OAO MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

Independent Auditors' Report

Consolidated Financial Statements
Years Ended December 31, 2003, 2002 and 2001

OAO MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

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INDEPENDENT AUDITORS' REPORT

To the shareholders of OAO Moscow City Telephone Network:

We have audited the accompanying consolidated balance sheets of OAO Moscow City Telephone Network ("MGTS") and its subsidiaries (collectively the "Group") as of December 31, 2003 and 2002, and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with 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 audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Group as of December 31, 2003 and 2002, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 4, in December 2003 the Group made a decision to dispose one of the Group's subsidiaries. As a result, the subsidiary's assets and liabilities and results of its operations are presented as discontinued operations in the accompanying financial statements.

May 21, 2004

OAO MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2003 AND 2002
(in U.S. dollars and in thousands)

	2003	2002
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents (Note 6)	$ 42,382	$ 39,777
Short-term investments (Note 7)	66,150	5,424
Accounts receivable, advances and taxes receivable, net (Note 8)	72,470	72,703
Inventories	13,839	11,306
Deferred income taxes, net (Note 15)	9,423	3,424
Assets of discontinued operations (Note 4)	58,999	76,031
Total current assets	263,263	208,665
NON-CURRENT ASSETS:		
Property, plant and equipment, net (Note 9)	931,639	833,328
Advance payments for property, plant and equipment	3,861	2,258
Long-term investments (Note 10)	78,422	76,516
Deferred income taxes, net (Note 15)	44,854	34,211
Total non-current assets	1,058,776	946,313
TOTAL ASSETS	$ 1,322,039	$ 1,154,978
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Debt maturing within one year (Note 11)	$ 51,700	$ 66,037
Accounts payable,taxes payable and other accrued liabilities (Note 12)	44,131	35,362
Deferred revenue, current portion (Note 13)	37,412	35,649
Liabilities of discontinued operations (Note 4)	42,498	45,491
Total current liabilities	175,741	182,539
NON-CURRENT LIABILITIES:		
Long-term debt (Note 11)	101,828	105,551
Deferred revenue (Note 13)	79,425	63,812
Retirement and post-retirement benefits (Note 14)	4,897	4,235
Property, plant and equipment contributions	88,388	64,493
Deferred income taxes (Note 15)	67,688	13,214
Total non-current liabilities	342,226	251,305
TOTAL LIABILITIES	517,967	433,844
MINORITY INTERESTS IN EQUITY OF SUBSIDIARIES	80,360	69,083
SHAREHOLDERS’ EQUITY:		
Preferred stock, 15,965,850 shares authorized, issued and outstanding (Note 16)	22,538	22,538
Common stock, 79,829,200 shares authorized, issued and outstanding (Note 16)	112,462	112,462
Additional paid-in capital	61,806	61,806
Retained earnings	515,193	455,245
Other comprehensive income (Note 3)	11,713	-
Total shareholders’ equity	723,712	652,051
TOTAL LIABILITIES AND SHAREHOLDERS’ EQUITY	$ 1,322,039	$ 1,154,978

See notes to consolidated financial statements.

OAO MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2003, 2002, AND 2001
(in U.S. dollars and in thousands except for earnings per share)

	2003	2002	2001
Operating revenues (Note 17)	$ 472,512	$ 380,899	$ 356,231
Operating expenses (Note 18)	(335,210)	(267,589)	(236,823)
OPERATING INCOME	137,302	113,310	119,408
Income from affiliates	894	3,025	2,287
Gain on disposal of long-term investments (Note 10)	3,560	-	1,195
Interest income	4,656	1,921	933
Interest expense	(17,200)	(30,135)	(29,267)
Currency translation gain	3,058	658	1,920
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAX EXPENSE AND MINORITY INTERESTS	132,270	88,779	96,476
Income tax expense (Note 15)	(33,773)	(20,313)	(29,223)
Minority interests	(20,060)	(14,572)	(13,036)
INCOME FROM CONTINUING OPERATIONS	78,437	53,894	54,217
(Loss)/income from discontinued operations (net of income tax effect of $1,589; $850 and $268)	(8,626)	3,562	849
Gain on disposal of discontinued operations (net of income tax effect of $476)	-	769	-
NET INCOME	$ 69,811	$ 58,225	$ 55,066
Earnings per common share before (loss)/income from discontinued operations, diluted and basic	$ 0.90	$ 0.63	$ 0.66
(Loss)/income from discontinued operations	(0.11)	0.05	0.01
Earnings per common share, diluted and basic (Note 20)	$ **0.79**	$ **0.68**	$ **0.67**
Weighted average number of common shares outstanding	79,829,200	79,829,200	79,829,200

See notes to consolidated financial statements.

OAO MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2003, 2002, AND 2001
(in U.S. dollars and in thousands)

	2003	2002	2001
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 69,811	$ 58,225	$ 55,066
Adjustments to reconcile net income to cash provided by operating activities:			
Loss/(income) from discontinued operations	8,626	(4,331)	(849)
Allowance for doubtful accounts	348	1,270	1,141
Depreciation charge	69,298	61,423	60,193
Currency translation gain	(3,058)	(658)	(1,920)
Income from affiliates	(894)	(3,025)	(2,287)
Deferred gain amortization	(735)	(735)	(735)
Deferred taxes	2,274	4,756	4,154
Post-retirement benefits	327	(2,575)	3,046
Loss on disposal of property, plant and equipment	3,459	526	49
Gain on disposal of long-term investments	(3,560)	-	(1,195)
Minority interest	20,060	14,572	13,036
Changes in certain assets and liabilities			
Accounts receivable, advances and taxes receivable	3,554	(1,202)	(17,916)
Inventories	(1,538)	644	2,462
Accounts payable, taxes payable and other accrued liabilities	1,368	(23,360)	798
Deferred revenue	10,243	18,313	(7,490)
Net cash provided by operating activities	179,583	123,843	107,553
CASH FLOWS FROM INVESTING ACTIVITIES:			
Dividends received from investees	830	1,643	1,721
Acquisition of subsidiary, net of cash received	-	(50)	352
Purchases of property, plant and equipment	(75,905)	(67,286)	(82,087)
Proceeds from sale of property, plant and equipment	2,219	2,467	1,979
Proceeds from sale of long-term investments	4,103	-	1,196
(Purchases)/proceeds from sale of short-term investments, net	(55,279)	3,088	4,468
Net cash used in investing activities	(124,032)	(60,138)	(72,371)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from borrowings	79,714	44,196	158,544
Repayments of borrowings	(114,041)	(69,038)	(150,896)
Repayments of vendor financing	(8,926)	(13,488)	(8,885)
Payments on capital leases	(4,041)	(5,201)	(5,243)
Dividends paid	(5,754)	(3,019)	(4,996)
Net cash used in financing activities	(53,048)	(46,550)	(11,476)
NET CASH USED IN DISCONTINUED OPERATIONS	-	(6,517)	(11,915)
EFFECTS OF CURRENCY TRANSLATION ON CASH AND CASH EQUIVALENTS	102	(665)	(2,564)
INCREASE IN CASH AND CASH EQUIVALENTS	2,605	9,973	9,227
CASH AND CASH EQUIVALENTS, beginning of year	39,777	29,804	20,577
CASH AND CASH EQUIVALENTS, end of year	$ 42,382	$ 39,777	$ 29,804

OAO MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2003, 2002, AND 2001 (continued)
(in U.S. dollars and in thousands)

	2003	2002	2001
SUPPLEMENTAL INFORMATION:			
Cash paid for interest, net of amounts capitalized	$ 17,197	$ 29,832	$ 30,783
Income taxes paid	30,398	19,373	21,181
NON CASH INVESTING AND FINANCING ACTIVITIES:			
Property, plant and equipment received free of charge	$ 18,793	$ 18,050	$ 12,736
Equipment acquired through vendor financing (Note 11)	17,093	8,522	3,234
Equipment acquired under capital leases (Note 11)	1,571	4,770	13,217

In addition, non-cash investing activities during the year ended December 31, 2003 included disposals of shares of subsidiaries and affiliates, as described in Notes 5 and 10.

See notes to consolidated financial statements.

OAO MOSCOW CITY TELEPHONE NETWORK AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY FOR THE YEARS ENDED DECEMBER 31, 2003, 2002, AND 2001
(in U.S. dollars and in thousands)

	Preferred stock		Common stock		Additional paid-in capital	Retained earnings	Other compre-hensive income	Total
	Shares	Amount	Shares	Amount				
Balances at January 1, 2001	**15,965,850**	**$ 12,346**	**79,829,200**	**$ 61,502**	**$ 64,255**	**$ 411,384**	**$ -**	**$ 549,487**
Net income	-	-	-	-	-	55,066	-	55,066
Dividends declared on preferred shares	-	-	-	-	-	(1,218)	-	(1,218)
Dividends declared on common shares	-	-	-	-	-	(1,801)	-	(1,801)
Balances at December 31, 2001	**15,965,850**	**$ 12,346**	**79,829,200**	**$ 61,502**	**$ 64,255**	**$ 463,431**	**$ -**	**$ 601,534**
Increase of par value of shares	-	10,192	-	50,960	-	(61,152)	-	-
Net income	-	-	-	-	-	58,225	-	58,225
Effect of acquisition from a related party	-	-	-	-	(2,449)	-	-	(2,449)
Dividends declared on preferred shares	-	-	-	-	-	(3,549)	-	(3,549)
Dividends declared on common shares	-	-	-	-	-	(1,710)	-	(1,710)
Balances at December 31, 2002	**15,965,850**	**$ 22,538**	**79,829,200**	**$ 112,462**	**$ 61,806**	**$ 455,245**	**$ -**	**$ 652,051**
Net income	-	-	-	-	-	69,811	-	69,811
Dividends declared on preferred shares	-	-	-	-	-	(6,576)	-	(6,576)
Dividends declared on common shares	-	-	-	-	-	(3,287)	-	(3,287)
Translation adjustment (Note 3)	-	-	-	-	-	-	47,052	47,052
Income tax effect of changes in the functional currency (Note 3)	-	-	-	-	-	-	(35,339)	(35,339)
Balances at December 31, 2003	**15,965,850**	**$ 22,538**	**79,829,200**	**$ 112,462**	**$ 61,806**	**$ 515,193**	**$ 11,713**	**$ 723,712**

The Board of Directors recommended to the shareholders to declare 2003 dividends of $0.04 on the common shares and $0.41 on the preferred shares.
Dividends paid per share in 2002 were $0.02 (2001: $0.02) on the common shares and $0.23 (2001: $0.07) on the preferred shares.

See notes to consolidated financial statements.

1. THE GROUP

Description of Business **–** OAO Moscow City Telephone Network ("MGTS") operates one of the largest metropolitan communication networks in the world. Founded in 1882 and nationalized in 1917, MGTS was privatized and became an open joint stock company in 1994. MGTS provides telecommunication services to residential subscribers, state-financed institutions and businesses within the city of Moscow.

The Group has two reportable segments, (1) MGTS and (2) MTU-Inform and other subsidiaries (see Note 19 for additional information on segments). The Group's controlling shareholder is AFK Sistema.

The principal activities of the Group's subsidiaries of are as follows:

Operating Entities	Short Name	Principal activity
ZAO "Company MTU-Inform"	MTU-Inform	Providing direct lines, digital channels and blocks of phone numbers to other telecom operators; providing data transmission services.
OAO "Personal Communications"	PeCom	Telecommunication services to residential subscribers and businesses of Moscow metropolitan area in CDMA standard (see Note 4).
ZAO "AMT"	AMT	Radiotelephony services and repair of telecommunication equipment.
ZAO "Mediatel"	Mediatel	Resale and maintenance of telecommunication equipment and software.
ZAO "Petrodvor"	Petrodvor	Providing services to the entities of the Group.

Affiliates of MGTS provide fixed-line and wireless telecommunication, data transmission, internet, electronic and voice mail, and teleconferencing services throughout the Moscow metropolitan area.

Local telephone services are regulated tariff services and changes in rate structure are subject to Ministry of Antimonopoly Policy ("MAP") approval. In 2003 and 2002, approximately 68% and 64%, respectively, of MGTS segment revenues were generated from regulated tariff services. Fixed monthly fees approved by MAP during 2003 are presented in the table below:

In Rubles:	January 1 – May 31, 2003	June 1 - July 31, 2003	August 1 - December 31, 2003
Residential customers (net of sales tax of 5%)	110	126	140
State financed institutions	125	126	140
Corporate entities	165	165	165

Residential customers are charged a fixed monthly fee while corporate entities and state-financed institutions are charged for local traffic in addition to a fixed monthly fee.

2. STRATEGIC ACTIONS

In December 2003, the Group announced its long-term investment program for the period from 2004 till 2012 providing for extensive capital expenditures including expansion and full digitalization of the Moscow telephone network. The program was approved by the resolution of Moscow City Government of December 16, 2003.

Capital expenditures under the investment program are currently estimated to be approximately $1,600 mln. during the years 2004-2012 and include reconstruction of 350 local telephone stations and installation of 4.3 mln. of new phone numbers.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND RECENT ACCOUNTING PRONOUNCEMENTS

Basis of Presentation – The accompanying financial statements have been prepared in conformity with the accounting principles generally accepted in the United States of America ("U.S. GAAP"). The Group's entities maintain accounting records in Russian Rubles ("RUR") in accordance with the requirements of Russian accounting legislation. The accompanying financial statements differ from the financial statements prepared for statutory purposes in the Russian Federation (the "RF") in that they reflect certain adjustments, appropriate to present the financial position, results of operations and cash flows in accordance with U.S. GAAP, which are not recorded in the accounting books of the Group's entities.

Principles of Consolidation – The consolidated financial statements include the accounts of MGTS and its subsidiaries after the elimination of significant intercompany transactions and balances. The ownership interest of MGTS and proportion of voting power of the Group in the significant subsidiaries as of December 31, 2003 and 2002 are as follows:

Operating entities	Ownership interest		Proportion of voting power	
	2003	2002	2003	2002
MTU-Inform	51%	51%	51%	51%
PeCom (Note 4)	42%	42%	83%	83%
AMT	100%	100%	100%	100%
Mediatel	51%	Affiliate	51%	Affiliate
Petrodvor	100%	100%	100%	100%

The Group's ownership structure includes interests in subsidiaries owned by entities, related by means of common control. Net assets and operating results of the subsidiaries related to such holdings are accounted for as minority interests.

Use of Estimates – The preparation of financial statements in conformity with U.S. GAAP requires that management make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses of the reporting period. Actual results could differ from these estimates.

Examples of significant estimates include the allowance for doubtful accounts, the recoverability of long-lived assets and valuation allowances on deferred taxes.

Concentration of Business Risk – The Group's principal business activities are within the RF. Laws and regulations affecting businesses operating in the RF are subject to rapid changes, which could impact the Group's assets and operations.

Foreign Currency Translation **–** The Group follows a translation policy in accordance with SFAS No. 52, "Foreign Currency Translation". Due to a highly inflationary economy in the Russian Federation in 2002 and 2001, the U.S. Dollar (the Group's reporting currency) has been designated as the Group's functional currency. Starting from January 1, 2003, the Russian economy ceased to be considered highly inflationary for accounting purposes. Management has determined that for the fiscal year beginning January 1, 2003, the functional currency of MGTS, AMT and Petrodvor is the Ruble. Accordingly, the reporting currency amounts were translated into Rubles at the exchange rate current at January 1, 2003. These amounts became the new accounting basis for non-monetary assets and liabilities.

Pursuant to Emerging Issues Task Force ("EITF") Issue No. 92-8, "Accounting for the Income Tax Effects under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary", the differences between the new functional currency bases of non-monetary assets and liabilities and their tax bases represent temporary differences, for which deferred taxes must be recognized. Income tax effect of changes in the functional currency amounting to $35.3 mln. was reported within other comprehensive income for the year ended December 31, 2003.

The Group determined U.S. Dollar ("USD") as its reporting currency and translated functional currency financial statements into USD. Assets and liabilities were translated at year-end exchange rates, while income and expense items are translated at the average rate for the quarter in which such transactions occurred. The resulting translation adjustment was recorded as a separate component of other comprehensive income.

Management believes that the USD remains the functional currency of MTU-Inform and Mediatel, as the majority of its revenue, costs, property and equipment purchased, debt and trade liabilities are either priced, incurred, payable or otherwise measured in USD. Accordingly, MTU-Inform and Mediatel continued to remeasure its books of record into USD. Under this method, monetary assets and liabilities are translated into USD at the rate in effect as of the balance sheet date. Non-monetary balance sheet amounts, revenues and expenses are translated at the rate prevailing on the dates of transactions. Exchange gains and losses arising from the remeasurement of monetary assets and liabilities not denominated in USD are included in currency translation gains in the statements of operations.

The official rate of exchange, as determined by the Central Bank of the RF, between the Ruble and the U.S. Dollar at December 31, 2003 was 29.45 (2002: 31.78; 2001: 30.14).

The Ruble is not a fully convertible currency outside of the territory of the RF. The translation of RUR-denominated assets and liabilities into USD for the purpose of these financial statements does not indicate that the Group could or will in the future convert the reported values of the assets and liabilities in USD.

Revenue Recognition **–** The Group's revenues are principally derived from the provision of local telephone and data transmission services which consist of (i) usage charges, (ii) a monthly telephone service fee, (iii) service activation and installation fees, (iv) sale of prepaid calling cards and (v) charges for value-added telecommunication services. The Group records revenues over the periods they are earned as follows:

(i) Revenues derived from local telephone usage and data transmission are recognized as the services are provided.

(ii) Monthly telephone service fees are recognized in the month during which the telephone services are provided to customers.

(iii) Upfront fees received for activation and installation of wireline and data transmission services are deferred and recognized over the expected customer relationship period. According to management estimates, the customer relationship period for wireline voice phone subscribers is 15 years for residential customers and 5 years for all other categories of subscribers. The customer relationship period for subscribers of MTU-Inform is estimated at three years.

(iv) Revenues from sale of prepaid calling cards are recognized as the cards are used by the customers or the prepaid cards expire.

(v) Revenues derived from value-added telecommunication services are recognized when the services are provided to customers.

Other related telecommunications service revenues are recognized as follows:

(i) Revenues from the provision of internet services are recognized when the services are provided to customers.

(ii) Interconnection fees from other telecommunications operators are recognized when the services are provided to the operators.

(iii) Lease income from operating leases is recognized over the term of the lease.

MGTS is required to grant discounts ranging from 20% to 100% on installation and monthly fees to certain categories of residential subscribers, such as pensioners, military veterans and disabled individuals, and is entitled to reimbursement from the federal budget for these discounts. Due to the lack of certainty of reimbursement, MGTS accounts for such revenues upon collection.

Cash and Cash Equivalents – Cash and cash equivalents include cash on hand, amounts on deposit in banks and cash invested temporarily in various instruments with maturities of three months or less at time of purchase.

Financial Instruments and Fair Value – Financial instruments carried on the balance sheets include cash and bank balances, receivables, investments, accounts payable and long-term debt. The particular recognition methods adopted are disclosed in the individual policy statements associated with each item.

Current financial instruments that potentially expose the Group to concentrations of credit risk consist primarily of cash and bank balances, receivables, short-term investments and accounts payable.

Long-term financial instruments that potentially expose the Group to concentrations of credit risk consist primarily of long-term investments and long-term debt. It is not practicable to estimate the fair value of most of these financial instruments. This is due to quoted market prices not being readily available and valuations not being completed or obtained due to the excessive costs involved. Fair values of corporate bonds issued by MGTS are disclosed in Note 11.

As of January 1, 2001, the Group adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities". This statement requires that all derivatives, including some embedded derivatives, be measured at fair value and recognized as either assets or liabilities. Changes are recorded in comprehensive income, depending on the designated use and effectiveness of the instruments. The effects of adoption were not material to the Group's financial position or results of operations.

Accounts Receivable – Accounts receivable are stated at their net realizable value after deducting an allowance for doubtful accounts. Such provisions reflect either specific cases of delinquency or defaults or estimates based on evidence of collectibility.

Concentrations of credit risk with respect to trade receivables are limited due to a highly diversified customer base, which includes a large number of individuals, private businesses and state-financed institutions.

Inventories – Inventories comprise cables, spare parts, telephones and accessories and are stated at the lower of cost or market. Cost is computed on an average cost basis.

Property, Plant and Equipment – Property, plant and equipment is stated at cost less accumulated depreciation, except for assets contributed by the majority shareholder under the investment program and assets received free of charge from third parties. These assets have been included at fair values based on the estimated market values at the time of the transfer.

Significant renovations are capitalized if they extend the life of the asset or significantly increase its revenue generating capacity. Repairs and maintenance are charged to the statement of operations as incurred.

Capital leases are recorded at the fair market value of the asset or the present value of future minimum lease payments, whichever is lower.

Items of property, plant and equipment that are retired or otherwise disposed of are eliminated from the balance sheet along with the corresponding accumulated depreciation. Any gain or loss resulting from such retirement or disposal is included in the determination of net income.

Property, plant and equipment is depreciated on a straight-line basis over the following estimated useful lives:

	Years
Buildings	47
Analogue telecommunication equipment	17
Digital telecommunication equipment	10
Transfer devices	31
Site improvements	44
Other equipment	3 – 25

Property, plant and equipment held and used by the Group are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of assets may have been impaired. Management believes that no impairment has occurred relating to the Group's investments in property, plant and equipment as of December 31, 2003.

The Group incurs costs associated with operating and other equipment which require installation and related works to enable assets to commence revenue generating activities. All costs necessarily incurred which are directly attributable to the construction, preparation and installation of an item to commence revenue-generating activities are capitalized.

Property, plant and equipment which was transferred to the Group free of charge is capitalized at its market value at the date of transfer and deferred revenue is recorded and amortized to the consolidated statement of operations over the contributed assets' life.

Goodwill – As of January 1, 2002, the Group adopted SFAS No. 142, "Goodwill and Other Intangible Assets". This Standard eliminates goodwill amortization from the statement of operations and requires an evaluation of goodwill for impairment (at the reporting unit level) upon adoption of this Standard, as well as subsequent evaluations on an annual basis, and more frequently if circumstances indicate a possible impairment. This impairment test is comprised of two steps. The initial step is designed to identify potential goodwill impairment by comparing an estimate of the fair value of the applicable reporting unit to its carrying value, including goodwill. If the carrying value exceeds fair value, a second step is performed, which compares the implied fair value of the applicable reporting unit's goodwill with the carrying amount of that goodwill, to measure the amount of goodwill impairment, if any.

If SFAS No. 142 had been applied retroactively to January 1, 2001, the net income for the year ended December 31, 2001 would have increased by $0.9 mln.

Investments – Investments in businesses in which the Group does not have control, but exercises significant influence over operating and financial policies ("affiliates"), are accounted for using the equity method. The Group's share of net income of affiliates is included in the statement of operations, and the Group's share of the net assets of affiliates is included in the balance sheet.

Investments in corporate shares where the Group owns more than 20% of share capital, but does not have the ability or intent to control or exercise significant influence over operating and financial policies, as well as investments in corporate shares where the Group owns less than 20% of share capital, are accounted for at cost of acquisition. Management periodically assesses realizability of the carrying values of such investments and provides valuation reserves, if required.

The promissory notes purchased by the Group are carried at cost and a discount against the nominal value is accrued over the period to maturity, if it exceeds one year. A provision is made, based on management assessment, for notes that are considered uncollectible.

Retirement and Post-Retirement Benefits – Contributions are made to the Government's social and medical insurance and retirement benefit schemes at the statutory rates in force during the year.

Starting from January 1, 2001, all social contributions, including contributions to the pension fund, were substituted with a unified social tax ("UST") calculated by the application of a regressive rate from 35.6% to 2% of the annual gross remuneration of each employee. UST is allocated to three social funds, including the pension fund, where the rate of contributions to the pension fund vary from 28% to 2%, respectively, depending on the annual gross salary of each employee. The contributions are expensed as incurred.

During the year ended December 31, 2002, MGTS established a defined contribution plan to provide eligible employees with additional income upon retirement. MGTS's contributions to the plan, totaling $0.9 mln. and $0.6 mln. in 2003 and 2002, respectively, (RUR 2,000 a year per eligible employee) are managed by the pension fund "Sistema", a party related by means of common control.

In addition, MGTS has historically offered its employees certain benefits upon and after retirement. The cost of such benefits is recognized during an employee's years of active service (Note 14).

Income Taxes – Income taxes have been computed in accordance with RF laws. From January 1, 2001, the RF enacted an income tax rate of 35%. Effective January 1, 2002, this rate was decreased to 24%. Also, income tax on dividends paid within Russia was decreased to 6% (from 15% in 2001), investment allowances were abandoned and carryforward period for unused taxable losses was increased to 10 years.

Deferred income taxes are accounted for under the liability method and reflect the tax effect of all significant temporary differences between the tax basis of assets and liabilities and their reported amounts in the consolidated financial statements. A valuation allowance is provided for deferred tax assets if it is more likely than not these items will either expire before the Group will be able to realize the benefit, or the future deductibility is uncertain.

Borrowing Costs – The Group capitalizes interest on borrowings during the active construction period of major capital projects. Capitalized interest is added to the cost of the underlying assets and is amortized over the useful lives of the assets. For the years ended December 31, 2003, 2002 and 2001 capitalized borrowing costs amounted to $1.2 mln., $0.6 mln. and $1.2 mln., respectively. Other borrowing costs were recognized as an expense in the period in which they were incurred. Debt issue costs are amortized to expense over the term to maturity.

MGTS historically issued offers to repurchase its outstanding bonds at a certain date. The offer price for the first issue of the bonds was stated above par value. This premium was amortized into interest expense over the bonds' term.

Earnings Per Share – Earnings per share is computed using the two-class method. Net income available to common shareholders is divided by the weighted average number of common shares outstanding in the year. Net income available to common shareholders is determined by reducing net income by the greater of dividends declared in the accounting period on preferred shares or of dividends on preferred shares guaranteed under MGTS' Charter.

Comprehensive Income – Comprehensive income is defined as net income plus all other changes in net assets from non-owner sources. The following is a reconciliation of comprehensive income, net of income tax effect:

	2003	2002	2001
Net income	69,811	58,225	55,066
Translation adjustment	47,052	-	-
Income tax effect of change in the functional currency	(35,339)	-	-
Total comprehensive income	**81,524**	**58,225**	**55,066**

Dividends – Annual dividends are recommended by the Board of Directors for approval of the shareholders in a general meeting. This occurs subsequent to year end and dividends are recognized in the year to which they relate.

Reclassifications – Certain reclassifications of prior years' amounts have been made to conform to the presentation adopted for 2003.

Recent Accounting Pronouncements – In June 2001, Financial Accounting Standard Board ("FASB") issued SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset and depreciated over the asset's useful life. An entity shall measure changes in the liability for an asset retirement obligation due to passage of time by applying an interest method of allocation to the amount of the liability at the beginning of the period. The interest rate used to measure that change shall be the credit-adjusted risk-free rate that existed when the liability was initially measured. That amount shall be recognized as an increase in the carrying amount of the liability and as an expense classified as an operating item in the statement of operations. The Group adopted SFAS No. 143 effective January 1, 2003. The adoption of SFAS No. 143 did not have a material impact on the Group's financial position or results of operations.

As of January 1, 2002, the Group adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". SFAS No. 144 establishes a single accounting model for long-lived assets to be disposed of by sale consistent with the fundamental provisions of SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of". While it supersedes APB Opinion No. 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions", it retains the presentation of discontinued operations but broadens that presentation to include a component of an entity (rather than a segment of a business). However, discontinued operations are no longer recorded at net realizable value and future operating losses are no longer recognized before they occur. Under SFAS No. 144, there is no longer a requirement to allocate goodwill to long-lived assets to be tested for impairment. It also establishes a probability weighted cash flow estimation approach to deal with situations in which there is a range of cash flows that may be generated by the asset being tested for impairment. SFAS No. 144 also establishes criteria for determining when an asset should be treated as held for sale. Following the adoption of SFAS No. 144, the Group reflected PeCom business as discontinued operations for all periods presented (see Note 4).

In April 2002, FASB issued SFAS No. 145, “Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections”. This Standard rescinds FAS No. 4, “Reporting Gains and Losses from Extinguishments of Debt”, and an amendment of that Standard, Standard No. 64, “Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements”. This Standard also rescinds Standard No. 44, “Accounting for Intangible Assets of Motor Carriers” and amends Standard No. 13, “Accounting for Leases”, to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. This Standard also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. The Group adopted the requirements of SFAS No. 145 effective January 1, 2003. The adoption of SFAS No. 145 did not have a material impact on the Group’s financial position or results of operations.

In June 2002, FASB issued SFAS No. 146, “Accounting for Costs Associated with Exit or Disposal Activities,” which addresses financial accounting and reporting for costs associated with exit or disposal activities and supersedes Emerging Issues Task Force (EITF) Issue No. 94-3, “Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring).” SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue 94-3, a liability for an exit cost as defined in EITF No. 94-3 was recognized at the date of an entity's commitment to an exit plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. The Group adopted the provisions of SFAS No. 146 effective January 1, 2003. The adoption of SFAS No. 146 did not have a material impact on the Group’s financial position or results of operations.

In November 2002, FASB issued FASB Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.” FIN No. 45 requires that the guarantor recognize, at the inception of certain guarantees, a liability for the fair value of the obligation undertaken in issuing such guarantee. FIN No. 45 also requires additional disclosure requirements about the guarantor’s obligations under certain guarantees that it has issued. The Group adopted the initial recognition and measurement provisions of this interpretation on a prospective basis to guarantees issued or modified after December 31, 2002. The adoption of FIN No. 45 did not have a material impact on the Group’s financial position or results of operations.

In November 2002, the Emerging Issues Task Force (“EITF”) issued a final consensus on EITF Issue No. 00-21, “Accounting for Revenue Arrangements with Multiple Deliverables.” EITF Issue No. 00-21 provides guidance on when and how an arrangement involving multiple deliverables should be divided in separate units of accounting. The Group adopted the requirements of EITF Issue No. 00-21 prospectively for arrangements entered into after June 15, 2003. The adoption of EITF Issue No. 00-21 did not have a material impact on the Group’s financial position or results of operations.

In December 2002, FASB issued SFAS No. 148, “Accounting for Stock-Based Compensation — Transition and Disclosure, an amendment of FASB Statement No. 123.” SFAS No. 148 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 SFAS No. 148 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 adopted the provisions of SFAS No. 148 effective January 1, 2003. The adoption of SFAS No. 148 did not have a material impact on the Group’s financial position or results of operations.

In April 2003, FASB issued SFAS No. 149, "Amendments of FASB Statements No. 133 on Derivative Instruments and Hedging Activities". SFAS No. 149 clarifies under what circumstances a contract with an initial investment meets the characteristic of a derivative, clarifies when a derivative contains a financing component, amends the definition of an underlying and certain other existing pronouncements. The Group adopted the requirements of SFAS No. 149 for contracts entered into or modified and for hedging relationships designated after June 30, 2003. The adoption of SFAS No. 149 did not have a material impact on the Group's financial position or results of operations.

In May 2003, FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." SFAS No. 150 requires issuers to classify as liabilities (or assets in some circumstances) certain classes of freestanding financial instruments that embody obligations for the issuer, including mandatory redeemable financial instruments, obligations to repurchase the issuer's equity shares by transferring assets and certain obligations to issue a variable number of shares. The Group adopted the requirements of SFAS No. 150 effective July 1, 2003. The adoption of SFAS No. 150 did not have a material impact on the Group's financial position or results of operations.

In December 2003, FASB issued a revision to SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88, and 106" ("SFAS No. 132R"). SFAS No. 132R revised employers' disclosure about pension plans and other postretirement benefit plans. It requires additional disclosures about the plan assets, benefit obligations, cash flows and net periodic benefit cost of defined benefit plans and other defined postretirement plans. It does not change the measurement or recognition of those plans required by previous Financial Accounting Board Standards. This statement is generally effective for financial statements with fiscal years ending after December 15, 2003. Following the adoption of SFAS No. 132R, the Group included the required annual disclosures in its consolidated financial statements as of and for the year ended December 31, 2003 (Note 14).

In December 2003, FASB issued a revision to Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" ("FIN 46R" or the "Interpretation"). FIN 46R clarifies the application of ARB No. 51, "Consolidated Financial Statements", to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. FIN 46R requires the consolidation of these entities, known as variable interest entities ("VIEs"), by the primary beneficiary of the entity. The primary beneficiary is the entity, if any, that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. Among other changes, the revisions of FIN 46R (a) clarified some requirements of the original FIN 46, which had been issued in January 2003, (b) eased some implementation problems, and (c) added new scope exceptions. FIN 46R deferred the effective date of the Interpretation for public companies, to the end of the first reporting period ending after March 15, 2004, except that all public companies must at minimum apply the provisions of the Interpretation to entities that were previously considered "special-purpose entities" under the FASB literature prior to the issuance of FIN 46R by the end of the first reporting period ending after December 15, 2003. The Group does not anticipate that the adoption of FIN 46 will have a material impact on its financial position, cash flows and results of operations.

In December 2003, the Securities Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") No. 104, "Revenue Recognition." SAB 104 updates portions of the interpretive guidance included in Topic 13 of the codification of Staff Accounting Bulletins in order to make this interpretive guidance consistent with current authoritative accounting and auditing guidance and SEC rules and regulations. The Group believes it is following the guidance of SAB 104.

4. DISCONTINUED OPERATIONS

During 2003, the management of AFK Sistema, the parent company of the Group, made a decision to dispose of PeCom operations.

In accordance with SFAS No. 144 the consolidated financial statements of the Group reflect PeCom business as discontinued operations for all periods presented. Accordingly, revenues, costs and expenses, assets, liabilities and cash flows of PeCom have been excluded from the respective captions in the statements of operations, balance sheets, and statements of cash flows and have been reported as income or loss from discontinued operations, net of applicable taxes; as assets and liabilities of discontinued operations; and as net cash used in discontinued operations for all periods presented.

Revenues from discontinued operations and income (loss) from discontinued operations before income taxes and minority interest for the years ended December 31, 2003, 2002 and 2001 are presented in the table below:

	2003	**2002**	**2001**
Revenues from discontinued operations	51,305	44,544	31,405
(Loss)/income from discontinued operations before income taxes and minority interest	(13,328)	10,759	5,533

Assets and liabilities of discontinued operations as of December 31, 2003 and 2002 consisted of the following:

	2003	**2002**
Current assets	9,688	9,521
Non-current assets	49,311	66,510
Total assets of discontinued operations	**58,999**	**76,031**
Current liabilities	27,639	40,089
Non-current liabilities	11,994	3,007
Minority interest	2,865	2,395
Total liabilities of discontinued operations	**42,498**	**45,491**

Assets of discontinued operations as of December 31, 2002 included goodwill in amount of $19.3 mln. assigned to PeCom. In May 2003, the management of AFK Sistema announced its intention to curtail further investments in PeCom. Concurrently, the Group performed an impairment test of goodwill assigned to PeCom and recorded an impairment charge of $19.3 mln., which was included in net loss from discontinued operations.

5. ACQUISITIONS AND DISPOSALS

In July 2002 MTU-Inform disposed of its holding in MTU-Intel, then a subsidiary of MTU-Inform, to the Group’s controlling shareholder for cash consideration of $0.1 mln. As a result, the Group’s voting power in MTU-Intel decreased from 38.0% to 25.5%.

Concurrently, control over operating and financial policies of MTU-Intel was transferred from MTU-Inform to the controlling shareholder. The Group changed its method of accounting for investment in MTU-Intel shares from consolidation in 2001 to equity method in 2002.

If the Group’s investment in MTU-Intel would be accounted for under equity method for all periods presented, consolidated assets as of December 31, 2001 would decrease by $10.1 mln. and consolidated revenues for the year then ended would decrease by $9.0 mln.

Subsequently, the Group's interest in MTU-Intel was increased from 25.5% to 30.0%, while control over MTU-Intel operations remained with the controlling shareholder.

In April 2003, the Group increased its ownership interest and voting power in Mediatel from 35.8% to 50.8% by purchasing shares from a related party for cash consideration of less than $0.1 mln. The Group changed its method of accounting for its investment in Mediatel shares from equity method in 2001 and 2002 to the consolidation method in 2003.

6. CASH AND CASH EQUIVALENTS

Cash and cash equivalents as of December 31, 2003 and 2002 consisted of the following:

	2003	2002
Rubles	20,982	22,916
U.S. Dollars	207	3,195
Restricted cash – U.S. Dollars	1,281	1,321
Other currencies	15	13
Cash equivalents	19,897	12,332
Total	**42,382**	**39,777**

Cash equivalents as of December 31, 2003 include USD and RUR denominated deposits with Moscow Bank for Reconstruction and Development ("MBRD"), a company related by means of common control. Cash equivalents as of December 31, 2002 include USD denominated promissory notes from MBRD. Such deposits and promissory notes have original maturities of three months or less.

Cash and cash equivalents held by the Group in MBRD as of December 31, 2003 and 2002 amounted to $29.4 mln. and $18.6 mln., respectively.

Restricted cash balances maintained under the terms of a letter of credit opened in Citibank for the redemption of Citibank loan amounted to $1.3 mln. as at December 31, 2003 and 2002.

7. SHORT-TERM INVESTMENTS

Short-term investments as of December 31, 2003 and 2002 consisted of the following:

	2003	2002
RUR-denominated promissory notes from related parties	28,289	-
USD-denominated promissory notes from related parties	12,000	-
RUR-denominated bank promissory notes	7,128	-
USD-denominated bank promissory notes	2,000	-
EUR-denominated bank promissory notes	1,250	-
RUR-denominated time deposit in MBRD	8,488	-
USD-denominated time deposit in MBRD	1,300	-
PeCom RUR-denominated promissory note	5,070	5,070
Other non-interest bearing loans to related parties	625	354
Total	**66,150**	**5,424**

RUR-denominated promissory notes from related parties are issued by MBRD and Sistema Telecom, an entity related by means of common control. Promissory notes of MBRD in the amount equivalent to $24.6 mln. bear interest of 11-13% per annum and mature in 2004. Promissory note of Sistema Telecom in the amount equivalent to $3.7 mln. bears interest of 6% per annum and matures in December 2004.

USD-denominated promissory notes of MBRD bear interest of 7-8% per annum and mature in 2004. Interest income received from related parties is disclosed in Note 22.

Bank promissory notes are receivable in 2004 and bear interest of 11-13%, 5% and 5% per annum for promissory notes denominated in RUR, USD and EUR, respectively.

Time deposits in MBRD have the original term of 6 months and bear interest of 12% and 7% for RUR-denominated and USD-denominated deposits, respectively.

PeCom RUR-denominated promissory note is interest-free and the principal amount is receivable on demand.

8. ACCOUNTS RECEIVABLE, ADVANCES AND TAXES RECEIVABLE, NET

Accounts receivable, advances and taxes receivable as of December 31, 2003 and 2002 consisted of the following:

	2003	2002
Customers	23,655	32,118
Related parties, including affiliates, Rostelecom and state-financed institutions	21,032	16,514
Other receivables and advances	15,554	4,851
VAT recoverable	12,636	20,056
Other taxes receivable	2,042	1,874
Allowance for doubtful accounts	(2,449)	(2,710)
Total	**72,470**	**72,703**

Rostelecom, provider of national long distance and international telecommunications services, is a subsidiary of Svyazinvest, which owns 28% of MGTS voting shares. Svyazinvest is controlled by the Government of the RF.

Rostelecom pays a fee to MGTS for the transit of domestic long distance and international calls originated by MGTS subscribers. Respective revenue amounts are disclosed in Note 17.

9. PROPERTY, PLANT AND EQUIPMENT, NET

Property, plant and equipment as of December 31, 2003 and 2002 consisted of the following:

	2003	2002
Buildings and site improvements	193,929	168,108
Switches and transmission devices	870,217	782,113
Other fixed assets	167,594	90,532
Construction in progress	70,485	66,740
Total cost	1,302,225	1,107,493
Accumulated depreciation	(370,586)	(274,165)
Total	931,639	833,328

Construction-in-progress and equipment for installation are not depreciated until an asset is placed into service.

10. LONG-TERM INVESTMENTS

Long-term investments as of December 31, 2003 and 2002 consisted of the following:

	2003		2002	
	Ownership, %	**Investment**	**Ownership, %**	**Investment**
Investments in affiliates:				
ZAO Comstar	50	36,520	50	32,906
ZAO Telmos	40	17,009	40	17,190
OAO MCC	24	7,262	24	6,730
ZAO MTU-Intel	30	5,695	30	5,349
Total investments in affiliates		66,486		62,175
Other investees, at cost	Various	6,771	Various	10,217
Interest free loans to investees		1,011		1,090
PeCom RUR-denominated promissory notes		3,735		-
Comincom RUR-denominated promissory note		-		2,705
MTU-Intel RUR-denominated promissory note		419		329
Total		**78,422**		**76,516**

In December 2003, the Group sold 14.55% of “Mezhregionalniy Transit Telecom” shares to AFK Sistema in exchange for PeCom promissory notes with total face value of $3.7 mln. and maturity not earlier than December 2006. The promissory notes are RUR-denominated and carry interest rate of 16% per annum. The gain realized on this transaction amounted to $3.6 mln.

During 1999, the Group disposed of its 10% holding in ZAO Combellga, a Moscow telecommunications operator. In April 2002, the Group agreed to defer repayment of $3.1 mln. outstanding on the respective note receivable to April 2005. In December 2003, the note receivable was settled for the amount of $3.9 mln., which included principal amount and interest accrued.

In October 2002, the Group sold its 50% share in ZAO Golden Line to MTU-Intel in exchange for 4.5% of MTU-Intel’s common shares, an interest-free promissory note with a face value of RUR 23.2 mln. ($0.8 mln.) and $0.1 mln. in cash. The promissory note maturing in 2007 is included in long-term investments at a discounted value of $0.4 mln. Discounted value has been determined using the current interest rates at which similar loans would have been offered to the Group by non-related borrowers.

Distributable retained earnings of the Group’s investees are based on amounts extracted from their statutory financial statements and may significantly differ from the amounts calculated on the basis of U.S. GAAP.

11. DEBT OBLIGATIONS

Debt obligations as of December 31, 2003 and 2002 consisted of the following:

	Currency	2003	2002
Bonds 1st issue, 1st tranche due 2003	RUR	-	9,540
Bonds 2nd issue	RUR	18,692	31,462
Bonds 3rd issue	RUR	33,951	-
Total corporate bonds		**52,643**	**41,002**
Sberbank	RUR	30,556	58,333
Vneshtorgbank	USD	11,652	12,565
Vneshtorgbank	RUR	-	2,359
Raiffeisenbank	USD	15,000	15,000
Citibank	USD	8,616	7,577
Gutabank	USD	2,837	5,421
Alfabank	USD	-	1,000
USD-denominated promissory notes	USD	-	3,831
RUR-denominated promissory notes	RUR	-	189
Long-term portion of vendor financing	Various	17,500	8,904
Short-term portion of vendor financing	Various	9,135	7,330
Long-term portion of finance leases	Various	2,135	3,967
Short-term portion of finance leases	Various	3,454	4,110
Total debt		**153,528**	**171,588**
Less amounts maturing within one year		(51,700)	(66,037)
Total long-term debt		**101,828**	**105,551**

Corporate bonds – In the fourth quarter of 2000, MGTS issued two tranches of RUR-denominated bonds (first issue) with aggregate face value of 600 mln. RUR (equivalent of $20.3 mln. as of December 31, 2003) due in 2003. The Group has fully repaid both tranches of the first issue of the bonds as of December 31, 2003.

In the fourth quarter of 2001, MGTS issued RUR-denominated bonds (second issue) with face value of 1,000 mln. RUR (equivalent of $33.4 mln. as of December 31, 2003) due in 2004. Interest is payable semi-annually. The issue has a floating interest rate, which is set for each coupon payment not later than 6 days before the date of the prior coupon payment. Interest (11.3% as at December 31, 2003) should not be less than the weighted average interest rate of OFZ (Russian Government Federal Bonds) as at the date the interest rate is fixed.

In February 2003, MGTS issued RUR-denominated bonds (third issue) with the face value of 1,000 mln. RUR (equivalent of $33.4 mln. as of December 31, 2003) due in 2005. The bonds carry a coupon of 12.3% during the first year of trading and of 17.0% during the second year.

Market value of the bonds approximates their carrying value as of December 31, 2003 and 2002.

Sberbank credit facility – In December 2000, MGTS signed a credit facility with Sberbank for a total amount equivalent to $90.0 mln. to refinance its obligations under Eurobond borrowings. The loan was received in three tranches during the first quarter of 2001. In September 2002, MGTS prolonged repayment of the outstanding balance ($30.6 mln. as of December 31, 2003) to the first quarter of 2005. The remaining balance was repaid in 2003. The interest rate on the prolonged loan was 18% during the first six months and 12% during the second six months of the year. Equipment valued by independent appraiser at $87.3 mln. is pledged to collateralize the outstanding balance as of December 31, 2003.

Vneshtorgbank – During the year ended December 31, 2002, the Group received a number of loans from Vneshtorgbank maturing in 2003-2007 to finance working capital. The loans are collateralized by pledge of equipment valued by the parties at $7.6 mln. The weighted average interest rate on the Vneshtorgbank loans outstanding as of December 31, 2003 is 8.3% per annum.

Raiffeisenbank – In September 2002, MGTS entered a credit line with Raiffeisenbank limited to $15.0 mln. The equipment pledged under the credit line as at December 31, 2003 is valued at $22.5 mln. In addition, MGTS is required to maintain monthly gross cash flows with the bank of not less than $1.5 mln. The loan bears interest of LIBOR+5% and matures in 2007. As of December 31, 2003, the LIBOR rate specified in the agreement equaled 1.4%.

Citibank – In September 2003, MGTS received a loan from Citibank for the purchase of equipment in the amount of $6.1 mln. The loan bears interest of LIBOR+5%, and is repayable in 8 semi-annual installments. The loan is collateralized by pledge of equipment in the amount of $5.4 mln. and by deposit in Citibank (Note 6) and guaranteed by Export Guarantee and Insurance Corporation, Czech Republic.

In July 2001, an uncollateralized bank loan was provided to MGTS by Citibank at LIBOR+1.6% for the purchase of equipment. The loan is guaranteed by Export Guarantee and Insurance Corporation, Czech Republic and AFK Sistema.

Based on restrictive covenants of the Citibank loan agreements, the Debt to Equity ratio and Debt Service to Earnings Before Interest and Taxes (“EBIT”) ratio of MGTS should not exceed 1:1. MGTS is not allowed to obtain borrowings individually exceeding $30.0 mln. (apart from the Sberbank loan, Raiffeisenbank loan and the third issue of MGTS bonds) or alienate more than 10% of its assets without the written approval of the Bank and its aggregate debt may not exceed $250.0 mln.

Gutabank – In 1999 and 2000, loans were provided to MGTS by Gutabank for the purchase of equipment from a foreign vendor. Under the terms of the agreements, MGTS is required to maintain monthly gross cash flows on the specified bank accounts in the amount of $14.0 mln. The loans are repayable in equal semiannual installments to be settled in 2005. The weighted average interest rate on the Gutabank loans is 13.0%.

Alfabank – In December 2002, MTU-Inform received a loan from Alfabank for $1.0 mln., bearing interest at 6.5% per annum, which was repaid in January 2003.

Promissory notes – In 2002, MGTS issued discounted notes to Donau-Bank. The notes had value of $5.3 mln. at maturity in December 2003 and a yield of 12%. The notes were settled in December 2003.

Vendor financing – Foreign suppliers of telecommunications equipment provide uncollateralized commercial credit to the Group denominated in various currencies on short-term and long-term bases, mostly interest free.

Finance leases – During 2001-2003, MGTS entered several lease agreements for telecommunications equipment. The agreements expire in 2004 -2007 and assume transfer of ownership for equipment to MGTS after the last lease payment is effected. The net book value of leased assets comprised $14.7 mln. and $14.1 mln. as of December 31, 2003 and 2002, respectively, while rent expense for the years 2003, 2002 and 2001 amounted to $0.8 mln., $1.3 mln. and $0.5 mln., respectively.

In 2003, the Group entered into a lease agreement with Invest-Svyaz-Holding, an entity related by means of common control. The net book value of assets leased under the agreement and the present value of the future net minimum lease payments is $1.7 mln.

The weighted average interest rate of all borrowings denominated in hard currency at December 31, 2003 and 2002 was 5.63% and 7.96%, respectively, while it was 11.97% and 20.13%, respectively, for borrowings denominated in RUR. These figures are calculated without taking into account borrowings from related parties, vendor financing arrangements and capital lease agreements.

The debt obligations as of December 31, 2003 have the following maturities:

2004	51,700
2005	88,304
2006	5,040
2007	6,576
2008	1,908
Total	**153,528**

12. ACCOUNTS PAYABLE, TAXES PAYABLE AND OTHER ACCRUED LIABILITIES

Accounts payable, taxes payable and other accrued liabilities as of December 31, 2003 and 2002 consisted of the following:

	2003	2002
Trade accounts payable	9,837	12,125
Accounts payable to related parties	2,678	2,732
Taxes payable	13,040	9,187
Accrued payroll	5,391	2,563
Accrued interest	2,263	3,161
Other liabilities	10,922	5,594
Total	**44,131**	**35,362**

The Group purchases equipment from Strom Telecom, Czech Republic, an entity related by means of common control. Accounts payable to Strom Telecom as of December 31, 2003 and 2002 amounted to $2.4 mln. and $1.2 mln., respectively.

13. DEFERRED REVENUE

Deferred revenue as of December 31, 2003 and 2002 consisted of the following:

	2003	2002
Short-term portion		
Deferred revenue from connection fees	24,489	20,327
Advances from customers	12,112	14,587
Deferred gain on disposal of an investment	811	735
Total	**37,412**	**35,649**
Long-term portion		
Deferred revenue from connection fees	79,425	63,060
Deferred gain on disposal of an investment	-	752
Total	**79,425**	**63,812**

The gain on sale of an investment to a related party has been deferred to future accounting periods and is recognized as the Group fulfills its obligations under the transaction.

14. RETIREMENT AND POST-RETIREMENT BENEFITS

MGTS has historically provided certain benefits to employees upon their retirement and afterwards. Currently such benefits include bonus payments of a fixed amount to retiring employees with at least five years of service (RUR 5,700 (USD 195 at the exchange rate current as of December 31, 2003) or RUR 11,400 (USD 390), depending on actual years of service); lifetime payments of a fixed amount to employees retiring with at least fifteen years of service (RUR 1,200 (USD 41) per employee, for the year ended December 31, 2003); and discounted telephone service to employees retiring with at least thirty years of service. An employee is withdrawn from the benefit scheme if their employment with MGTS is discontinued prior to retirement.

The assumed discount rate used in determining net periodic cost is 8% per annum. The future benefit payments to retirees are expected to be paid as follows:

2004	1,469
2005	423
2006	397
2007	373
2008	352
2009-2013	1,291
Thereafter	592
Total	**4,897**

15. INCOME TAX EXPENSE

The Group's provision for income tax for the years ended December 31, 2003, 2002 and 2001 is as follows:

	2003	2002	2001
Current taxes	31,499	15,557	25,069
Deferred taxes	2,274	4,756	4,154
Total income tax expense	**33,773**	**20,313**	**29,223**

The provision for income taxes is different from that which would be obtained by applying the statutory income tax rate to net income before income tax and minority interests. The items causing this difference are as follows:

	2003	2002	2001
Income tax charge computed on income before taxes at standard tax rate applicable to the Group of 24% (35% in 2001)	31,745	21,307	33,767
Currency exchange and translation differences	(968)	(1,115)	1,111
Effect of rates different from standard	(161)	(545)	(457)
Non-deductible items	3,157	666	12,523
Effect of changes in income tax rate	-	-	10,918
Tax credits	-	-	(10,374)
Change in valuation allowance	-	-	(18,265)
Income tax expense	**33,773**	**20,313**	**29,223**

Temporary differences between the tax and accounting bases of assets and liabilities give rise to the following deferred tax assets and liabilities at December 31, 2003 and 2002:

	2003	2002
Deferred tax assets		
Accrued operating expenses	2,548	2,598
Post-retirement benefits	1,175	1,062
Property, plant and equipment contributions	21,213	10,999
Deferred revenues	25,135	14,633
Tax losses carry forward	1,539	8,343
Allowance for doubtful accounts	2,667	-
Total	**54,277**	**37,635**
Deferred tax liabilities		
Undistributed earnings of affiliates	(4,338)	(4,076)
Depreciation of property, plant and equipment	(63,187)	(8,536)
Other	(163)	(602)
Total	**(67,688)**	**(13,214)**

The Group does not record a deferred tax liability related to undistributed earnings of MTU-Inform, as it intends to permanently reinvest these earnings.

16. SHAREHOLDERS' EQUITY

Common shares carry voting rights with no guarantee of dividends.

Preferred shares carry guaranteed dividend rights amounting to the higher of (a) 10% of the income of MGTS as disclosed in the Russian statutory accounting reports prepared under Russian accounting regulations and (b) the dividends paid on common shares. No dividends may be declared on common shares before dividends on preferred shares are declared. Where the preferred dividend payable according to the Charter is not paid in any year the preferred shares also carry voting rights. At the annual shareholders meetings in June 2003 and 2002 the payment of a dividend to preferred shareholders was approved.

Preferred shares carry no voting rights except on resolutions regarding liquidation or reorganization of MGTS, changes to dividend levels of preferred shares, or the issuance of additional preferred stock. Such resolutions require two-thirds approval of preferred shareholders. The preferred shares have no rights of redemption.

In the event of liquidation, preferred shares have priority over common shares. In this circumstance, holders of preferred shares receive the par value of their shares, or the amounts payable to common shareholders, if higher.

In accordance with the Charter, MGTS is permitted to repurchase, on the open market, up to 10% of its common and preferred shares each year. Repurchased shares must either be sold or cancelled within one year of being purchased. MGTS has no treasury shares as at December 31, 2003.

In June 2002 MGTS increased the par value of each share of its common and preferred stock from 20 RUR to 40 RUR. Consequently, the aggregate par value of the issued stock was increased by reclassifying the respective amount from the Group's retained earnings as of the date of approval of this transaction by shareholders.

17. OPERATING REVENUES

Operating revenues for the years ended December 31, 2003, 2002 and 2001 consisted of the following:

	2003	2002	2001
MGTS - Fixed monthly charges			
Companies	61,607	58,225	56,406
State financed institutions	24,006	17,648	14,569
Residential customers	113,176	74,096	57,036
MGTS - Local traffic fees			
Companies	26,483	23,022	25,140
State financed institutions	2,430	2,337	2,567
MGTS - Service activation fees			
Companies	15,077	13,286	14,062
State financed institutions	1,411	1,220	1,376
Residential customers	5,094	4,056	3,053
MGTS - Data transmission	14,847	6,421	-
MGTS - OAO Rostelecom interconnect	24,742	21,244	32,459
MGTS - Rental of lines	37,177	27,241	17,720
MGTS - Other	38,221	39,651	39,389
MTU-Inform and other subsidiaries	108,241	92,452	92,454
Total	**472,512**	**380,899**	**356,231**

MGTS is not licensed to provide domestic long-distance and international long-distance, or DLD/ILD, telecommunications services directly to its subscribers, but must route such traffic through a DLD/ILD licensed operator. As a result, DLD/ILD traffic originated by MGTS subscribers is carried by Rostelecom, which bills MGTS subscribers directly. In 2003 MGTS had an agreement with Rostelecom pursuant to which Rostelecom paid MGTS approximately $2.0 mln. per month of its DLD/ILD revenues generated by MGTS subscribers.

18. OPERATING EXPENSES

Operating expenses for the years ended December 31, 2003, 2002 and 2001 consisted of the following:

	2003	2002	2001
Employee costs	126,066	86,435	76,491
Depreciation charge	69,298	61,423	60,193
Repairs and maintenance	52,353	41,882	37,415
Taxes other than income taxes	12,991	14,622	13,326
Network traffic	4,036	5,301	6,306
Utilities and energy	13,013	10,257	8,849
Rent	9,484	8,249	3,733
Bank charges	6,531	4,761	3,843
Advertising	5,810	2,834	2,935
Insurance	6,052	4,022	3,675
Transportation	2,389	1,902	1,872
Provision for bad debts	348	1,270	1,141
Sundry expenses	26,839	24,631	17,044
Total	**335,210**	**267,589**	**236,823**

19. SEGMENT INFORMATION

An analysis of the Group's business segment information for the years ended December 31, 2003, 2002 and 2001 is as follows:

Year ended December 31, 2003	MGTS	MTU-Inform and other subsidiaries	Total
Net sales to external customers	364,271	108,241	472,512
Intersegment sales	16,118	-	16,118
Income from affiliates	894	-	894
Interest income	2,207	2,449	4,656
Interest expense	(17,057)	(143)	(17,200)
Depreciation charge	(59,514)	(9,784)	(69,298)
Operating income	82,504	54,798	137,302
Income tax expense	(18,147)	(15,626)	(33,773)
Investments in affiliated companies	73,257	-	73,257
Segment assets	1,104,584	178,856	1,283,440
Capital expenditures	99,106	14,256	113,362

Year ended December 31, 2002	MGTS	MTU-Inform and other subsidiaries	Total
Net sales to external customers	288,447	92,452	380,899
Intersegment sales	14,574	-	14,574
Income from affiliates	3,025	-	3,025
Interest income	950	971	1,921
Interest expense	(29,990)	(145)	(30,135)
Depreciation charge	(52,367)	(9,056)	(61,423)
Operating income	70,282	43,028	113,310
Income tax expense	(10,342)	(9,971)	(20,313)
Investments in affiliated companies	72,392	-	72,392
Segment assets	966,952	130,205	1,097,157
Capital expenditures	82,504	15,470	97,974

Year ended December 31, 2001	MGTS	MTU-Inform and other subsidiaries	Total
Net sales to external customers	263,777	92,454	356,231
Intersegment sales	10,594	-	10,594
Income from affiliates	2,287	-	2,287
Interest income	792	141	933
Interest expense	(28,465)	(802)	(29,267)
Depreciation charge	(51,377)	(8,816)	(60,193)
Operating income	66,217	53,191	119,408
Income tax expense	(7,702)	(21,521)	(29,223)
Investments in affiliated companies	73,257	-	73,257
Segment assets	920,931	136,028	1,056,959
Capital expenditures	100,103	11,171	111,274

The reconciliation of segment assets to the respective information in the consolidated financial statements is as follows:

	2003	2002	2001
Total segment assets	1,283,440	1,097,157	1,056,959
Assets of discontinued operations	58,999	76,031	75,783
Intersegment assets	(20,400)	(18,210)	(25,507)
Consolidated assets	1,322,039	1,154,978	1,107,235

20. EARNINGS PER SHARE

Earnings per common share have been calculated using the two-class method on the basis of earnings and weighted average number of common shares outstanding calculated as follows:

	2003	2002	2001
Net income from continuing operations	78,437	53,894	54,217
(Loss) income from discontinued operations	(8,626)	4,331	849
Less: dividends declared on preferred shares	(6,576)	(3,549)	(1,218)
Net income available to common shareholders	**63,235**	**54,676**	**53,848**

Weighted average number of common shares outstanding was 79,829,200 for each of three years in the period ended December 31, 2003.

21. OPERATING LEASES

(a) As lessor **–** The Group leases excess office space through operating leases, the majority of which are cancelable. Assets under operating leases are included in property, plant and equipment. The amount of rent income under these agreements is not significant to the Group's results.

(b) As lessee **–** The Group leases buildings and office space mainly from Moscow Government through contracts, which expire in various years through 2008. Rental expenses under operating leases are included in the statement of operations (Note 18). Future minimum lease payments due under non-cancelable leases at December 31, 2003 are:

2004	6,636
2005	2,810
2006	2,593
2007	2,447
2008	2,390
Thereafter	27,786
Total	**44,662**

The land on which the Group's buildings and other facilities are located is owned by the City of Moscow. The Group pays the city rent for the land based on the total area and location of land occupied. Land rental expense was approximately $2.8 mln. for the year ended December 31, 2003 and $0.9 mln. for each of the years ended as of December 31, 2002 and 2001.

22. RELATED PARTY TRANSACTIONS

The Group provides services to affiliates and companies related by means of common control. The revenues generated from these companies in 2003, 2002 and 2001 were approximately $64.0 mln., $53.0 mln. and $51.0 mln., respectively.

The Group purchases insurance services from Rosno, a company related by means of common control. The respective insurance expense in 2003, 2002 and 2001 amounted to $4.8 mln., $4.7 mln. and $3.3 mln., respectively.

The Group purchases telecommunication equipment from Strom Telecom s.r.o, a company related by means of common control. The cost of equipment purchased from Strom Telecom in 2003, 2002 and 2001 was $9.7 mln., $8.1 mln. and $17.1 mln., respectively.

Interest income received from MBRD on bank and deposit accounts in 2003, 2002 and 2001 amounted to $1.2 mln, $0.4 mln. and $0.2 mln., respectively. Interest income received on MBRD promissory notes in 2003, 2002 and 2001 amounted to $1.7 mln., $0.3 mln. and $0.2, respectively.

23. COMMITMENTS AND CONTINGENCIES

Issued guarantees **–** MGTS is a guarantor under the credit facility with a limit of $65.0 mln. provided to Comstar by Vnesheconombank. The facility is effective till January 2005. The guarantee amounted to $7.1 mln. and $12.3 mln. as of December 31, 2003 and 2002, respectively.

MGTS is a guarantor under the credit facility with a limit of $4.2 mln. provided to RTK-Leasing, a related party, by Vneshtorgbank. The facility is to be settled prior to July 2004. The guarantee amounted to $1.5 mln. and $3.1 mln. as of December 31, 2003 and 2002, respectively.

In December 2002 MTU-Inform and Alfabank signed a Guarantee agreement. According to the agreement MTU-Inform guaranteed a loan of $4.0 mln. provided to Golden Line by Alfabank. The loan matures in November, 2005. In addition, MTU-Inform pledged equipment with a fair value of $4.7 mln.

In December 2003 MTU-Inform pledged telecommunication equipment in the amount of $17.4 mln. to guarantee a loan provided by MBRD to Skylink, a related party. The amount of the loan as of December 31, 2003 is $15.7 mln. and is to be settled in December 2004.

Under these guarantees the Group could be potentially liable for a maximum amount of $29 mln. in case of the borrower's default under the obligations. As of December 31, 2003, no event of default has occurred under any of the guarantees issued by the Group.

Contingencies **–** The Russian economy, while deemed to be of market status beginning in 2002, continues to display certain traits consistent with that of an emerging market. These characteristics have in the past included higher than normal inflation, insufficient liquidity of the capital markets, and the existence of currency controls which cause the national currency to be illiquid outside of Russia. The continued success and stability of the Russian economy will be subject to the government's continued actions with regard to legal, and economic reforms.

On January 1, 2004, a new Law on telecommunications came into effect in Russia. The law sets the legal basis for the telecommunications business in Russia and defines the status that state bodies have in the telecommunications sector. The Group cannot predict with any certainty how the new law will affect it. The new law creates a new interconnect pricing regime in 2004 that should be more transparent and unified and it creates a universal service charge calculated as a percentage of revenue which will be introduced from 2005. The new law may increase the regulation of the Group's operations and until the time when appropriate regulations consistent with the new law are promulgated, there will be a period of confusion and ambiguity as regulators interpret the legislation.

In recent years, the Russian government has initiated revisions of the Russian tax system. Effective January 1, 1999, the first part of the Tax Code was enacted. Effective January 1, 2001, the second part of the Tax Code was enacted and effective January 1, 2002 new regulations, relating to federal income tax were enacted. The new tax system is generally intended to reduce the number of taxes, the overall tax burden on businesses, and to simplify the tax laws.

Russia currently has a number of laws related to various taxes imposed by both federal and regional governmental authorities. Applicable taxes include value added tax (''VAT''), corporate income tax (profits tax), a number of turnover-based taxes, and payroll (social) taxes, together with others. The government's policy on implementation of these regulations is often inconsistent or nonexistent. These facts create tax risks in Russia that is more significant than typically found in countries with more developed tax systems.

The tax inspection is currently challenging the application by MGTS of certain provision of the tax legislation, including application of the investment allowance for income tax purposes in 2001. The tax inspection assessment amounted to the equivalent of $5.1 mln. at the rate current at balance sheet date. The Group will contest the assessment on the grounds that application of the investment allowance was in compliance with tax laws in effect at the time. No accrual has been made in the accompanying financial statements with respect of this claim.

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

In the ordinary course of business, the Group may be party to various legal and tax proceedings, and subject to claims. In the opinion of management, the Group's liability, if any, in all pending litigation, other legal proceeding or other matters, will not have a material effect upon the financial condition, results of operations or liquidity of the Group.

Licenses – Substantially all the Group's revenues are derived from operations conducted pursuant to licenses to operate in Moscow and the Moscow region granted by the Russian Government. The Voice Phone Communication license expires in July 2008. Suspension or termination of the Group's main license or any failure to renew it could have a material adverse effect on the financial position and operations of the Group. However, the Group has no reason to believe that the license will not be renewed or suspended or terminated, and the management estimates the possibility of such events as very low.

Commitments – In December 2003 MGTS signed an agreement to acquire telecommunications equipment and related services from ECI Telecom. The vendor financing amounting to $4.6 mln. will bear interest of LIBOR + 3% and be repayable in 7 equal quarterly installments starting February 2004.

Interest of the Moscow City Government in the telecommunications sector in the Moscow metropolitan area – The operations of the telecommunications network in Moscow are of considerable interest to the City Government. The City Government has exercised and may be expected to continue to exercise influence over the Group's operations. In particular, the City Government may influence setting of tariffs charged to customers to protect low income groups, such as pensioners.

25. SUBSEQUENT EVENTS

In January 2004 the Group entered an agreement with Ericsson Nikola Tesla D. D., Croatia for purchase of telecommunication equipment for the total amount of $2.6 mln. payable in 2004-2005.

In March 2004 the Group entered a lease agreement with Invest-Svyaz-Holding for purchase of telecommunication equipment from Strom Telecom. The total amount of future minimal lease payments under the agreement is $12.5 mln. payable in 2004-2007. Net book value of leased equipment is approximately $10.7 mln.

In the first quarter of 2004 the Group entered several agreements for purchase of telecommunication equipment from Siemens AG, Germany for the total amount of $14.4 mln. with payments due in 2004 and 2005.

In April 2004, MGTS issued 5-year RUR-denominated bonds in the amount of 1,500 mln. RUR (approximately $50.9 mln.). The bonds carry a coupon of 10% per annum. The Group made an unconditional offer to repurchase the bonds at par value in April 2006.

In May 2004, AFK Sistema announced completion of the operational merger of its three digital operators, including MTU-Inform, Comstar and Telmos. The completion of the legal merger is expected in 2005. The merged company will operate under the name of “Comstar United Telesystems”. Until completion of the legal merger of the three companies the management functions will be carried out by Comstar. Management of the Group can not estimate the potential effect of the merger on the financial position and results of operations of the Group.