 roubles after denomination).

Exchange restrictions and controls exist relating to converting the rouble into other currencies. At present the rouble is not convertible outside of the Russian Federation. The Group companies registered in the Russian Federation were required to convert 25% of foreign currency revenues into the local currency prior to 2005 and starting 2005 – 10% of their foreign currency revenues. Future movements in the exchange rates between the rouble and US\$ will affect the carrying value of the Group's rouble denominated monetary assets and liabilities. Such movements may also affect the Group's ability to realise non-monetary assets presented in US\$ in these consolidated financial statements. Accordingly, any translation of rouble amounts to US\$ should not be construed as a representation that such amounts, have been, could be, or will in the future be converted into US\$ at the exchange rate as of the balance sheet dates or at any other exchange rate.

(b) *Principles of consolidation*

These 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 from one reporting period to another with the exception of newly adopted accounting pronouncements.

(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 contingent liabilities, allowances for doubtful accounts; employee compensation programs; depreciation and amortization of property, plant and equipment and intangible assets; impairment of long-lived assets; asset retirement obligations; inventory values; valuations of investments and determining when investment impairments are other than temporary; assets and liabilities assumed in a purchase business combinations and deferred taxes, including 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.

(b) Cash and cash equivalents

Cash and cash equivalents comprise cash balances, cash on current accounts with banks, bank deposits and other highly liquid investments with original maturity of 90 days or less, that are readily convertible to known amount of cash.

(c) Restricted cash

Restricted cash comprise funds legally or contractually restricted as to withdrawal.

(d) Accounts receivable

Accounts receivable are stated at cost less an allowance for doubtful debts. Management quantifies this allowance, based on current information regarding the collectibility of the receivable. Amounts previously written off which are subsequently collected are recognized as income.

(e) Value added taxes

Value added taxes (VAT) related to sales and services rendered are payable to the tax authorities upon the collection of receivables from customers. Input VAT is reclaimable against sales VAT upon payment for purchases. The input VAT paid in respect of capital expenditures is reclaimable upon the commissioning of the respective capital assets into operations. 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 recognized in the balance sheet on a gross basis and disclosed separately as a current asset and liability. Where an allowance has been made for doubtful debts, a loss is recorded for the gross amount of the debtor, including VAT. The related VAT liability is maintained until the debtor is written off for tax purposes.

(f) Inventories

Inventories are carried at the lower of acquisition cost 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.

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(g) Investments in marketable debt and equity securities

Marketable debt and equity securities consist of investments in all corporate debt securities and those equity securities which have determinable fair values and 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 and comprehensive income.

Held-to-maturity securities

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

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

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.

(h) 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 to exist.

Investments in non-marketable equity 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 other than temporary diminution in value. Provisions are recorded for the investments in securities of the companies which are experiencing significant financial difficulties for which recovery is not expected within a reasonable period in the future, or under bankruptcy proceedings.

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(i) Property, plant and equipment

Property, plant and equipment are stated at acquisition cost less accumulated depreciation and impairment, if any. Assets under construction and equipment awaiting installation are included in property, plant and equipment, accounted for at cost and are not depreciated until commissioned into operation.

Subsequent expenditures

Expenditures incurred to replace a component of an item of property, plant and equipment that is accounted for separately, are capitalized. 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 and comprehensive income as incurred.

Capitalized interest

Interest is capitalized in connection with the construction and acquisition of major qualifying assets. 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. Depreciation commences from the time an asset is put into operation. Depreciation is not charged on assets to be disposed or land. The range of estimated useful lives is as follows:

| | |
|-----------------------------|---------------|
| Buildings and constructions | 25 – 40 years |
| Machinery and equipment | 15 years |
| Vehicles | 10 years |
| Transfer devices | 20 years |
| Other | 5 years |

(j) Impairment of long-lived assets

Long-lived assets 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 the asset to the future undiscounted cash flows expected to be generated by the asset. If the carrying amount of the assets is determined to be not recoverable, the impairment to be recognised is measured as the amount by which the carrying amount of the asset exceeds its fair value, generally determined by reference to the discounted future cash flows. Assets held for sale that meet certain criteria are measured at the lower of their carrying account or fair value less cost to sell.

(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 Group also maintains a non-contributory defined benefit plan for its full-time employees. The pensions earned as well as the interest on the projected benefit obligations are accrued in accordance with FAS 87 "Employers' Accounting for Pensions".

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(l) Income Taxes

Deferred income tax assets and liabilities are recognised for the future tax consequences attributable to differences between the financial statements' carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in the years in which these temporary differences are expected to reverse. The Group provides valuation allowances for deferred tax assets for which it does not consider realisation of such assets to be more likely than not.

(m) Asset retirement obligations

A liability for an asset retirement obligation is recorded at fair value in the period in which it is incurred. When the liability is initially recorded, a corresponding cost is capitalized 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. The Group bears asset retirement obligations in respect of its main production facilities. These obligations have indeterminate settlement dates since the Group currently plans to operate such assets in perpetuity.

(n) Borrowings

Borrowings are recognized initially at cost, net of any discounts or premiums. Debt issue costs are deferred and amortized over the period of the borrowing as an adjustment to yield using the effective interest rate method. Subsequent to initial recognition, borrowings are stated at amortized cost with any difference between cost and redemption value being recognized in the consolidated statement of income and comprehensive income, as expense over the period of the borrowings using the effective interest method.

(o) 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 has been incurred and the amount of loss can be reasonably estimated.

(p) Segment reporting

The Group conducts its operations within one business segment: Production of titanium sponge and manufacturing of titanium products. This is based on the way management assesses operating performance and makes operating and investing decisions. All the principal production and manufacturing units are located in the Russian Federation.

The Group's exports in monetary terms in 2004 were 72% (2003: 66%) of the total sales.

(q) Dividends

Dividends are recognized as a liability in the period in which they are declared. Dividends on VSMPO's ordinary shares, if declared, will be payable in Russian Roubles.

(r) Revenue recognition

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

(s) Comprehensive income

Comprehensive income includes all changes in equity from non-owner sources.

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(t) Environmental expenditures

Expenditures for current operations are expensed or capitalised, as appropriate. Expenditures relating to existing conditions caused by past operations, and which do not contribute to future revenues, are expensed. Liabilities are recorded when remedial efforts are probable and the costs can be reasonably estimated. The liability may include non discounted costs such as site investigations, consultant fees, feasibility studies, outside contractor and monitoring expenses. Estimates are not reduced by potential claims for recovery unless recovery is probable.

(u) Financial instruments

The fair value of financial instruments is determined with reference to various market information and other valuation methods as considered appropriate. However, considerable judgement is required to interpret market data and to develop estimates of fair value. The carrying values of cash and cash equivalents, trade accounts receivable, trade accounts payable and income and other taxes payable approximate their fair values because of the short maturities of these instruments. Marketable securities are carried at fair values in the consolidated balance sheets. Fair values of long-term borrowings from third parties and restructured taxes approximate their carrying values as these instruments bear interest at rates which are commensurate with market interest rates available for debt with similar characteristics. Management believes that it is not practicable to estimate fair value of related party receivables and payables.

(v) Interest

Interest income is recognised in the consolidated statement of income and comprehensive income as it is earned. All interest and other costs incurred in connection with borrowings are expensed as incurred as part of interest expense, except for interest capitalized as part of the cost of qualifying long-lived assets.

(w) Recent accounting pronouncements

In December 2003, the FASB issued Interpretation No. 46R, Consolidation of Variable Interest Entities, which revised Interpretation No. 46, issued in January 2003. The Interpretation addresses the consolidation of business enterprises (variable interest entities) to which the usual condition of consolidation (ownership of a majority voting interest) does not apply. This Interpretation focuses on financial interests that indicate control. It concludes that in the absence of clear control through voting interests, a company's exposure (variable interest) to the economic risks and potential rewards from the variable interest entity's assets and activities are the best evidence of control. Variable interests are rights and obligations that convey economic gains and losses from changes in the value of the variable interest entity's assets and liabilities. Variable interests may arise from financial instruments, service contracts and other arrangements. If an enterprise holds a majority of the variable interests of an entity, it would be considered the primary beneficiary. The primary beneficiary would be required to include assets, liabilities and the results of operations of the variable interest entity in its financial statements. The Group adopted the Interpretation in 2004. The adoption of FIN 46R did not have a material impact on the Group's consolidated financial statements.

In November 2004, the FASB issued FAS No. 151, Inventory Costs, an Amendment of ARB No. 43, Chapter 4, which is effective for the Group starting January 1, 2006. The standard amends the guidance in Accounting Research Bulletin (ARB) No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and spoilage. In addition, the standard requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The Company is currently evaluating the impact of this standard.

In March 2005, the FASB issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations. The Interpretation requires entities to record a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. The term "conditional asset retirement obligation" refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The Interpretation shall be effective no later than December 31, 2005 and early adoption is encouraged. The Group believes that the adoption of this Interpretation in 2005 will not have a material impact on its consolidated financial statements.

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(x) Reclassifications

Certain amounts in previously issued consolidated financial statements have been reclassified to conform to the current period presentation. Such reclassifications have no effect on net income or shareholders' equity.

4 ASSETS HELD FOR SALE

In December 2003 the Group acquired 50.07% of the shares of Tekhnolog, a company which owns certain vacant properties in Moscow, for US\$ 30,023. The Group acquired this asset primarily for investment purposes. In 2004 certain parties related to the shareholders entered into binding arrangements with the Group to buy out Tekhnolog. In March 2005 the company was sold for a cash consideration of US\$ 30,058 (Note 23). At December 31, 2004 the asset and liabilities relating to Tekhnolog were classified as held for sale in the consolidated balance sheet.

The revenues and pretax income generated by Tekhnolog in 2004 amounted to US\$ 1,594 and US\$ 187, respectively. The major classes of assets and liabilities of operations held for sale in the consolidated balances sheet are as follows:

| | December 31, 2004 |
|--|----------------------|
| Assets: | |
| Receivables | 257 |
| Inventories | 126 |
| Property, plant and equipment | 30,547 |
| Total assets held for sale | 30,930 |
| Liabilities: | |
| Accounts payable | (45) |
| Long-term borrowings | (313) |
| Total liabilities of operations held for sale | (358) |

5 CASH AND CASH EQUIVALENTS

| | December 31, 2004 | December 31, 2003 |
|--|----------------------|----------------------|
| Cash at bank - US\$ | 25,734 | 11,969 |
| Cash at bank - Russian roubles | 5,381 | 1,608 |
| Cash at bank - Euro, Swiss francs, Pound Sterling | 3,341 | 1,508 |
| Cash in hand | 3,179 | 21 |
| Short-term bank deposits | - | 966 |
| Other cash equivalents | 100 | 380 |
| Total cash and cash equivalents, including amounts classified as assets held for sale | 37,735 | 16,452 |
| Cash and cash equivalents presented as assets held for sales (Note 4) | (257) | - |
| Total cash and cash equivalents | 37,478 | 16,452 |
| Restricted cash | 2,400 | 5,200 |

At December 31, 2003 a short-term bank deposit was placed with the International Moscow Bank at 0.2% p.a. with maturity date of January 5, 2004.

Restricted cash as at December 31, 2003 included a deposit of US\$ 5,000 with the International Moscow Bank and of US\$ 200 with Citibank. The Group pledged the deposit of US\$ 5,000 to secure the repayment of a short-term loan obtained by VSMPO Tirus GmbH from Bayerische Hypo- und Vereinsbank AG (Note 10).

5 CASH AND CASH EQUIVALENTS (continued)

At December 31, 2003 VSMPO Tirus US had a letter of credit of US\$ 200 with Citibank, which expired March 31, 2004. The letter of credit was secured by a pledge and assignment of a certificate of deposit with Citibank in the name of VSMPO Tirus US.

Restricted cash as at December 31, 2004 is comprised of certificates of deposit pledged with Citibank as collateral for letters of credit issued in the amounts of US\$ 2,100 and US\$ 300. The letters of credit mature April 29, 2005 and March 31, 2005, respectively.

6 INVESTMENTS

| | December 31, 2004 | December 31, 2003 |
|---------------------------|----------------------|----------------------|
| Joint Venture - Uniti LLC | 3,401 | 540 |
| Other investments | 677 | - |
| Total investments | 4,078 | 540 |

The Group entered into an agreement on April 29, 2003 with Allegheny Technologies Incorporated to form a joint venture to engage in the marketing and sale of titanium products and conversion services. The joint venture is organized in the form of Uniti LLC, a company registered in the United States of America. The Group owns a 50% interest in the joint venture and accounts for this interest under the equity method.

The Group's share in the earnings (loss) of Uniti of US\$ 2,861 and US\$ (210) for the years ended December 31, 2004 and 2003, respectively, reflects the elimination of the Group's share of profits in inventory.

7 TAXES AND OTHER RECEIVABLES

| | December 31, 2004 | December 31, 2003 |
|--|----------------------|----------------------|
| VAT recoverable | 54,131 | 36,918 |
| Prepaid taxes | 747 | 831 |
| Prepaid customs duties | 858 | 1,344 |
| Other non-trade receivables | 3,981 | 4,717 |
| Other non-trade receivables presented as assets held for sale (Note 4) | (126) | - |
| Total taxes and other receivables | 59,591 | 43,810 |

8 INVENTORIES, NET

| | December 31, 2004 | December 31, 2003 |
|----------------------------------|----------------------|----------------------|
| Raw materials | 63,063 | 43,712 |
| Work in progress | 67,058 | 58,991 |
| Finished products | 96,451 | 63,948 |
| Less: Provision for obsolescence | (10,615) | (9,349) |
| Total inventory, net | 215,957 | 157,302 |

Inventory with a carrying value US\$ 24,001 and US\$ 23,124 at December 31, 2004 and 2003, respectively was pledged as collateral for certain borrowings of the Group (Note 10).

9 PROPERTY, PLANT AND EQUIPMENT, NET

| | December 31, 2004 | December 31, 2003 |
|--|----------------------|----------------------|
| Land | 3,575 | 1,254 |
| Buildings & Constructions | 102,856 | 94,654 |
| Machinery & Equipment | 171,765 | 153,768 |
| Vehicles | 6,996 | 11,348 |
| Transfer devices | 19,815 | 18,269 |
| Other | 59,382 | 43,000 |
| Less: accumulated depreciation | (126,496) | (105,532) |
| Net book value | 237,893 | 216,761 |
| Construction in progress | 46,346 | 39,771 |
| Advances for construction | 18,793 | 4,795 |
| Less: Buildings presented as assets held for sale (Note 4) | (30,547) | - |
| Total property, plant and equipment, net | 272,485 | 261,327 |

Fully depreciated facilities comprise US\$ 35,034 at December 31, 2004 and US\$ 33,809 at December 31, 2003. Idle facilities comprise US\$ 122 at December 31, 2004 and US\$ 526 at December 31, 2003.

Carrying and pledge values of property, plant and equipment subject to liens under loan agreements comprise US\$ 52,964 and US\$ 61,916 at December 31, 2004 (US\$ 34,463 and US\$ 47,605 at December 31, 2003) respectively (Note 10).

10 SHORT AND LONG-TERM BORROWINGS

| | Currency | December 31, 2004 | December 31, 2003 |
|---|----------|----------------------|----------------------|
| SHORT-TERM BORROWINGS | | | |
| Bank loans | | | |
| Sberbank; interest from 7.2% to 7.6% (Note a) | (1) | - | 9,020 |
| Sberbank; interest of 7.5% (Note a) | (3) | 13,817 | - |
| Sberbank; interest of 10.0% (Note a) | (2) | 315 | - |
| Vneshtorgbank; interest from 7.0 % to 9.0% (Note b) | (1) | 14,000 | 15,751 |
| International Moscow Bank; interest of LIBOR + from 3.0% to 3.7% (Note c) | (1) | 40,711 | 16,418 |
| Citibank; interest of LIBOR + from 0.65% to 3.5% (Note d) | (1) | 19,760 | 20,000 |
| Credit Lyonnais; interest of LIBOR + from 3.0% (Note e) | (1) | - | 7,112 |
| Bayerische Hypo-und Vereinsbank AG; interest of 4.25% (Note f) | (1) | - | 4,925 |
| International Moscow Bank; interest of LIBOR + 3.4% (Note c) | (1) | - | 15,755 |
| Other | | 354 | 546 |
| Total short-term borrowings from third parties | | 88,957 | 89,527 |
| LONG-TERM BORROWINGS | | | |
| Company loans | | | |
| Promissory notes; non-interest bearing | (2) | - | 679 |
| Other company loans; non-interest bearing | (2) | - | 246 |
| Total long-term borrowings from third parties | | - | 925 |

All interest rates are on a per annum basis.

- (1) US\$ denominated loans;
- (2) Russian rouble denominated loans;
- (3) EURO denominated loans;

Details of significant collateralised loan balances are summarised below:

(a) Sberbank

The loans are collateralised by pledge of inventories (Note 8). In addition, the Group is required to maintain a settlement account with the bank to accumulate cash collections.

10 SHORT AND LONG-TERM BORROWINGS (continued)

(b) Vneshtorgbank

The loans are collateralised by a pledge of inventories (Note 8). In addition, the Group is required to maintain a settlement account with the bank to accumulate cash collections.

The loans contain certain restrictive covenants in relation to the sale of assets, pledges of property, total amount of borrowings, change of controlling shareholders, changes in Group management and other.

(c) International Moscow Bank

The loans are collateralized by the pledge of property, plant and equipment (Note 9) and inventories (Note 8). Under the terms of the agreements the Group is also required to maintain a required level of cash flows through the accounts opened with the bank.

The loans contain certain restrictive covenants in relation to the sale of assets, pledges of property, total amount of borrowings, change of controlling shareholders, changes in Group management and other.

The bank is authorized by the Group to direct debiting of the bank accounts opened by the Group with the bank for the purpose of loan settlement.

(d) Citibank

The Group is required to maintain a settlement account with the bank to accumulate cash collections.

Under the terms of the agreements, the Group is required to comply with a number of restrictive covenants in relation to sale of assets, pledges of property, change of controlling shareholders, total amount of borrowings, related parties' transactions and other.

The loans at December 31, 2004 and 2003 included credit lines opened by VSMPO Tirus US with Citibank in the amount of US\$ 10,000. The amount available under the line terms is equal to the lesser of US\$ 10,000 or the sum of (a) 80% of eligible accounts receivable and (b) the lesser of US\$ 5,000 or 50% of eligible inventory. Monthly interest of LIBOR plus margin of 2.98% and 1.83% (LIBOR plus margin) is payable at December 31, 2004 and 2003 respectively. All the assets of VSMPO Tirus US (including non-current assets of US\$ 4,396 and US\$ 1,417 and current assets of US\$ 51,133 US\$ 45,752 at December 31, 2004 and 2003 respectively, at carrying values) are pledged as collateral for the amounts outstanding and a US\$ 10,000 standby letter of credit issued by the Group. The loans under the line were repaid in full on January 19, 2005 (Note 23).

(e) Credit Lyonnais

Under the terms of the agreements, the Group is required to comply with a number of restrictive covenants in relation to pledges of assets, amount of export revenue and other.

(f) Bayerische Hypo und Vereinsbank AG

The credit line is secured by an International Moscow Bank guarantee. The guarantee is secured by the Group's deposit in the amount of US\$ 5,000 placed with International Moscow Bank (Note 5).

Unused short-term lines of credit comprised US\$ 15,980 and US\$ 3,539 at December 31, 2004 and 2003 respectively.

11 INCOME AND OTHER TAXES PAYABLE

| | December 31, 2004 | December 31, 2003 |
|--|----------------------|----------------------|
| Deferred VAT | 1,523 | 538 |
| Income tax | 7,018 | 1,021 |
| Property tax | 546 | 1,160 |
| Other taxes | 595 | 1,712 |
| Provision for taxes and duties (Note 22) | 6,734 | 1,869 |
| Income and other taxes | 16,416 | 6,300 |

12 OTHER CURRENT LIABILITIES

| | December 31, 2004 | December 31, 2003 |
|--|----------------------|----------------------|
| Advances received | 14,082 | 9,143 |
| Payroll and social tax payable | 8,735 | 7,500 |
| Promissory notes | 288 | - |
| Antidumping duties (Note 22) | 920 | - |
| Other payables | 3,775 | 6,304 |
| Other payables presented as liabilities of operations held for sale (Note 4) | (45) | - |
| Total other current liabilities | 27,755 | 22,947 |

13 RESTRUCTURED TAXES

Prior to January 1, 2002 the Company had been granted a 10-year restructuring of its tax liability (including fines and delayed interest) from the tax authorities. The restructured tax liability (excluding fines and delayed interest) bears interest of 5.5% p.a. The tax liability shall be settled by equal quarterly instalments by December 31, 2011.

The Company's entitlement to tax restructuring is conditional on timely payment of both the current and restructured taxes (inclusive of interest). In 2004 the Company paid US\$ 507 of restructured taxes. If the tax liability is settled ahead of schedule, the Company receives a right to partial or full forgiveness of the related fines and delayed interest.

14 PENSION OBLIGATIONS

VSMPO and its subsidiary – Avisma have pension plans which are unfunded and non-contributory arrangements. The plans were created during the 1990s recognizing service accrued before those dates. At December 31, 2004 there were 22,700 (December 31, 2003: 22,296) active members and 10,815 (December 31, 2003: 10,842) pensioners. No plan assets are maintained.

An actuarial valuation of the pension plans was performed at December 31, 2001 and was rolled forward to December 31, 2003 and December 31, 2004. The valuation was performed using the Projected Unit Method with a discount rate of 9.18% (2003: 9.18%).

| | December 31, 2004 | December 31, 2003 |
|---------------------------------|----------------------|----------------------|
| Pension obligations | | |
| Employees | 16,721 | 8,080 |
| Pensioners | 7,352 | 5,975 |
| | 24,073 | 14,055 |
| Funded status | | |
| Projected benefits obligations | 24,073 | 14,055 |
| Funded status | 24,073 | 14,055 |
| Unrecognized actuarial loss | (1,081) | (306) |
| Unrecognized prior service cost | (6,991) | - |
| Translation adjustment | - | 23 |
| Accrued pension costs | 16,001 | 13,772 |

| | December 31, 2004 | December 31, 2003 |
|-----------------------------------|----------------------|----------------------|
| Current accrued pension cost | 1,602 | 645 |
| Non-current accrued pension cost | 14,399 | 13,127 |
| Total accrued pension cost | 16,001 | 13,772 |

14 PENSION OBLIGATIONS (continued)

| | Year ended December 31, 2004 | Year ended December 31, 2003 |
|---|------------------------------------|------------------------------------|
| Net periodic pension costs | | |
| Service cost | 694 | 652 |
| Interest cost | 1,284 | 1,108 |
| Net periodic pension costs | 1,978 | 1,760 |
| Change in projected benefit obligations | | |
| Projected Benefit Obligation (opening balance) | 14,055 | 11,798 |
| Service cost | 694 | 652 |
| Interest cost | 1,284 | 1,108 |
| Actuarial loss | 793 | - |
| Amendments | 6,733 | - |
| Benefits paid | (659) | (489) |
| Translation adjustment | 1,173 | 986 |
| Projected Benefit Obligation (closing balance) | 24,073 | 14,055 |

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

| | Pension benefits |
|-----------------|---------------------|
| 2005 | 1,602 |
| 2006 | 2,047 |
| 2007 | 2,438 |
| 2008 | 2,433 |
| 2009 | 2,970 |
| Years 2010-2014 | 17,128 |

| Assumptions at: | December 31, 2004 | December 31, 2003 |
|---|----------------------|----------------------|
| Interest rate for discounting liabilities | 9.18% | 9.18% |
| Salary increase rate | 9.18% | 9.18% |

15 INCOME TAXES

| | Year ended December 31, 2004 | Year ended December 31, 2003 |
|---------------------------------|------------------------------------|------------------------------------|
| Current tax expense | 32,487 | 19,448 |
| Deferred tax (credit)/charge | (4,825) | 1,559 |
| Total income tax expense | 27,662 | 21,007 |

The Group records deferred income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes", applying the specific provisions for foreign companies using the US\$ as the reporting currency.

15 INCOME TAXES (continued)

Deferred income tax balances were classified in the consolidated balance sheets as follows:

| | December 31, 2004 | December 31, 2003 |
|-------------------------------------|----------------------|----------------------|
| Current deferred tax liability | (14,449) | (16,130) |
| Non-current deferred tax liability | (21,411) | (22,013) |
| Total deferred tax liability | (35,860) | (38,143) |

Presented below is a reconciliation between total income tax expense and theoretical income tax expense determined by applying the Russian statutory income tax rate to income before income taxes and minority interest:

| | Year ended December 31, 2004 | Year ended December 31, 2003 |
|---|------------------------------------|------------------------------------|
| Income before income taxes and minority interest: | 85,600 | 65,439 |
| Theoretical tax charge at statutory rate of 24% | 20,544 | 15,705 |
| Increase in income tax resulting from: | | |
| Effects of different tax rates | 2,544 | 916 |
| Non-deductible expenses and non-taxable income | 4,574 | 4,386 |
| Total income tax expense | 27,662 | 21,007 |

Deferred tax assets (liabilities) were comprised of differences arising between the carrying values and tax bases of the following assets and liabilities:

| | December 31, 2004 | December 31, 2003 |
|---|----------------------|----------------------|
| Deferred income tax assets: | | |
| Inventory | 1,339 | 6,228 |
| Accounts receivable | 68 | 515 |
| Accounts payables and accruals | 4,414 | - |
| Other assets | - | 390 |
| Total gross deferred income tax assets | 5,821 | 7,133 |
| Deferred income tax liabilities: | | |
| Property, plant and equipment | (21,411) | (22,013) |
| Inventory | (7,016) | - |
| Accounts receivable | (12,123) | (21,967) |
| Other assets | (201) | - |
| Unrealized gain on a change in valuation of investments | (162) | - |
| Accounts payables and accruals | (768) | (1,296) |
| Total gross deferred income tax liabilities | (41,681) | (45,276) |
| Net deferred tax liability | (35,860) | (38,143) |

The amount of foreign earnings deemed permanently reinvested was US\$ 15,378 and US\$ 3,981 at December 31, 2004 and December 31, 2003, respectively. At December 31, 2004 the amount of unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries that are essentially permanent in duration was determined as US\$ 6,120 (December 31, 2003: US\$ 1,265).

16 SHARE CAPITAL

The share capital of VSMPO is composed of the following:

| | Authorised and issued shares | Par value per share | Authorised and issued shares | Par value per share |
|-------|---------------------------------|------------------------|------------------------------------|------------------------|
| | December 31, 2004 | December 31, 2004 | December 31, 2003 | December 31, 2003 |
| VSMPO | 10,625,600 | 1 rouble | 10,625,600 | 1 rouble |

At 31 December 2002 2,078,300 shares were held as treasury stock. Following a number of transactions in 2003 the Group disposed all of its treasury shares which resulted in a net gain of US\$ 3,596. At December 31, 2003 a receivable of US\$ 2,641 was outstanding and included in equity of the consolidated balance sheet.

In 2004 VSMPO repurchased 3,673 of its shares, of which 2,703 were subsequently sold realizing a gain of US\$ 255. At December 31, 2004 the Group had 970 VSMPO shares with a value of US\$ 74 in treasury.

In accordance with Russian legislation treasury stock should be sold or retired with one year from the date of purchase.

Each share of common stock entitles the holder to participate in shareholders' meetings, receive dividends and in the event of liquidation, receive its share of distributable reserves to the extent available.

The statutory accounting reports of VSMPO are the basis for profit distribution and other appropriations. Russian legislation identifies the basis of distribution as the current year net profit. However, this legislation and other statutory laws and regulations dealing with the distribution rights are open to legal interpretation. Therefore, management believes at present it would not be appropriate to disclose an amount of distributable reserves in these consolidated financial statements.

In September 2004 VSMPO declared dividends for the year ended December 31, 2003 of 11 Russian roubles per share for the total of US\$ 3,966. Dividends payable amounted to US\$ 25 at December 31, 2004.

17 SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

| | Year ended December 31, 2004 | Year ended December 31, 2003 |
|-------------------------------------|------------------------------------|------------------------------------|
| Personnel costs | 35,912 | 27,849 |
| Selling expenses | 15,196 | 15,272 |
| Research and development expenses | 4,998 | 5,186 |
| Bad debt expense | 179 | 1,344 |
| Provision on inventory obsolescence | 725 | 6,724 |
| Materials | 1,636 | 2,283 |
| Utilities | 1,846 | 1,264 |
| Pension Obligations Provision | 1,319 | 1,271 |
| Insurance | 6,018 | 3,182 |
| Consulting expenses | 1,928 | 567 |
| Other | 14,447 | 10,677 |
| | 84,204 | 75,619 |

18 MINORITY INTEREST

Minority interest relates principally to the Company's 56.97% owned subsidiary – Avisma (2003: 61.78%).

In 2004 the Group acquired an additional interest in Avisma of 0.67% for a cash consideration of US\$ 526. The fair value of the net assets acquired comprised US\$ 526 (net of negative goodwill of US\$ 493) as of the acquisition date.

Later the Group sold 38,726 common shares and 117,712 preferred shares of Avisma to third parties for a cash consideration of US\$ 3,744 realizing a gain of US\$ 130 relative to the purchase price of the shares, but an overall loss in these consolidated financial statements of US\$ 4,771 determined as the difference between the cash consideration and the underlying carrying value of the net assets disposed.

In 2004 the Company initiated a process of legal reorganisation in the form of the accession of Avisma to the Company and such process was consummated in 2005 (Note 23).

19 SALES OF PRODUCTS BELONGING TO THIRD PARTIES

In 2004, the Group sold US\$ 27,214 of products belonging to third parties. As a result, the Group has an obligation to settle in respect of these products. Accordingly, no profit margin was recognized on such sales and a liability equal to the fair value of the products was recorded in the consolidated financial statements and will be marked-to-market until such time as the Group settles its liability in respect of these products. Upon settlement of its liability in respect of the products, the Group will recognize profit margin equal to the difference between the fair value and the cost of such products to the Group.

20 RELATED PARTY TRANSACTIONS

Related party transactions are disclosed on the face of each primary consolidated financial statement. Such transactions primarily comprise transactions with parties related to the shareholders and transactions with Uniti, LLC (Note 6).

Balance sheet captions and statement of income and comprehensive income captions with the parties related to the shareholders for the years ended December 31, 2004 and 2003 comprised of the following:

Balance sheet captions:

| | December 31, 2004 | December 31, 2003 |
|--|----------------------|----------------------|
| Short-term loans (Note a) | 2,248 | - |
| Long-term loans (Note b) | - | 32,771 |
| Other non-current receivables | 2,089 | - |
| Total receivable from related parties | 4,337 | 32,771 |
| Other current liabilities (Note c) | (5,643) | - |
| Long-term borrowings (Note d) | (1,316) | - |
| Total payable to related parties | (6,959) | - |

Statement of Income and Comprehensive Income captions:

| | Year ended December 31, 2004 | Year ended December 31, 2003 |
|------------------------------|------------------------------------|------------------------------------|
| Consulting expenses (Note c) | (5,643) | - |

(a) Short-term loans

The loan advanced in 2004 to the related parties bore interest at 4% p.a. and was unsecured. This loan was repaid in February 2005.

20 RELATED PARTY TRANSACTIONS (continued)

(b) Long-term loans

Loans outstanding from related parties as at December 31, 2003 were non-interest bearing and unsecured. These loans were fully repaid in 2004.

(c) Other current liabilities and consulting expenses

Other current liabilities due to related parties were in respect of certain consultancy services provided in 2002-2004.

(d) Long-term borrowings

In 2004 the Group received a non-interest bearing and unsecured loan from related parties repayable in 2006.

Transactions and balances with with Uniti LLC (Note 6) for the years ended December 31, 2004 and 2003 were as follows:

Balance sheet captions:

| | December 31, 2004 | December 31, 2003 |
|-------------------------------|----------------------|----------------------|
| Trade accounts receivable | 9,854 | 3,758 |
| Trade accounts payable | (103) | - |
| Net balance receivable | 9,751 | 3,758 |

Statement of Income and Comprehensive Income captions:

| | Year ended December 31, 2004 | Year ended December 31, 2003 |
|----------------------------|------------------------------------|------------------------------------|
| Sales of titanium products | 33,314 | 3,320 |
| Commission expenses | (872) | (25) |

21 RISKS AND UNCERTAINTIES

Operating environment. The Russian Federation 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.

Commercial risks

(i) Foreign exchange risk. The Group minimizes its sales risks by having a wide range of geographical zones for sales, which allow the Group to respond quickly to unexpected changes in the situation on one or more sales markets on the basis of an analysis of the existing and prospective markets.

No individual customer comprised more than 10% of the Group's sales during 2004 and 2003. Management does not believe that the Group is reliant on particular customer.

The Group relies on export sales to generate foreign currency earnings. As the Group exports a significant portion of its production, it is exposed to foreign currency risk as well as global economic and political risks.

21 RISKS AND UNCERTAINTIES (continued)

Due to its foreign currency denominated assets and liabilities, the Group is subject to the risk arising from foreign exchange rate fluctuations. The net foreign currency position as at December 31, 2004 is as follows:

| | US\$ | Euro | Other currencies |
|--|----------|----------|------------------|
| Cash and cash equivalents | 28,134 | 2,518 | 4,080 |
| Accounts receivable | 61,454 | 5,742 | 174 |
| Loans given | - | 2,248 | - |
| Accounts payable and other liabilities | (12,866) | (8,050) | (599) |
| Short-term borrowings | (74,471) | (13,817) | - |

(ii) Interest rate risk. The Group's income and operating cash flows are substantially independent of changes in market interest rates. The Group is exposed to interest rate risk through market value fluctuations of interest-bearing short and long-term borrowings. The interest rates on borrowings are disclosed in Note 10. The Group has no significant interest-bearing assets, other than disclosed in Note 5.

22 COMMITMENTS AND CONTINGENCIES

Capital commitments. The Group is engaged in construction and equipment renovation programs. The construction programs are subject to periodic reviews and actual construction costs may vary from these estimates for many reasons including, but not limited to, general business conditions; environmental regulations; exchange rate fluctuations; the cost and efficiency of construction labour, equipment and materials; and the availability and cost of capital. At December 31, 2004 capital commitments amount to \$ 18,613 (December 31, 2003: \$ 5,686).

Taxation. The Group's principal operations are in Russia. 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 local, regional and federal authorities. Notably recent developments in the Russian environment suggest that the authorities in this country are becoming more active in seeking to enforce, through the Russian court system, interpretations of tax legislation, in particular in relation to the use of certain commercial trading structures, which may be selective for particular tax payers and different to the authorities' previous interpretations or practices. Different and selective interpretations of tax regulations by various government authorities and inconsistent enforcement create further uncertainties in the taxation environment in the Russian Federation.

Tax declarations, together with related documentation, are subject to review and investigation by a number of authorities, each of which may impose fines, penalties and interest charges. Fiscal periods remain open to review by the authorities for three calendar years preceding the year of review (one year in the case of customs). Under certain circumstances reviews may cover longer periods. In addition, in some instances, new tax regulations effectively have been given retroactive effect. Additional taxes, penalties and interest which may be material to the financial position of the taxpayers may be assessed in the Russian Federation as a result of such reviews.

As at December 31, 2004 and 2003 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 consolidated financial statements (Note 11). Management will continue to monitor the situation as legislation and practice evolve in the jurisdictions in which the Group operates.

22 COMMITMENTS AND CONTINGENCIES (continued)

Non-cancellable lease. VSMPO Tirus US leases warehouse and office facilities and certain equipment under non-cancelable operating leases. The following is a schedule of minimum rental payments required under these leases as of December 31, 2004 and 2003:

| | Year ended December 31, 2004 | Year ended December 31, 2003 |
|------|------------------------------------|------------------------------------|
| 2004 | - | 716 |
| 2005 | 520 | 602 |
| 2006 | 340 | 495 |
| 2007 | 335 | 296 |
| 2008 | 320 | 288 |
| 2009 | 63 | 48 |

The rental expense amounted to US\$ 721 and US\$ 365 for the years ended December 31, 2004 and 2003, respectively.

Environmental contingencies. The Group and its predecessor entities have operated in the Russian Federation for many years. Governmental authorities are continually considering environmental regulations and their enforcement and the Group periodically evaluates its obligations related thereto. As obligations are determined, they are recognised immediately. The outcome of environmental liabilities under proposed or any future legislation, or as a result of stricter enforcement of existing legislation, cannot reasonably be estimated. Under current levels of enforcement of existing legislation, management believes there are no probable liabilities, which will have a materially adverse effect on the financial position or the operating results of the Group.

Legal contingencies. The Group is the named defendant in a number of lawsuits as well as a named party in other proceedings arising in the ordinary course of business. While the outcomes of such contingencies, lawsuits or other proceedings cannot be determined at present, management believes that any resulting liabilities will not have a materially adverse effect on the financial position or the operating results of the Group.

Antidumping. As of December 31, 2003 VSMPO Tirus US and Avisma were being investigated in relation to an antidumping claim against pure and alloy magnesium from Russia. In 2004, VSMPO Tirus US and its legal counsel devoted substantive attention to defending the Group's interest in this case. In September 2004 the U.S. Department of Commerce made a preliminary determination on an antidumping claim resulting in a 10.62% provisional penalty on magnesium imports beginning from October 2004 through February 2005. In February 2005 a final determination on an antidumping claim was made which set the provisional penalty rate on subsequent imports at 21.71%. The additional penalty associated with this determination, however, has no impact on import duties paid prior to February 16, 2005. In addition, this new rate represents a deposit rate. VSMPO Tirus US has the possibility of receiving refunds on all provisional penalties. It is not possible to gauge the likelihood and amount of refunds at this stage. Management continues to vigorously defend the Group's interest in this case.

In addition, as of December 31, 2003 VSMPO Tirus US was involved in a Generalized System of Preferences ("GSP") review. In September 2004, the U.S. Department of Commerce eliminated GSP status on wrought titanium, resulting in a 15% duty assessment on such products beginning in November 2004.

23 SUBSEQUENT EVENTS

In January 2005 VSMPO Tirus U.S., Inc. entered into a Loan and Security agreement with a financial institution. The borrowing limit on the new line of credit is US\$ 25,000. The credit line is secured by all the assets of VSMPO Tirus U.S., Inc. and also contains certain restrictive net worth covenants and limitations on the amount available under the line. Advances under the line will be designated as Prime Rate Loans or Eurodollar Rate Loans. Depending on classification of outstanding balances, interest will be payable at a rate equal to Prime Rate as to the Prime Rate Loans and a rate equal to the Adjusted Eurodollar Rate plus 1.75% p.a. as to the Eurodollar Rate Loans. The term of the Loan and Security Agreement is for three years, with the option to renew from year to year thereafter.

VSMPO signed an agreement on March 10, 2005 to sell its interest in Tekhnolog for cash consideration of US\$ 30,058 with a related party. The consideration was received by VSMPO in full in 2005.

On June 15, 2005 VSMPO received a final approval from the Russian Federal Antimonopoly Service of legal reorganisation of VSMPO and Avisma, its subsidiary. The legal reorganisation was effected in the form of the accession of Avisma to VSMPO by issuance of Company common stock in exchange for a minority stake in Avisma. In particular, in 2005 the Company issued 1,339,685 common shares, of which 904,908 shares were exchanged for a minority stake in Avisma in the proportion of 2 to 1 for common stock and 1 to 1 for preferred stock. The remaining 434,777 common shares of the Company were retired. 1,053 common shares and 2,671 preferred shares of minority shareholders, who voted against the reorganisation or did not participate in the exchange, were repurchased by Avisma for roubles 4 253.92 per common share and roubles 2 137.92 per preferred share. The statutory reorganisation was completed as of July 1, 2005. The reorganised company was renamed to OAO "Corporation VSMPO-AVISMA".

In July 2005, the annual General Stockholders' Meeting of VSMPO approved dividends for the year ended December 31, 2004 of rouble 29 per share in the total amount of rouble 308,068 thousand (US\$ 11,102 at the exchange rate as at December 31, 2004).

In November 2005 OAO "Corporation VSMPO-AVISMA" acquired 100% of the outstanding shares of the Swedish company "Carl.Edblom.titan AB", which held a controlling interest of 50.1% in Closed Joint-Stock Company "Plant SETAB Nikopol", a Ukrainian company engaged in production and sale of seamless titanium tubes. The amount of the consideration was US\$ 8,000.