# Open Joint Stock Company Polymetal

**Independent Auditors' Report**

**Consolidated Financial Statements**
For The Years Ended 31 December 2008 and 2007

# OPEN JOINT STOCK COMPANY POLYMETAL

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## STATEMENT OF MANAGEMENT'S RESPONSIBILITIES FOR THE PREPARATION AND APPROVAL OF THE CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

The following statement, which should be read in conjunction with the independent auditors' responsibilities stated in the independent auditors' report, is made with a view to distinguishing the respective responsibilities of management and those of the independent auditors in relation to the consolidated financial statements of Open Joint Stock Company Polymetal ("JSC Polymetal") and its subsidiaries (the "Group").

Management is responsible for the preparation of the consolidated financial statements that present fairly the financial position of the Group as at December 31, 2008 and 2007, and the results of its operations, cash flows and changes in shareholders' equity for the years then ended, in compliance with Accounting Principles Generally Accepted in the United States of America ("U.S. GAAP").

In preparing the consolidated financial statements, management is responsible for:

- Selecting suitable accounting policies and applying them consistently;
- Making judgments and estimates that are reasonable and prudent;
- Stating whether U.S. GAAP has been followed, subject to any material departures disclosed and explained in the consolidated financial statements;
- Preparing the consolidated financial statements on a going concern basis, unless it is inappropriate to presume that the Group will continue in business for the foreseeable future.

Management is also responsible for:

- Designing, implementing and maintaining an effective and sound system of internal controls, throughout the Group;
- Maintaining proper accounting records that disclose, with reasonable accuracy at any time, the financial position of the Group, and which enable them to ensure that the consolidated financial statements of the Group comply with U.S. GAAP;
- Maintaining statutory accounting records in compliance with local legislation and accounting standards in the respective jurisdictions in which the Group operates;
- Taking such steps as are reasonably available to them to safeguard the assets of the Group; and
- Preventing and detecting fraud and other irregularities.

The consolidated financial statements for the years ended December 31, 2008 and 2007 were approved by management on April 28, 2009:

On behalf of the Board of Directors:

| | |
|---|---|
| **Nesis V.N.** | **Cherkashin S.A.** |
| Chief Executive Officer | Chief Financial Officer |

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## INDEPENDENT AUDITORS' REPORT

To the Shareholders of Open Joint Stock Company "Polymetal":

We have audited the accompanying consolidated balance sheets of Open Joint Stock Company "Polymetal" and its subsidiaries (the "Group") as at December 31, 2008 and 2007, and the related consolidated statements of operations, changes in shareholders' equity, and cash flows 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 consolidated financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the Group's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides 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 at December 31, 2008 and 2007, 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.

Deloitte & Touche

April 28, 2009

# OPEN JOINT STOCK COMPANY POLYMETAL

## CONSOLIDATED BALANCE SHEETS
## AT DECEMBER 31, 2008 AND 2007
***(In thousands of U.S. Dollars, except share and per share data)***

| | Note | December 31, 2008 | December 31, 2007 |
|---|---|---|---|
| **Assets** | | | |
| Cash and cash equivalents | | 4,077 | 5,019 |
| Prepayments to suppliers | | 11,827 | 12,540 |
| Inventories | 5 | 202,419 | 213,141 |
| Short-term VAT receivable | 6 | 62,718 | 52,078 |
| Short-term deferred tax asset | 7 | 11,758 | 3,806 |
| Other current assets | 8 | 23,862 | 18,057 |
| **Total current assets** | | **316,661** | **304,641** |
| Property, plant and equipment, net | 9 | 484,134 | 502,470 |
| Goodwill | 10 | 23,741 | 30,141 |
| Investments in joint ventures | 11 | 18,124 | 269 |
| Long-term loans to related parties | 12 | 8,214 | 6,119 |
| Long-term VAT receivable | 6 | 13,953 | 10,288 |
| Long-term deferred tax asset | 7 | 11,648 | 3,926 |
| **Total non-current assets** | | **559,814** | **553,213** |
| **Total assets** | | **876,475** | **857,854** |
| **Liabilities and shareholders' equity** | | | |
| Accounts payable and accrued liabilities | | 28,738 | 32,254 |
| Short-term debt and current portion of long-term debt | 13 | 316,369 | 152,006 |
| Taxes payable | | 10,060 | 9,453 |
| Short-term deferred tax liability | 7 | 6,338 | 11,437 |
| Current portion of capital lease liabilities | | - | 2,417 |
| **Total current liabilities** | | **361,505** | **207,567** |
| Long-term accounts payable and accrued liabilities | 28 | 4,523 | - |
| Long-term portion of capital lease liabilities | | - | 147 |
| Long-term debt | 14 | - | 71,200 |
| Deferred tax liability | 7 | 29,458 | 37,628 |
| Reclamation and mine closure obligation | 15 | 26,128 | 8,035 |
| Deferred payments | 16 | 5,193 | 7,438 |
| **Total non-current liabilities** | | **65,302** | **124,448** |
| **Total liabilities** | | **426,807** | **332,015** |
| **Commitments and contingencies** | 31 | - | - |
| **Shareholders' equity** | | | |
| Share capital (2,444,000,000 shares authorized with par value of Ruble 0.2 per share; 315,000,000 shares issued at December 31, 2008 and 2007; 315,000,000 and 309,459,677 shares outstanding at December 31, 2008 and 2007, respectively) | 17 | 6,698 | 6,698 |
| Additional paid-in capital | | 400,122 | 367,129 |
| Treasury shares, at cost (5,540,323 ordinary shares at December 31, 2007) | 17 | - | (50) |
| Accumulated other comprehensive (loss)/income | | (37,276) | 56,208 |
| Retained earnings | | 80,124 | 95,854 |
| **Total shareholders' equity** | | **449,668** | **525,839** |
| **Total liabilities and shareholders' equity** | | **876,475** | **857,854** |

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

# OPEN JOINT STOCK COMPANY POLYMETAL

## CONSOLIDATED STATEMENTS OF OPERATIONS
## FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007
***(In thousands of U.S. Dollars, except share and per share data)***

| | Note | December 31, 2008 | December 31, 2007 |
|---|---|---|---|
| Revenues | 19 | 502,731 | 308,747 |
| Cost of sales | 20 | 300,729 | 254,638 |
| **Gross profit** | | **202,002** | **54,109** |
| General, administrative and selling expenses | 24 | 90,142 | 42,275 |
| Other operating expenses | 25 | 36,231 | 27,423 |
| **Operating income/(loss)** | | **75,629** | **(15,589)** |
| Interest expense | | 20,675 | 12,607 |
| Loss from investments in joint ventures | 11 | 8,393 | - |
| Exchange loss/(gain), net | | 44,520 | (11,433) |
| **Income/(loss) before income tax and extraordinary gain** | | **2,041** | **(16,763)** |
| Income tax expense | 26 | 18,611 | 6,063 |
| **Loss before extraordinary gain** | | **(16,570)** | **(22,826)** |
| Extraordinary gain – Excess of fair value of acquired net assets over cost | 28 | 840 | **-** |
| **Net loss** | | **(15,730)** | **(22,826)** |
| Basic and diluted loss per share (expressed in U.S. Dollars): | 17 | | |
| Loss per share from continuing operations | | (0.053) | (0.074) |
| Earnings per share from extraordinary gain | | 0.003 | - |
| | | (0.050) | (0.074) |
| Weighted average number of shares outstanding | | 312,450,725 | 307,581,330 |

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

# OPEN JOINT STOCK COMPANY POLYMETAL

## CONSOLIDATED STATEMENTS OF CASH FLOWS
## FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007
***(In thousands of U.S. Dollars)***

| | Note | December 31, 2008 | December 31, 2007 |
|---|---|---|---|
| **Cash flows from operating activities** | | | |
| Net loss | | (15,730) | (22,826) |
| Adjustments to reconcile net loss to cash provided from operations: | | | |
| Depreciation and depletion | | 48,522 | 47,329 |
| Deferred income tax benefit | 26 | (11,254) | (6,379) |
| Loss on disposal of property, plant and equipment | 25 | 4,624 | 343 |
| Share-based compensation | 24 | 31,902 | 10,584 |
| Exchange loss/(gain), net | | 44,520 | (11,433) |
| Loss on impairment of long-lived asset | 25 | - | 6,676 |
| Write-down of inventory to lower of cost or market | 20 | 10,583 | - |
| Loss from investments in joint ventures | | 8,393 | - |
| Other non-cash expenses | | 4,820 | 10,577 |
| Changes in working capital, excluding cash: | | | |
| Accounts receivable | | - | 3,587 |
| Prepayments to suppliers | | (2,811) | 1,813 |
| Inventories | | (29,058) | (36,174) |
| VAT receivable | | (22,907) | (4,060) |
| Other current assets | | (8,799) | (11,074) |
| Accounts payable and accrued liabilities | | 17,328 | 8,655 |
| Taxes payable | | 636 | (424) |
| **Net cash provided by/(used in) operating activities** | | **80,769** | **(2,806)** |
| | | | |
| **Cash flows from investing activities** | | | |
| Additions to property, plant and equipment | | (112,490) | (115,654) |
| Proceeds from the sale of property, plant and equipment | | 1,808 | 4,211 |
| Acquisition of subsidiaries and minority interest, net of cash acquired | 28 | (22,014) | (18,250) |
| Proceeds from sale of subsidiaries | | 55 | - |
| Investments in joint ventures | | (27,422) | - |
| Loans provided to third parties | | (526) | - |
| Repayment of loans provided to third parties | | - | 392 |
| Loans provided to related parties | | (4,566) | - |
| Repayment of loans provided to related parties | | 1,131 | 465 |
| **Net cash used in investing activities** | | **(164,024)** | **(128,836)** |
| | | | |
| **Cash flows from financing activities** | | | |
| Proceeds from short-term borrowings | | 367,256 | 242,907 |
| Repayment of short-term borrowings | | (356,992) | (352,110) |
| Proceeds from long-term borrowings | | - | 388,506 |
| Repayment of long-term borrowings | | (67,614) | (450,996) |
| Proceeds from issuance of shares, net of costs incurred of U.S. Dollar 10,716 | 17 | - | 299,284 |
| Bonus received from depositary | 16 | - | 8,560 |
| Proceeds from long-term loans and borrowings from related parties | | 200,142 | 45,013 |
| Repayments of long-term loans and borrowings from related parties | | (57,681) | (44,797) |
| Purchase of treasury shares | 28 | - | (50) |
| Proceed from issuance of shares under employee stock option plan | | 212 | - |
| Capital lease payments | | (2,182) | (6,663) |
| **Net cash provided by financing activities** | | **83,141** | **129, 654** |

**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007 (CONTINUED)**
***(In thousands of U.S. Dollars)***

| | Note | December 31, 2008 | December 31, 2007 |
|---|---|---|---|
| Effect of foreign currency translation on cash and cash equivalents | | (828) | 475 |
| **Net decrease in cash and cash equivalents** | | **(942)** | **(1,513)** |
| Cash and cash equivalents at the beginning of the year | | 5,019 | 6,532 |
| **Cash and cash equivalents at the end of the year** | | **4,077** | **5,019** |
| | | | |
| **Supplementary cash flow information** | | | |
| Interest paid | | 23,050 | 18,800 |
| Income taxes paid | | 37,983 | 2,345 |
| | | | |
| Non-cash investing and financing activities: | | | |
| Investments in joint ventures | 29 | 3,482 | - |

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

## OPEN JOINT STOCK COMPANY POLYMETAL

### CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
### FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007
***(In thousands of U.S. Dollars, except share data)***

| | Note | Number of shares outstanding | Share capital | Additional paid-in capital | Treasury shares | Accumulated other comprehen-- sive (loss)/ income | Retained earnings | Total shareholders' equity |
|---|---|---|---|---|---|---|---|---|
| **Balance at December 31, 2006** | | **275,000,000** | **6,397** | **56,710** | **-** | **10,447** | **118,680** | **192,234** |
| Comprehensive income: | | | | | | | | |
| Net loss | | - | - | - | - | - | (22,826) | (22,826) |
| Other comprehensive income: currency translation adjustment | | - | - | - | - | 45,761 | - | 45,761 |
| Total comprehensive income | | | | | | | | 22,935 |
| Share issuance, net of transaction costs of 10,716 | 17 | 40,000,000 | 301 | 299,835 | - | - | - | 300,136 |
| Share based compensation | 18 | - | - | 10,584 | - | - | - | 10,584 |
| Acquisition of treasury shares | 17 | (5,540,323) | - | - | (50) | - | - | (50) |
| **Balance at December 31, 2007** | | **309,459,677** | **6,698** | **367,129** | **(50)** | **56,208** | **95,854** | **525,839** |
| Comprehensive loss: | | | | | | | | |
| Net loss | | - | - | - | - | - | (15,730) | (15,730) |
| Other comprehensive loss: currency translation adjustment | | - | - | - | - | (93,484) | - | (93,484) |
| Total comprehensive loss | | | | | | | | (109,214) |
| Amortization of the bonus received from depositary | 16 | - | - | 929 | - | - | - | 929 |
| Share based compensation | 18 | - | - | 31,902 | - | - | - | 31,902 |
| Issuance of treasury shares | 17 | 5,540,323 | - | 162 | 50 | - | - | 212 |
| **Balance at December 31, 2008** | | **315,000,000** | **6,698** | **400,122** | **-** | **(37,276)** | **80,124** | **449,668** |

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

# 1. BACKGROUND

## Business activities

Open Joint Stock Company Polymetal (hereinafter JSC "Polymetal" or "the Company") and its subsidiaries ("the Group") is engaged in gold and silver mining and related activities, including exploration, extraction, processing and reclamation. Since incorporation, the Group has acquired a number of gold and silver mining properties, which require significant investment to bring to commercial production. The Group owns producing assets at Vorontsovkoye and Lunnoe fields, Dukat and Khakandjinskoye mines.

The Group has three reportable segments which are based on regional locations in Russia. All of the Group's customers, operations and assets are located in Russia.

The Group holds the following significant mining licenses: Vorontsovskoye field (Sverdlovsk region), Lunnoe field, Arylakh, Dukat and Kubaka field (Magadan region), Khakandjinskoye, Urjevskoe and Albazino field (Khabarovsk region).

## Ownership structure

Open Joint Stock Company "Interregional Research and Production Association Polymetal" was incorporated on March 12, 1998 in the Russian Federation. On December 19, 2006, the Open Joint Stock Company "Interregional Research and Production Association Polymetal" was renamed as Open Joint Stock Company "Polymetal".

The Company's majority shareholder prior to November 2005 was Closed Joint Stock Company ICT ("CJSC ICT"), which, together with its subsidiaries formed the ICT group. In November 2005, CJSC ICT sold their interests in the Company to Open Joint Stock Company Nafta Moskva ("JSC Nafta Moskva").

In 2006, after restructuring of JSC Nafta Moskva, Nafta Moskva (Cyprus) Limited, a subsidiary of JSC Nafta Moskva, became the sole shareholder of the Company until the Company's public offering. In February 2007, the Company placed 40,000,000 ordinary shares with par value of Rouble 0.2 per share in the form of Global Depositary Receipts ("GDRs") on the London Stock Exchange, as well as shares on "Stock Exchange Russian Trading System" ("RTS") and "Moscow Interbank Currency Exchange" ("MICEX").

In June 2008 Nafta Moskva (Cyprus) Limited sold all of its interest in the Company (68.0%) to three parties: Quotan International Limited, ultimate beneficiary owner of which is Alexander Nesis (24.05%), PPF Group NV, ultimate beneficiary owner of which is Petr Kellner (24.9%), and Inure Enterprises Limited, ultimate beneficiary owner of which is Alexander Mamut (19.05%). Another 17.1% of the Company's shares are held by Deutsche Bank Trust Company Americas and as at December 31, 2008 there are no other shareholders who hold more than 10% of the total share capital of the Company.

***(In thousands of U.S. Dollars, except share data)***

### Operating environment and working capital deficit

In recent months a number of major economies around the world have experienced volatile capital and credit markets. A number of major global financial institutions have either been placed into bankruptcy, taken over by other financial institutions and/or supported by government funding. As a consequence of the recent market turmoil in capital and credit markets both globally and in Russia, notwithstanding any potential economic stabilisation measures that may be put into place by the Russian Government, there exists as at the date these consolidated financial statements are authorised for issue economic uncertainties surrounding the continual availability, and cost, of credit both for the Group and its counterparties, the potential for economic uncertainties to continue in the foreseeable future and, as a consequence, the potential that assets may be not be recovered at their carrying amount in the ordinary course of business, and a corresponding impact on the Group's profitability.

As of December 31, 2008 the Group's current liabilities exceeded its current assets by U.S. Dollar 44,844. Additionally, the Group incurred a net loss of U.S. Dollar 15,730 for the year ended December 31, 2008.

Management's efforts to improve the Group's liquidity position are concentrated primarily on extending and refinancing the existing borrowings and obtaining new debt from existing lenders, including Nomos-Bank, Gazprombank and VTB (see Notes 13, 14 and 32) and equity financing by the issue of ordinary shares (see Note 32). While access to such financing has become more difficult with the tightened credit markets, management believes it will be able to obtain, however expects the associated financing costs to increase.

Management is of the opinion that the Group will continue as a going concern.

### Composition of the Group

The Company and its subsidiaries are collectively referred to as "the Group". As at December 31, 2008, the Company had the following significant mining subsidiaries:

| Name of subsidiary | Field | Voting interest % | Effective ownership interest % |
|---|---|---|---|
| CJSC Zoloto Severnogo Urala | Vorontsovkoye | 100 | 100 |
| JSC Okhotskaya GGC | Khakandjinskoye, Urjevskoe | 100 | 100 |
| CJSC Serebro Magadana | Dukat, Lunnoe, Arylakh | 100 | 100 |

On April 1, 2008 the Group merged two of its subsidiaries – CJSC Serebro Territorii and CJSC Serebro Magadana. Starting from the second quarter of 2008 all production activities of these subsidiaries are performed by CJSC Serebro Magadana. Other changes in the Group structure and voting and ownership interests in major production subsidiaries in the years ended December 31, 2008 and 2007 are described in Notes 28 and 29.

## 2. BASIS OF PRESENTATION

These consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"). The Company and its significant subsidiaries are all domiciled in the Russian Federation and maintain their accounting records and prepare their statutory financial statements in accordance with the Regulations on Accounting and Reporting of the Russian Federation ("RAR"). The accompanying consolidated financial statements have been prepared from these accounting records and adjusted, where necessary, to comply with U.S. GAAP.

**Recently issued accounting pronouncements**

***Accounting pronouncements effective during the reporting period***

In June 2006, the Financial Accounting Standards Board ("FASB") issued Financial Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in accordance with Statement of Financial Accounting Standards ("SFAS") No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 became effective for fiscal years beginning after December 15, 2006. The Group adopted FIN 48 on January 1, 2007. The adoption of FIN 48 had no impact on the Group's beginning retained earnings.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ("SFAS No. 157"). SFAS No. 157 defines fair value, establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements. SFAS No. 157 creates a fair value hierarchy, which prioritizes the inputs that should be used in determining fair value. Under this pronouncement, companies must provide disclosures containing relevant information in the financial statements, allowing users to assess inputs used to measure fair value, as well as the effect of those measurements on earnings for the periods presented, including a reconciliation of the beginning and ending balances separately for each major category of assets and liabilities. The adoption of the relevant effective provisions of SFAS No. 157 in 2008 did not have a material impact on the Group's financial position or results of operations.

In October 2008, the FASB issued Staff Position ("FSP") No. 157-3, *Determining the Fair Value of a Financial Asset When The Market for That Asset Is Not Active* ("FSP No. 157-3"), effective October 2008, to clarify the application of the provisions of SFAS No. 157 in an inactive market and how an entity would determine fair value in an inactive market. FSP No. 157-3 was effective upon issuance, including prior periods for which financial statements have not been issued and applies to the Group's December 31, 2008 financial statements. The adoption of FSP No. 157-3 in 2008 did not have a material impact on the Group's financial position or results of operations other than expanded disclosures.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financials Liabilities – Including an Amendment of FASB Statement No. 115* ("SFAS No. 159"). This standard permits, but does not require, measurement of certain financial assets and financial liabilities at fair value. If the fair value option is elected, the unrealized gains and losses are reported in earnings at each reporting date. Generally, the fair value option may be elected on an instrument-by-instrument basis, as long as it is applied to the instrument in its entirety. The fair value option election is irrevocable, unless a new election date occurs. SFAS No. 159 requires prospective application and also establishes certain additional presentation and disclosure requirements. The standard is effective for financial statements issued for fiscal years beginning after November 15, 2007.

The Group adopted the provisions of SFAS No. 159 effective January 1, 2008. Management has decided not to designate any additional financial instruments to be accounted for at the fair value effective January 1, 2008 and therefore the adoption of this standard did not have an impact on the Group's financial position or results of operations.

***Accounting pronouncements effective in the future***

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ("SFAS No. 141R"). SFAS No. 141R significantly changes the accounting for business combinations. Under SFAS No. 141R, an acquirer entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition date fair value with limited exceptions. SFAS No. 141R will change the accounting treatment for certain specific acquisition related items including expensing acquisition related costs as incurred, valuing noncontrolling interest at fair value at the acquisition date and expensing restructuring costs associated with the acquired business. SFAS No. 141R will be effective to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

In February 2008, the FASB released FASB Staff Position ("FSP") FAS No. 157-2, *Effective Date of FASB Statement* No. 157 ("FAS 157-2"), which delayed the effective date of SFAS No. 157 for all nonfinancial assets and liabilities to fiscal years beginning after November 18, 2008, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The Group is currently evaluating the impact of FAS No. 157-2 on the consolidated financial statements, and the adoption of this statement is not expected to have a material effect on the consolidated financial position, results of operations or cash flows.

In March 2008, the FASB issued SFAS No. 161, *Disclosure about Derivative Instruments and Hedging Activities* ("SFAS No. 161"). This statement improves financial reporting about derivative instruments and hedging activities by enhanced disclosures of their effects on entity's financial position, financial performance and cash flows. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008 with early application encouraged. The Group does not believe that SFAS No. 161 will have an impact on its financial position, results of operations or cash flows.

In May 2008, the FASB issued SFAS No. 162, *the Hierarchy of Generally Accepted Accounting Principles* ("SFAS No. 162"), which identifies a consistent framework for selecting the accounting principles to be used in preparing financial statements for nongovernmental entities that are presented in conformity with U.S. GAAP. The current GAAP hierarchy was criticized due to its complexity, ranking position of FASB Statements of Financial Accounting Concepts and the fact that it is directed at auditors rather than entities. SFAS No. 162 will be effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The FASB does not expect that SFAS No. 162 will change the current practice, and the Group does not believe that SFAS No. 162 will have an impact on its financial position, results of operations or cash flows.

In November 2008, the FASB ratified Emerging Issues Task Force ("EITF") 08-6, *Equity Method Investment Accounting Considerations* ("EITF No. 08-6"). EITF No. 08-6 clarifies the accounting for certain transactions and impairment considerations involving equity method investments in the context of issuance of FAS141(R), *Business Combinations*, and Statement 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51*. EITF No. 08-6 applies to all investments accounted for under the equity method.

***(In thousands of U.S. Dollars, except share data)***

Among other things EITF No. 08-6 clarifies initial measurement of equity investments; impairment testing of equity investments; accounting by equity investor for a share issuance by an investee. EITF No. 08-6 is effective in fiscal years beginning on or after December 15, 2008, and interim periods within those fiscal years. Earlier application is not permitted. The Group will adopt EITF No. 08-6 effective January 1, 2009. The Group does not expect EITF No. 08-6 to have a material impact on the Group's consolidated financial position and results of operations.

**Use of estimates**

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, including discussion and disclosure of contingent liabilities. Significant areas requiring the use of management estimates relate to the determination of mineral reserves, mine closure liabilities, reclamation and environmental obligations, estimates of recovery rates for the heap leach process, the valuation of inventory, impairment of assets and valuation allowances for deferred tax assets. Actual results could differ from these estimates.

**Reporting and functional currency**

The Russian Ruble (“Ruble”) is considered to be the functional currency of the Company and all its subsidiaries domiciled in the Russian Federation. Most of the Group’s sales revenues and purchases and certain financing agreements are settled in Russian Rubles. The U.S. Dollar is the reporting currency selected by the Group for purposes of financial reporting in accordance with U.S. GAAP.

As a result, the transactions and balances in the accompanying consolidated financial statements have been translated into U.S. Dollars in accordance with the relevant provisions of SFAS No. 52, *Foreign Currency Translation*. Consequently, assets and liabilities are translated at period closing exchange rates. Revenues, expenses, gains and losses have been translated using period average exchange rates. Translation differences resulting from the use of these exchange rates have been included as a separate component of shareholders’ equity.

Transactions in foreign currencies are recorded at the exchange rate prevailing on the date of the transaction. Assets and liabilities denominated in foreign currencies are expressed in the functional currency at the exchange rates in effect at the balance sheet date.

The following exchange rates were used at the reporting dates:

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| U.S. Dollar | 29.38 | 24.55 |
| Average exchange rate for the year, U.S. Dollars | 24.85 | 25.55 |

## 3. SIGNIFICANT ACCOUNTING POLICIES

**Principles of consolidation**

The consolidated financial statements include the results of operations of all entities in which the Company directly or indirectly controls more than 50 percent of the voting power and all variable interest entities in which the Company, or a subsidiary in the Group is regarded to be the primary beneficiary.

All intercompany transactions and balances between Group companies have been eliminated.

**Business acquisitions**

Business acquisitions from third parties are accounted for using the purchase method of accounting. Under this method, the purchase price is allocated to the assets acquired and liabilities assumed based on the fair value at the time of the acquisition. The excess purchase price over the fair value of identifiable assets and liabilities acquired is treated as goodwill. The results of operations of entities acquired from third parties are included in the Group's results of operations from the date of acquisition.

Acquisitions of entities under common control are accounted for on a carryover basis, which results in the historical book value of assets and liabilities of the acquired entity being combined with the assets and liabilities of the Group. The consolidated and combined historical statements of the Group are retroactively restated to reflect the effect of the acquisition during the entire period in which the entities where under common control. Any difference between the purchase price and the net assets acquired is reflected in shareholders' equity.

**Investments in incorporated joint ventures**

A joint venture is an entity in which the Group holds a long-term interest and which is jointly controlled by the Group and one or more external joint venture partners under a contractual agreement that provides for strategic, financial and operating policy decisions relating to the activities requiring unanimous consent of the parties sharing control.

Investments in incorporated joint ventures are accounted for using the equity method. The initial investments in these entities are recorded at cost. After the acquisition, the Group's share of profits or losses of incorporated joint ventures is recognized in the income statement as earnings from equity method investees. The carrying amount of investments in incorporated joint ventures is adjusted to recognize all cumulative post-acquisition movements in the equity of the investee.

The carrying value of equity method investments in incorporated joint ventures is evaluated for impairment when conditions indicate that a decline in fair value below the carrying amount is other than temporary, at least annually. When an indicated impairment exists, the carrying value of the Group's investment in those entities is written down to its fair value.

**Asset impairment**

The Group assesses its held-for-use long lived assets for impairment when events or changes in circumstances indicate that the related carrying amount may not be recoverable. If the sum of estimated future cash flows on an undiscounted basis is less than the carrying amount of the related assets, an impairment is considered to exist. The related impairment loss is measured by comparing the estimated future cash flows on a discounted basis to the carrying amount of the asset.

An individual operating mine is not a typical "going-concern" business because of the finite life of its reserves. The allocation of goodwill to an individual operating mine will result in an eventual goodwill impairment due to the wasting nature of the mine reporting unit. In accordance with the provisions of SFAS No. 142, *Goodwill and Other Intangibles* ("SFAS No. 142"), the Group performs a review of goodwill for impairment, at least annually or whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

In accordance with SFAS No. 142, goodwill is reviewed for impairment by comparing the carrying value of each reporting unit's net assets (including allocated goodwill) to the fair value of those net assets. In assessing the fair value the management estimates the future cash flows on an discounted basis to be generated by each reporting unit, being the individual mines, smelting and refining operations. If the reporting unit's carrying amount is greater than its fair value, then a second step is performed whereby the portion of the fair value that relates to the reporting unit's goodwill is compared to the carrying value of that goodwill. The Company recognizes a goodwill impairment charge for the amount by which the carrying value of goodwill exceeds the fair value. The Company has determined that there are no impairment losses in respect of goodwill for any of the reporting periods covered by these financial statements.

**Cash and cash equivalents**

Cash and cash equivalents include cash and other highly liquid investments that are readily convertible to known amounts of cash and with an original maturity of three months or less at the date of purchase.

**Inventories**

Inventories including gold and silver in process, refined metals, dore, ore stockpiles, spare parts and consumable supplies are stated at the lower of cost or market value. Cost is determined as the sum of the applicable expenditures and charges directly or indirectly incurred in bringing inventories to their existing condition and location.

Work-in-process (which includes gold and silver) and dore are valued at the average total production costs at the relevant stage of production. Ore stockpiles are valued at the average moving cost of mining ore. Spare parts and consumable supplies are valued at the weighted average cost. Refined metals are valued at the cost of production per unit of gold or silver.

Write downs for unrealizable inventory are made in full.

**Financial instruments**

A financial instrument is defined as cash, evidence of an ownership interest in an entity, or a contract that imposes an obligation to deliver or right to receive cash or another financial instrument. The fair values of financial instruments are determined with reference to various market information and other valuation methods, as considered appropriate. However, considerable judgment is required to interpret market data and to develop the estimates of fair value. Accordingly, the estimates presented herein may differ from the amounts the Group could receive in current market exchanges.

For long-term borrowings, the difference between the fair value and carrying value, as at December 31, 2007, was not material as interest rates as at December 31, 2007 approximated market rates and there was no change in the credit rating of the Group in 2007. The Group has no long-term borrowings as at December 31, 2008.

As at December 31, 2008 and 2007, the carrying values of cash and cash equivalents, accounts payable and accrued liabilities, short-term debt, and loans to related parties approximate their fair values because of the short maturities of these instruments.

As at December 31, 2008 and 2007, it is not practicable for the Group to estimate the fair values of all of its investments in affiliates, as quoted market prices are not readily available and, due to nature of the investments, valuations are not being completed or obtained.

**Derivatives**

SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities,* (“SFAS No. 133”), establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. SFAS No. 133 requires an entity to recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. SFAS No. 133 provides that normal purchase and normal sale contracts, when appropriately designated, are not subject to the statement. Normal purchase and normal sale contracts are contracts which provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. To qualify for the normal purchase and normal sale exception, it must be probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery. The Group’s forward sales contracts qualify for this exception. The Group does not have any other derivative financial instruments.

**Property, plant and equipment**

Property, plant and equipment consist of assets of the Group directly related to mining and processing of ore and include costs of development of the mining properties, the costs of acquisition or construction of property, plant and equipment and capitalized interest. Expenditures for major improvements and renewals are capitalized. The cost of maintenance, repairs and replacement of minor items of plant and equipment is charged to operations as incurred. Interest attributable to the acquisition or construction of property, plant and equipment is capitalized using an overall borrowing rate as a cost of the asset up to the time the asset is put into use. All other interest is expensed as incurred. Gains and losses on the disposal of assets are included in the statement of operations in the period of disposal.

Mineral exploration costs are expensed as incurred. When it has been determined that a mineral property can be economically developed as a result of established proven and probable reserves, the costs incurred in exploration and development of such property, including costs to further delineate the ore body and remove any overburden to initially expose the ore body are capitalized.

In accordance with EITF Issue 04-6, *Accounting for Stripping Costs in the Mining Industry*, post production stripping costs are considered the costs of the extracted minerals under a full absorption costing system and are recognized as a component of inventory to be recognized in cost of sales in the same period as the revenue from the sales of inventory.

Leased property, plant and equipment meeting the criteria of capital lease are capitalized; valued at the lower of the assets fair value and net present value of the total minimum future lease payments. The corresponding part of lease payments is recorded as a liability. Depreciation of capitalized leased assets related to mining is computed using the units-of-production method or over the term of the lease, if shorter.

Depletion of property, plant and equipment related to mining are computed using the units-of-production method based on the actual production for the period compared with total estimated proven and probable reserves. In respect of those items of property, plant and equipment whose useful lives are expected to be less than the life of mine, depreciation over the period of the items’ useful life is applied.

Depreciation of non-mining assets is provided on a straight-line basis over the economic useful lives of these assets at the following annual rates:

- Machinery and equipment 1-20 years;
- Transport and other 1-10 years.

Construction-in-progress comprises costs directly related to mine development, construction of buildings, infrastructure, processing plant, machinery and equipment. Cost also includes finance charges capitalized during the development and construction periods where such costs are financed by borrowings. Amortization or depreciation of these assets commences when the assets are put into production.

**Pension obligations**

The Group pays mandatory contributions to the state social funds, including the Pension Fund of the Russian Federation, which are expensed as incurred. For the year ended December 31, 2008 and 2007, the Group contributed U.S. Dollar 14,923 and 14,919, respectively.

**Reclamation and mine closure**

The Group accounts for reclamation, site restoration and closure obligations based on the provisions of SFAS No. 143, *Accounting for Asset Retirement Obligations*. When the liability is initially recorded, the Group capitalizes the cost by increasing the carrying amount of the related long lived asset. Over time, the liability is accreted to its present value at the end of each period, and the capitalized cost is amortized over the mine life or the useful life of the related asset.

**Income taxes**

The Group accounts for income taxes using the balance sheet liability method required by SFAS No. 109. Deferred income tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statements carrying amounts of existing assets and liabilities and their respective tax bases. Deferred income tax assets and liabilities are measured using enacted tax rates for periods in which these temporary differences are expected to reverse. Valuation allowances are provided for deferred income tax assets when management believes that it is more likely than not that the assets will not be realized.

In the normal course of business the Group is subject to examination by taxing authorities throughout the Russian Federation. Interregional Inspectorate of the Federal Tax Service (“the IIFTS”) have commenced examinations of the Group’s tax returns for 2006 through 2007. No significant adjustments have been proposed by the IIFTS as at December 31, 2008.

Uncertain tax positions are recognized in the financial statements for positions which are considered more likely than not of being sustained based on the technical merits of the position upon an audit by the tax authorities. The measurement of the tax benefit recognized in the financial statements is based upon the largest amount of tax benefit that, in management’s judgment, is greater than 50% likely of being realized based on a cumulative probability assessment of the possible outcomes.

***(In thousands of U.S. Dollars, except share data)***

### Revenue recognition

Revenue is derived principally from the sale of gold and silver and is measured at the fair value of consideration received or receivable, after deducting discounts. A sale is recognized when the significant risks and rewards of ownership have passed. This is usually when title and risk have passed to the customer and the goods have been delivered to the customer. Revenue is presented in the consolidated statement of operations net of VAT.

The Group sells metal to banks through long-term agreements. The sales price, as determined in the agreement, may be variable based upon the London Bullion Market Association spot price or fixed.

### Share based compensation

The Group's board of directors award share options to certain employees. The Group applies SFAS No. 123 (revised 2004), *Share-Based Payment* ("SFAS No. 123(R)"), to its accounting for share based compensation. SFAS No. 123(R) requires companies to recognize compensation costs for share-based payments to employees based on the grant-date fair value of the award.

The fair value of share-based payments is calculated at the grant date using the Black-Scholes option pricing model. For equity-settled share-based payments, the fair value is determined using the Black-Scholes model and expensed on a straight-line basis over the vesting period based on the Group's estimate of the shares that will eventually vest.

Share options are subject to a three year vesting condition and the fair value is recognized as an employee benefit expense with a corresponding increase in additional paid-in-capital over the vesting period. The proceeds received, net of any directly attributable transaction costs are credited to share capital (nominal value) and additional paid-in-capital when the options are exercised.

### Comprehensive (loss)/income

Comprehensive (loss)/income is defined as all changes in shareholders' equity, except those arising from transactions with shareholders. Comprehensive (loss)/income includes net (loss)/income and other comprehensive (loss)/income, which for the Group consists of changes in foreign currency translation gains or losses.

## 4. RECLASSIFICATIONS

Certain comparative information presented in the consolidated balance sheet as at December 31, 2007 and consolidated statement of operations for the year ended December 31, 2007 has been reclassified in order to achieve comparability with the presentation used in the consolidated balance sheet as at December 31, 2008 and consolidated statement of operations for the year ended December 31, 2008. After considering all relevant quantitative and qualitative information, the Group concluded that these reclassifications are not material to the consolidated financial statements as at and for the year ended December 31, 2007:

| | Before reclassifications | After reclassifications | Difference |
|---|---|---|---|
| Consumables and spare parts | 73,613 (a) | 90,466 | 16,853 |
| Refined metals | 29,072 (a) | 12,219 | (16,853) |
| Interest expense | 10,519 (b) | 12,607 | 2,088 |
| Capital lease finance costs | 2,088 (b) | - | (2,088) |

*(In thousands of U.S. Dollars, except share data)*

(a) In the consolidated financial statements for the year ended December 31, 2007, certain consumables and spare parts were classified as refined metals. In the consolidated financial statements for the year ended December 31, 2008, these amounts were reclassified to consumables and spare parts within Note 5.

(b) In the consolidated statement of operations for the year ended December 31, 2007, capital lease finance costs were presented separately. As the amount of such costs 2008 was insignificant, capital lease finance costs was combined with interest expense in the consolidated statement of operations for the year ended December 31, 2008; the prior period statement was revised to conform with this presentation.

These reclassifications had no impact on profit for the year or shareholders' equity for 2007.

## 5. INVENTORIES

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| Consumables and spare parts | 101,803 | 90,466 |
| Ore stock piles | 47,225 | 62,106 |
| Work-in-process | 48,912 | 35,566 |
| Dore | 81 | 12,784 |
| Refined metals | 3,840 | 12,219 |
| Other than metal work-in-progress | 558 | - |
| **Total** | **202,419** | **213,141** |

During the year ended December 31, 2008, management of the Group identified a balance of ore stockpiles which had a lower content of precious metals. The management determined that the net realizable value of such ore was lower than its cost. Accordingly, the Group wrote down this inventory, in the amount of U.S. Dollar 10,583, to zero at December 31, 2008 (see Note 20). The write-down adjustment relates to the Khabarovsk segment.

## 6. VAT RECEIVABLE

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| Short-term VAT receivable | 62,718 | 52,078 |
| Long-term VAT receivable | 13,953 | 10,288 |
| **Total** | **76,671** | **62,366** |

Long-term value-added tax ("VAT") receivable primarily represents VAT balances resulting from capital expenditures and operating activities which are not expected to be recovered within the next calendar year due to specific requirements of the tax regulations. Management believes that these balances are fully recoverable from the tax authorities when the respective capital assets qualify as having been put into operation for VAT purposes.

***(In thousands of U.S. Dollars, except share data)***

## 7. DEFERRED TAX

The components of deferred tax assets and liabilities were as follows:

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| **Deferred tax assets:** | | |
| Tax losses carried forward | 7,308 | 2,140 |
| Reclamation and mine closure obligation | 5,226 | 1,359 |
| Property, plant and equipment | 3,216 | - |
| Inventories | 2,712 | - |
| Accounts payable and accrued liabilities | 2,142 | 1,121 |
| Deferred payments | 1,124 | 1,786 |
| Other current assets | 1,678 | 1,326 |
| **Total deferred tax assets** | **23,406** | **7,732** |
| **Deferred tax liabilities:** | | |
| Property, plant and equipment | (29,458) | (37,628) |
| Inventories | (6,338) | (11,437) |
| **Total deferred tax liabilities** | **(35,796)** | **(49,065)** |
| **Net deferred tax liabilities** | **(12,390)** | **(41,333)** |
| Deferred tax asset, short-term | 11,758 | 3,806 |
| Deferred tax asset, long-term | 11,648 | 3,926 |
| Deferred tax liability, short-term | (6,338) | (11,437) |
| Deferred tax liability, long-term | (29,458) | (37,628) |

Tax losses carried forward represent the amounts, available for offset against future taxable income generated by CJSC Serebro Magadana, JSC Okhotskaya GGC and the Company during the period up to 2015. Each legal entity within the Group represents a separate tax-paying component for income tax purposes. The tax losses of one entity cannot be used to reduce taxable income of other entities in the Group.

As at December 31, 2008 and 2007 the aggregate tax losses carried forward were U.S. Dollar 36,542 (Rubles 1,073,629 thousand) and U.S. Dollar 8,917 (Rubles 218,878 thousand) respectively.

As at January 1, 2007 the Group changed the tax base calculation of its work-in-progress, ore, dore and refined metals, allocating certain direct production costs previously treated as costs of the period incurred and not allocated to inventory for statutory tax purposes. The impact of this change on the deferred tax liability and income tax expense as at December 31, 2007 was U.S. Dollar 8,136 (basic and diluted loss per share decreased by U.S. Dollars 0.026).

The Group does not recognize a deferred tax liability on undistributed earnings of its subsidiaries as it expects that these earnings will ultimately be recovered in tax-free transactions.

***(In thousands of U.S. Dollars, except share data)***

## 8. OTHER CURRENT ASSETS

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| Taxes receivable | 11,941 | 12,442 |
| Other receivables | 4,472 | 4,111 |
| Other current assets | 7,449 | 1,504 |
| **Total** | **23,862** | **18,057** |

## 9. PROPERTY, PLANT AND EQUIPMENT

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| Buildings and underground workings | 221,742 | 210,710 |
| Machinery and equipment | 141,354 | 155,607 |
| Transport and other | 42,263 | 52,079 |
| Mineral rights | 135,795 | 159,294 |
| Construction-in-progress | 125,653 | 96,090 |
| **Total cost** | **666,807** | **673,780** |
| **Less: Accumulated depreciation and depletion** | **(182,673)** | **(171,310)** |
| **Net book value** | **484,134** | **502,470** |

Construction-in-progress is not being amortized as it was not yet put into use as at December 31, 2008 and 2007, respectively. Construction-in-progress consists of long-term deferred exploration expenditures which amounted to U.S. Dollar 52,627 and U.S. Dollar 41,520 at December 31, 2008 and 2007, respectively. The rest of construction-in-progress represents the construction of the production facilities and development of the underground mine at CJSC Serebro Magadana.

Mineral rights of the Group are comprised of mineral rights acquired by the Group upon purchase of subsidiaries. Accumulated depletion of mineral rights was U.S. Dollar 32,978 and U.S. Dollar 28,467 at December 31, 2008 and 2007, respectively.

In 2007, management of the Group decided that it was no longer economically viable to mine the open pit reserves located at Lunnoe field. Therefore, the related open pit mine was written off entirely, which has resulted in an impairment loss of U.S. Dollar 6,676 (see Note 25), which relates entirely to the Magadan segment.

At December 31, 2008 there were no property, plant and equipment under the capital lease agreements. At December 31, 2007, capital leases included within property, plant and equipment totalled U.S. Dollar 47,555 (of which machinery and equipment was U.S. Dollar 39,197 and transport and other was U.S. Dollar 8,358).

At December 31, 2008 no property, plant and equipment was pledged as collateral. As at December 31, 2007, property, plant and equipment with a carrying value of U.S. Dollar 13,860 was pledged as collateral for the loan from ABN Amro (see Note 14).

*(In thousands of U.S. Dollars, except share data)*

## 10. GOODWILL

| | December 31, 2008 | December 31, 2007 |
|---|---|---|
| **Beginning balance** | **30,141** | **31,896** |
| Additions during the current year (Note 28) | - | 10,183 |
| Disposals during the current year (Note 29) | (1,792) | - |
| Reclassification | - | (13,226) |
| Translation effect | (4,608) | 1,288 |
| **Total** | **23,741** | **30,141** |

During the year ended December 31, 2007, the Group reclassified certain amounts from goodwill to mineral rights within property, plant and equipment related to 2006 acquisitions. Subsequent to the issuance of the consolidated financial statements of the Group for the year ended December 31, 2006, management determined that in accordance with EITF 04-3, *Mining Assets: Impairment and Business Combination*, value beyond proven and probable reserves not previously identified separately from goodwill in the purchase price allocation, should instead be classified as mineral rights, which are a component of property, plant and equipment. In addition, management determined that the interests acquired during 2006 in CJSC Enisey Mining and Geological Company and Albazino Resources LLC did not meet the definition of acquired businesses in accordance with SFAS No. 141, *Business Combinations*, and should instead have been accounted for as acquisitions of mineral rights. As a result, an amount of goodwill of U.S. Dollar 13,226 as at December 31, 2007 was reclassified to mineral rights within property, plant and equipment, net of deferred taxes equal to U.S. Dollar 2,422.

## 11. INVESTMENTS IN JOINT VENTURES

Investments in joint ventures as of December 31, 2008 and 2007 consisted of the following:

| | December 31, 2008 | | December 31, 2007 | |
|---|---|---|---|---|
| | Voting power, % | Carrying value | Voting power, % | Carrying value |
| Asgat Polymetal LLC | 50 | 225 | 50 | 269 |
| Joint Venture with Anglogold Ashanti Limited | 50 | 17,899 | - | - |
| **Total** | | **18,124** | | **269** |

In February 2008, the Company signed an agreement to set up a strategic alliance and a joint venture with AngloGold Ashanti Limited (the "JV"). Within the framework of this agreement each party owns 50% in the JV, to which the Company contributed its shares in CJSC Enisey Mining and Geological Company and Imitzoloto LLC, holding Anenskoye and Aprelovskoye gold mining licenses, respectively, and made a cash contribution of U.S. Dollar 14,298. The JV was set up in order to execute development projects in several territories of the Russian Federation.

***(In thousands of U.S. Dollars, except share data)***

Currently, the JV's development projects are at an early stage: the research activities have begun and prepayments are being made to the geological and engineering companies, however the proven and probable reserves have not yet been identified. The Group expects to start production and generate cash flows from precious metals sales in 2011. Until proven and probable reserves has been identified and measured, an uncertainty exists regarding the recoverability of the investment in the JV.

The JV holds investments in several companies. As of February 14, 2008 and December 31, 2008 the Company's share of these investments included:

| | **Ownership interest, %** |
|---|---|
| CJSC Enisey Mining and Geological Company (Note 29) | 50 |
| Imitzoloto LLC (Note 29) | 50 |
| Amikan LLC | 50 |
| AS APK LLC | 50 |
| Zoloto Taigi LLC | 50 |

The aggregate financial position and results of operations of these companies as of December 31, 2008 and for the period from February 14, 2008 to December 31, 2008 are as follows:

| | |
|---|---|
| **As of December 31, 2008** | |
| Non-current assets | 54,895 |
| Current assets | 26,888 |
| Non-current liabilities | (50,763) |
| Current liabilities | (3,074) |
| **For the period from February 14, 2008 to December 31, 2008** | |
| Net loss | 16,786 |
| Group's share in joint venture's net loss | 8,393 |

As at December 31, 2008, there were no indicators of impairment associated with the Group's investment in joint ventures.

## 12. LONG-TERM LOANS TO RELATED PARTIES

| | **Interest rate** | **December 31, 2008** | **December 31, 2007** |
|---|---|---|---|
| Accord-Invest LLC | 10.5% | 5,260 | 5,334 |
| Employees | 1% | 839 | 785 |
| Other | | 2,115 | - |
| **Total (Note 30)** | | **8,214** | **6,119** |

Accord-Invest LLC together with the Company was under common control of the parent company ICT Group (see Note 1). The loan to Accord-Invest is unsecured and is due in January 2010.

Carrying value of the long-term loans provided to related parties approximate their fair value as interest rates as at December 31, 2008 reflect the market conditions.

*(In thousands of U.S. Dollars, except share data)*

## 13. SHORT-TERM DEBT AND CURRENT PORTION OF LONG-TERM DEBT

| | Interest rate (actual rate as at December 31, 2008) | December 31, 2008 | December 31, 2007 |
|---|---|---|---|
| **Debt from third parties** | | | |
| **U.S. Dollar denominated** | | | |
| VTB | Libor + 5% (6.68%) | 100,297 | - |
| UniCredit Bank | Libor + 3.25% (4%) | 45,066 | - |
| Current portion of long-term debt (Note 14) | | - | 152,006 |
| **Total U.S. Dollar denominated** | | **145,363** | **152,006** |
| **Russian Ruble denominated** | | | |
| Bank of Khanty-Mansiysk | 15% | 34,491 | - |
| **Total Russian Ruble denominated** | | **34,491** | **-** |
| **Total debt from third parties** | | **179,854** | **152,006** |
| **Debt from related parties – Russian Ruble denominated** | | | |
| Nomos-Bank | 18% | 49,523 | - |
| Other | | 199 | - |
| Current portion of long-term debt (Note 14) | | 86,793 | - |
| **Total debts from related parties – Russian Ruble denominated (Note 30)** | | **136,515** | **-** |
| **Total** | | **316,369** | **152,006** |

During 2008 the Group entered into short-term loan agreements with VTB, UniCredit Bank and Bank of Khanty-Mansiysk. Interest for funds drawn under these agreements is payable on a monthly basis.

These agreements contain restrictive conenants, conditions and default provisions. At December 31, 2008, under the most restrictive covenant, 10% of the Group’s property cannot be pledged or alienated.

Short-term debt facilities are not collateralized.

*(In thousands of U.S. Dollars, except share data)*

## 14. LONG-TERM DEBT

| | Interest rate | December 31, 2008 | December 31, 2007 |
|---|---|---|---|
| **Debt from third parties** | | | |
| **U.S. Dollar denominated** | | | |
| Sberbank | Libor + 2% | - | 98,000 |
| ABN Amro Bank | Libor + 2% | - | 50,525 |
| Bank Uralsib | 8% | - | 44,000 |
| Gazprombank | 8% | - | 15,200 |
| **Total U.S. Dollar denominated** | | **-** | **207,725** |
| **Russian Ruble denominated** | | | |
| Gazprombank | 8% | - | 15,481 |
| **Total Russian Ruble denominated** | | **-** | **15,481** |
| **Total debt from third parties** | | **-** | **223,206** |
| Less current portion of long-term debt (Note 13) | | - | (152,006) |
| **Total debt from third parties** | | **-** | **71,200** |
| **Debt from related parties – Russian Ruble denominated** | | | |
| Nomos-Bank | 18% | 86,793 | - |
| **Total debts from related parties – Russian Ruble denominated** | | **86,793** | **-** |
| Less current portion of long-term debt (Note 13) | | **(86,793)** | **-** |
| **Total debt from related parties – Russian Ruble denominated** | | **-** | **-** |
| **Total** | | - | **71,200** |

### Nomos-Bank

In November 2008, the Group received a long-term loan facility from Nomos-Bank which allows the Group to borrow funds, denominated in Ruble, up to U.S. Dollar 102,109 (Roubles 3,000,000 thousand as at December 31, 2008) to finance current operations. All amounts drawn down under this long-term facility are repayable within one year. The loan facility is valid until November 2011. Interest is payable on a monthly basis. As at December 31, 2008, the outstanding balance under the credit facility was U.S. Dollar 86,793 (the available undrawn balance was U.S. Dollar 15,316).

The repayment of this long-term facility is guaranteed with a pledge of revenues under the sales contracts with Nomos-Bank (see Note 31). Covenants to the long-term loan facility require the Group to maintain certain financial ratios, prohibit any change to the general nature of the business and limit the disposal of assets. At December 31, 2008, under the most restrictive covenant, 20% of the Group's property cannot be pledged or alienated.

**VTB**

In May 2008, the Group received a long-term loan facility from VTB which allows the Group to borrow funds, denominated in Rubles, up to U.S. Dollar 25,527 (Rubles 750,000 thousand as at December 31, 2008) to finance its current operations. The loan facility is valid until January 2010. Interest is payable on a monthly basis. As at December 31, 2008, the outstanding balance under the credit facility was nil, the available undrawn balance was U.S. Dollar 25,527.

Covenants to the long-term loan facility require the Group to maintain certain financial ratios, prohibit any change to the general nature of the business and limit the disposal of assets. At December 31, 2008, under the most restrictive covenant, 10% of the Group's property cannot be pledged or alienated.

**Sberbank**

In December 2006, the Group received a long-term loan facility from Sberbank of Russia which allows the Group to borrow up to U.S. Dollar 153,000 to finance its current operations, contract financing, including replenishment of working capital. Interest on amounts drawn was payable monthly, and is based on LIBOR plus 2%, which resulted in rates of 6.4875% as at December 31, 2007. As at December 31, 2007 U.S. Dollar 98,000 was drawn under this facility. In December 2008, this loan facility was fully repaid.

The Group was required to comply with certain financial and non-financial covenants to prevent the closure of the Sberbank credit facility.

**Gazprombank**

In September 2007, the Group received a long-term facility from Gazprombank which allowed the Group to borrow funds, denominated in either U.S. Dollars or Rubles, up to U.S. Dollar 62,969 (using exchange rates as at December 31, 2008) to finance its current operations. The credit facility was valid through December 2008. As at December 31, 2007 U.S. Dollar 15,200 was drawn under this facility. Interest for funds drawn under this facility was payable on a monthly basis at a fixed rate of 8%. In December 2008, this loan facility was fully repaid.

Covenants related to the long-term facility required the Group to maintain certain financial ratios, prohibited any change to the general nature of the business and limited the disposal of assets.

**ABN Amro Bank**

In December 2006, the Group received a long-term loan from ABN Amro Bank ("ABN Amro") in the amount of U.S. Dollar 60,000 to refinance its debt to Standard Bank London. The loan was repayable in monthly installments commencing in June 2007 up to the last installment in December 2008. Interest was payable monthly, and is based on LIBOR plus 2%, which resulted in rates of 6.4875% as at December 31, 2007. Under the loan agreement with ABN Amro, the Group was required to comply with certain financial and non-financial covenants.

***(In thousands of U.S. Dollars, except share data)***

The loan agreement restricted the Group from:

(i) Disposing of its assets (including transfers, leases or sales);
(ii) Undertaking any type of corporate reorganization (including mergers and demerges);
(iii) Creating or incurring other forms of financial indebtedness (such as making loans or granting guarantees); and
(iv) Taking any actions in respect of its shares, capital or participatory interest (including issuing new shares or otherwise altering its existing share capital) without the prior written consent of ABN Amro except for the offer and listing of up to 40% of the Company's share capital.

The loan agreement restricted the Company's ability to pay dividends for any of its financial years during the term of the loan or to make acquisitions in excess of U.S. Dollar 5 million without the prior written consent of ABN Amro. In 2008 the loan facility from ABN Amro was fully repaid.

**Bank Uralsib**

In June 2007, the Group received a long-term facility from Bank Uralsib which allowed the Group to borrow up to U.S. Dollar 60,000 to finance its current operations. The credit facility was valid until July 2008. Interest was payable on a monthly basis. Covenants to the loan agreements required the Group to maintain certain financial ratios, prohibit any change to the general nature of the business and limit the disposal of assets. In 2008 the loan facility from Bank Uralsib was fully repaid.

As at December 31, 2008, the total balance available for drawing down under existing loan facilities is U.S. Dollar 40,843.

## 15. RECLAMATION AND MINE CLOSURE OBLIGATION

Mine closure obligations include decommissioning and land restoration costs and are recognized on the basis of existing project business plans as follows:

| **Name of subsidiary** | **CJSC Zoloto Severnogo Urala** | **JSC Okhotskaya GGK** | **CJCS Serebro Magadana** | **JSC Omolon Gold Mining Company** | **Total** |
|---|---|---|---|---|---|
| **Balance as at December 31, 2006** | **1,495** | **2,272** | **3,463** | **-** | **7,230** |
| Accretion of reclamation and mine closure obligation | 57 | 157 | 65 | - | **279** |
| Translation effects | 108 | 167 | 251 | - | **526** |
| **Balance as at December 31, 2007** | **1,660** | **2,596** | **3,779** | **-** | **8,035** |
| Additional obligations recognized from business combinations occuring during the year (Note 28) | - | - | - | 9,582 | **9,582** |
| Revision of estimated future cash flows | 2,667 | 3,070 | 4,493 | - | **10,230** |
| Accretion of reclamation and mine closure obligation | 64 | 174 | 74 | 1,045 | **1,357** |
| Translation effects | (283) | (454) | (634) | (1,705) | **(3,076)** |
| **Balance as at December 31, 2008** | **4,108** | **5,386** | **7,712** | **8,922** | **26,128** |

During 2008 the Group reassessed the amount of reclamation and mine closure obligation due to changes in the future cash flows and the inflation rates. As a result, the additional reclamation and mine closure obligation raised, which was presented as a change in estimate.

The Group does not have assets that are legally restricted for purposes of settling asset retirement obligations.

## 16. DEFERRED PAYMENTS

Deferred payments as at December 31, 2008 comprised of an upfront payment received from Deutsche Bank Trust Company Americas. This payment was made to the Company in 2007 in exchange for the Company selecting Deutsche Bank Trust Company Americas (the “Bank”) as its executive depositary bank for a GDR program on the London Stock Exchange. According to the terms of depositary agreement, the Bank is required to execute the function of the depositary for a seven year period. In case of early termination of the depositary agreement, the Company will have to pay back an element of this as compensation

## 17. SHAREHOLDERS’ EQUITY AND EARNINGS PER SHARE

As at December 31, 2008 and 2007, the authorized share capital of the Company comprised of 2,444,000,000 ordinary shares with a par value of Ruble 0.2 per share and 100,000 series A preference shares with a par value of Ruble 100.

As at December 31, 2008 and 2007, the issued share capital of the Company comprised of 315,000,000 ordinary shares with a par value of Ruble 0.2 per share. As at December 31, 2008 and 2007, the outstanding share capital of the Company comprised of 315,000,000 and 309,459,677 ordinary shares with a par value of Ruble 0.2 per share, respectively. No preference shares were issued or outstanding.

As discussed in Note 1, in February 2007, the Company placed 40,000,000 ordinary shares with a par value of Ruble 0.2 per share in the form of GDR’s on the London Stock Exchange. The proceeds from issuance of such shares were U.S. Dollar 307,844 in cash, which were reduced by transaction costs of U.S. Dollar 10,716.

In September 2007, as part of the Group’s acquisition of Polymetal ESOP, the Group acquired 5,540,323 treasury shares (see Note 28). In February and August 2008, options to purchase all these ordinary shares were exercised by the employees in accordance with share option plan (see Note 18).

Reserves available for distribution to shareholders are based on the statutory financial statements of the Company as a stand-alone entity, which are prepared in accordance with the Regulations on Accounting and Reporting of the Russian Federation, and which differ significantly from U.S. GAAP. Russian legislation identifies the basis of distribution as accumulated profit. However, current legislation and other statutory regulations dealing with distribution rights are open to legal interpretation; consequently, actual distributable reserves may differ from the amount of accumulated profit under Russian statutory accounting rules.

The Company had potentially dilutive securities, namely the Group’s share option plan, which was established during 2007 (see Note 18). As the Company generated a net loss for each of the years ended December 31, 2008 and 2007, the stock options were anti-dilutive and therefore excluded from the calculation of diluted loss per share. Accordingly, basic and diluted loss per share were equal for the years ended December 31, 2008 and 2007.

***(In thousands of U.S. Dollars, except share data)***

## 18. SHARE-BASED PAYMENTS

In 2007, the Group established a share option plan (the “Option Plan”) for executive directors and senior employees of the Group.

The number of shares which a qualifying participant was entitled to was determined by the Board of Directors on March 1, 2007. The options vested over a three year period from the grant date, contingent on continued employment with the Group.

In accordance with the Option Plan among other conditions the qualifying participant has the right to early redemption and acquisition of all shares due to change in the Group’s controlling shareholders’ structure. As a result of such change (see Note 1) all the share options fully vested in June 2008.

A summary of the Group’s Option Plan is presented below:

| | Number of shares | Weighted average exercise price (per share), U.S. Dollar | Weighted average fair value of options (per share), U.S. Dollar | Aggregate intrinsic value, U.S. Dollar |
|---|---|---|---|---|
| **Outstanding at December 31, 2006** | **-** | **-** | **-** | **-** |
| Granted | 5,540,323 | 0.04 | 6.97 | 38,848 |
| Exercised | - | - | - | - |
| Forfeited | - | - | - | - |
| **Outstanding at December 31, 2007** | **5,540,323** | **0.04** | **6.97** | **38,848** |
| Exercised | (5,540,323) | 0.04 | 6.97 | (38,848) |
| Forfeited | - | - | - | - |
| **Outstanding at December 31, 2008** | **-** | **-** | **-** | **-** |

The fair value of share options granted during the year ended December 31, 2007, was estimated using the Black-Scholes option pricing model. The following assumptions were used to value share based awards:

- *Expected forfeitures.* This assumption was estimated using historical trends of employees turnover. As the Group typically only grants options to senior employees and the turnover rate for such employees is minimal, the Group estimated expected forfeitures to be 5% a year.
- *Expected volatility.* Since the Group’s ordinary shares are publicly traded only since February 2007, expected volatility has been estimated based on an analysis of the historical stock price volatility of comparable public companies for a preceding period equal to the expected term of the option grant being valued.
- *Expected term.* As the option plan has a three year vesting condition and the participant may exercise his right to redeem shares within three month of the date of obtaining the right to do so, the Group estimated the expected term as three years.

*(In thousands of U.S. Dollars, except share data)*

- *Fair value of common stock* is equal to the market price of underlying shares at the grant date.
- *Risk-free interest rate.* To estimate the risk-free rate, the Group used the implied yield currently available on Russian Eurobonds with a remaining term equal to the expected term of the option grant being valued.

| | |
|---|---|
| Risk free rate | 5.5% |
| Expected dividend yield | 0% |
| Expected volatility | 35.0% |
| Expected life, years | 3 |
| Fair value of shares, U.S. Dollars | 7.05 |

For the year ended December 31, 2008, share based compensation in the amount of U.S. Dollar 31,902 (for the year ended December 31, 2007 – U.S. Dollar 10,584) was recognized in general, administrative and selling expenses. As at December 31, 2008, the Group had no unrecognized share based compensation.

## 19. REVENUES

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| **Sales to third parties** | | |
| Sberbank | 235,906 | 115,510 |
| VTB | 115,399 | - |
| ABN Amro Bank | 108,970 | 104,079 |
| Gazprombank | 26,603 | 60,674 |
| Uralsib | 12,167 | 25,644 |
| **Total sales to third parties** | **499,045** | **305,907** |
| Other | 3,686 | 2,840 |
| **Total** | **502,731** | **308,747** |

Revenue from Sberbank was included in revenue of the North Ural segment – U.S. Dollar 67,610; the Khabarovsk segment – U.S. Dollar 84,550; and the Magadan segment – U.S. Dollar 83,746.

Revenue from VTB was included in revenue of the North Ural segment – U.S. Dollar 32,714; the Khabarovsk segment – U.S. Dollar 27,514; and the Magadan segment – U.S. Dollar 55,171.

Revenue from ABN Amro Bank was entirely included in revenue of the Magadan Segment.

***(In thousands of U.S. Dollars, except share data)***

Revenues analyzed by geographical regions are presented below:

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| Sales within Russian Federation | 393,761 | 204,668 |
| Sales to Europe | 108,970 | 104,079 |
| **Total** | **502,731** | **308,747** |

Presented below is an analysis of revenue from gold and silver sales:

| | Year ended December 31, 2008 | | | Year ended December 31, 2007 | | |
|---|---|---|---|---|---|---|
| | Thousand ounces | Average price (U.S. Dollar per troy ounce) | U.S. Dollars | Thousand ounces | Average price (U.S. Dollar per troy ounce) | U.S. Dollars |
| Gold | 280 | 870.73 | 243,805 | 235 | 700.52 | 164,622 |
| Silver | 17,386 | 14.68 | 255,240 | 16,152 | 8.75 | 141,285 |
| **Total** | | | **499,045** | | | **305,907** |

In 2007, the Group delivered silver to ABN Amro Bank at fixed prices as determined by the terms of the sales contract ranging from U.S. Dollar 7.7891 to U.S. Dollar 7.82 per troy ounce for total sales of 14,493,940 troy ounces. The variance between the sales at fixed prices under the contract as compared to market prices quoted on the London Bullion Market Association (“LBMA”) resulted in a reduction to revenues of U.S. Dollar 75,704.

Discounts from the LBMA market prices on other sales to banks for the year ended December 31, 2008, amounted to U.S. Dollar 323 (2007: U.S. Dollar 722) for gold and U.S. Dollar 2,073 (2007: U.S. Dollar 1,752) for silver sales. Sales are recorded in the financial statements net of discounts.

***(In thousands of U.S. Dollars, except share data)***

## 20. COST OF SALES

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| **Cash operating costs** | | |
| On-mine costs (Note 21) | 102,364 | 85,920 |
| Smelting costs (Note 22) | 112,892 | 108,634 |
| Purchase of metal from a third party | - | 20,499 |
| Mining tax | 30,024 | 18,332 |
| Other costs | 2,639 | 4,891 |
| **Total cash operating costs** | **247,919** | **238,276** |
| Depreciation and depletion of operating assets (Note 23) | 46,621 | 55,266 |
| Accretion of reclamation and mine closure obligation | 1,357 | 531 |
| **Total costs of production** | **295,897** | **294,073** |
| Increase in metal inventory | (10,648) | (46,503) |
| Effect of change in accounting estimates | 2,616 | 7,068 |
| Write-down of ore to lower of cost or market (Note 5) | 10,583 | - |
| **Total change in metal inventory** | **2,551** | **(39,435)** |
| Cost of other sales | 2,281 | - |
| **Total** | **300,729** | **254,638** |

The nature of the heap leaching process inherently limits the ability to precisely monitor inventory levels and, as a result, the balancing process is constantly monitored and estimates of recovery rates are refined based on actual results over time. As a result of reviews done to meet regulatory requirements, during 2008 and 2007 the Group determined that the estimated recovery rates for the heap leach process at the Vorontsovskoye field applied previously to record costs associated with heap leach activities should be revised to reflect actual experience. As a result of the change in estimate, an amount of U.S. Dollar 2,616 (2007: U.S. Dollar 7,068) was charged to costs of sales.

## 21. ON-MINE COSTS

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| Consumables and spare parts | 47,962 | 42,976 |
| Labour | 23,411 | 22,202 |
| Services | 21,850 | 15,013 |
| Taxes, other than income | 5,544 | 3,704 |
| Other expenses | 3,597 | 2,025 |
| **Total (Note 20)** | **102,364** | **85,920** |

***(In thousands of U.S. Dollars, except share data)***

## 22. SMELTING COSTS

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| Consumables and spare parts | 49,902 | 49,583 |
| Labour | 23,450 | 24,273 |
| Services | 33,653 | 29,062 |
| Taxes, other than income | 5,550 | 4,796 |
| Other expenses | 337 | 920 |
| **Total (Note 20)** | **112,892** | **108,634** |

## 23. DEPRECIATION AND DEPLETION OF OPERATING ASSETS

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| Mining | 26,705 | 30,917 |
| Smelting | 19,916 | 24,349 |
| **Total (Note 20)** | **46,621** | **55,266** |

## 24. GENERAL, ADMINISTRATIVE AND SELLING EXPENSES

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| Labour | 31,991 | 16,675 |
| Share based compensation (Note 18) | 31,902 | 10,584 |
| Services | 17,270 | 11,147 |
| Other | 8,979 | 3,869 |
| **Total** | **90,142** | **42,275** |

## 25. OTHER OPERATING EXPENSES

| | Year ended December 31, 2008 | Year ended December 31, 2007 |
|---|---|---|
| Exploration expenses | 11,123 | 1,973 |
| Social payments | 7,723 | 4,407 |
| Taxes, other than income | 6,151 | 4,367 |
| Loss on fixed asset disposals | 4,624 | 343 |
| Consulting services | 1,984 | 6,137 |
| Impairment of property, plant and equipment (Note 9) | - | 6,676 |
| Other expenses | 4,626 | 3,520 |
| **Total** | **36,231** | **27,423** |

*(In thousands of U.S. Dollars, except share data)*

## 26. INCOME TAX

| | **Year ended December 31, 2008** | **Year ended December 31, 2007** |
|---|---|---|
| Current income taxes | 29,865 | 12,442 |
| Deferred income taxes | (11,254) | (6,379) |
| **Total** | **18,611** | **6,063** |

A reconciliation between the reported amount of income tax expense attributable to income/(loss) before income tax and extraordinary gain that would result from applying the statutory income tax rate for the years ended December 31, 2008 and 2007 is as follows:

| | **Year ended December 31, 2008** | **Year ended December 31, 2007** |
|---|---|---|
| **Income/(loss) before income tax and extraordinary gain** | **2,041** | **(16,763)** |
| Statutory income tax expense/(benefit) at tax rate of 24 percent | 408 | (4,023) |
| Effect of change in tax rate | (2,455) | - |
| Share based compensation | 7,656 | 2,540 |
| Permanent loss from investment in joint ventures | 398 | - |
| Permanent tax differences (non-deductible expenses) | 12,604 | 7,546 |
| **Total income tax expense** | **18,611** | **6,063** |

The actual tax expense differs from the amount which would have been determined by applying the statutory rate of 24% (2007: 24%) to the income/(loss) from operations before tax and extraordinary gain as a result of the application of relevent jurisdictional tax regulations, which disallow certain deductions which are included in the determination of accounting profit. These deductions include share-based compensation, social related expenditures and other non-production costs, certain general, administrative, financing, foreign exchange related and other costs.

In November 2008, the government of the Russian Federation enacted a law decreasing the statutory tax rate from 24% to 20% effective from January 1, 2009. These changes in tax rates resulted in a reduction in the net deferred income tax liability in the amount of U.S. Dollar 2,455 as at December 31, 2008.

***(In thousands of U.S. Dollars, except share data)***

As at December 31, 2008, the Group included accruals for unrecognized income tax benefits of U.S. Dollar 2,301. The reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

| | **December 31, 2008** | **December 31, 2007** |
|---|---|---|
| **Beginning balance** | **1,839** | **411** |
| Translation (gain)/loss | (303) | 30 |
| Additions based on tax position related to the current year | 765 | 1,398 |
| **Total** | **2,301** | **1,839** |

The whole amount would affect the Group's effective tax rate if recognized.

The Group records penalties and accrued interest related to uncertain tax positions in income tax expense. As at December 31, 2008 and 2007, U.S. Dollar 362 and 91, respectively, were included in the liability for uncertain tax positions for the probable payment of interest and penalties.

The items that are affected by expiring statute of limitations within the next 12 months amount to U.S. Dollar 411 (2007: nil).

## 27. SEGMENTS

The Group has three reportable segments:

- North Ural region (CJSC Zoloto Severnogo Urala);
- Khabarovsk region (JSC Ohotskaya GGK); and
- Magadan region (CJSC Serebro Magadana).

The reportable segments are determined based on the Group’s geographic regional profile. Minor companies (management, exploration, purchasing and other companies) which are not included within any of the aforementioned operating segments, are included within Corporate and other.

Segment results comprise segment gross profit, calculated as segment revenues less cost of sales for each segment. Segment expenses represent cost of sales, which are costs incurred to produce gold and silver at each operating mine.

Revenues of the corporate and other segment comprise revenues from services provided to third parties by the Group’s non-mining subsidiaries. These include exploration works for mining companies and design services related to ore field development and precious metal extraction technologies.

*(In thousands of U.S. Dollars, except share data)*

| **As of and for the year ended December 31, 2008** | **North Ural** | **Khabarovsk** | **Magadan** | **Total reportable segments** | **Corporate and other** | **Intersegment operations and balances** | **Total** |
|---|---|---|---|---|---|---|---|
| Revenue | 113,466 | 118,372 | 274,035 | **505,873** | 135,224 | (138,366) | **502,731** |
| Cost of sales | (61,760) | (86,681) | (161,432) | **(309,873)** | (141,791) | 150,935 | **(300,729)** |
| Gross profit | 51,706 | 31,691 | 112,603 | **196,000** | (6,567) | 12,569 | **202,002** |
| General, administrative and selling expenses | | | | | | | **(90,142)** |
| Other operating expenses | | | | | | | **(36,231)** |
| Interest expense | | | | | | | **(20,675)** |
| Loss from investments in joint ventures | | | | | | | **(8,393)** |
| Exchange loss | | | | | | | **(44,520)** |
| **Total income before income tax and extraordinary gain** | | | | | | | **2,041** |
| Segment assets: | | | | | | | |
| Property, plant and equipment, net | 87,223 | 119,225 | 189,038 | **395,486** | 88,648 | - | **484,134** |
| Accounts receivable, inventories, prepayment to suppliers and VAT receivables | 64,655 | 79,850 | 106,403 | **250,908** | 59,893 | (19,884) | **290,917** |
| Goodwill | - | 13,863 | 8,508 | **22,371** | 1,370 | - | **23,741** |
| Total segment assets | 151,878 | 212,938 | 303,949 | **668,765** | 149,911 | (19,884) | **798,792** |
| Unallocated assets: | | | | | | | |
| Cash and cash equivalents | | | | | | | **4,077** |
| Other assets | | | | | | | **73,606** |
| **Total assets** | | | | | | | **876,475** |

*(In thousands of U.S. Dollars, except share data)*

| **As of and for the year ended December 31, 2007** | **North Ural** | **Khabarovsk** | **Magadan** | **Total reportable segments** | **Corporate and other** | **Intersegment operations and balances** | **Total** |
|---|---|---|---|---|---|---|---|
| Revenue | 80,661 | 77,947 | 150,430 | **309,038** | 112,261 | (112,552) | **308,747** |
| Cost of sales | (66,892) | (61,320) | (146,955) | **(275,167)** | (102,633) | 123,162 | **(254,638)** |
| Gross profit | 13,769 | 16,627 | 3,475 | **33,871** | 9,628 | 10,610 | **54,109** |
| General, administrative and selling expenses | | | | | | | **(42,275)** |
| Other operating expenses | | | | | | | **(27,423)** |
| Interest expense | | | | | | | **(12,607)** |
| Exchange gain | | | | | | | **11,433** |
| **Total loss before income tax and extraordinary gain** | | | | | | | **(16,763)** |
| Segment assets: | | | | | | | |
| Property, plant and equipment, net | 96,269 | 145,229 | 190,265 | **431,763** | 70,707 | - | **502,470** |
| Accounts receivable, inventories, prepayment to suppliers and VAT receivables | 64,259 | 74,233 | 133,666 | **272,158** | 138,424 | (122,534) | **288,048** |
| Goodwill | - | 16,592 | 10,183 | **26,775** | 3,366 | - | **30,141** |
| Total segment assets | 160,528 | 236,054 | 334,114 | **730,696** | 212,497 | (122,534) | **820,659** |
| Unallocated assets: | | | | | | | |
| Cash and cash equivalents | | | | | | | **5,019** |
| Other assets | | | | | | | **32,176** |
| **Total assets** | | | | | | | **857,854** |

***(In thousands of U.S. Dollars, except share data)***

## 28. ACQUISITION OF SUBSIDIARIES

### CJSC Serebro Magadana

In November 2004, the Group acquired the remaining 20% interest in its subsidiary CJSC Serebro Magadana, the license owner for the Dukat mine, from P.A.S. Silver (Cyprus) Ltd. The Group paid U.S. Dollar 21,226 in cash at the time of the acquisition and agreed to pay up to U.S. Dollar 22,500 in additional contingent future payments. The future payments were to be determined annually based on the average yearly silver price per troy ounce ("FPS") in the range U.S. Dollar 5.5 per ounce to U.S. Dollar 10.0 per ounce:

| Range of silver price per troy ounce | Annual installments |
|---|---|
| 5.5 < FPS < 6.0 | 500 |
| 6.0 < FPS < 7.0 | 1,000 |
| 7.0 < FPS < 8.0 | 2,000 |
| 8.0 < FPS < 9.0 | 5,000 |
| 9.0 < FPS < 10.0 | 6,000 |
| 10.0 < FPS | 8,000 |

The agreement also contained a provision for early repayment on the occurrence of certain events, such as a public share offering. In the event of public offering the Group would pay 50% of any remaining contingent consideration within 30 days after listing.

The Group paid U.S. Dollar 2,000 during 2006 related to 2005 actual silver prices. In March 2007, as a result of the IPO in February 2007, the Group paid U.S. Dollar 10,250, which represented 50% of the total remaining potential contingent consideration of U.S. Dollar 20,500. The Group paid an additional amount of U.S. Dollar 8,000 during 2007 related to 2006 actual silver prices.
The remaining contingent consideration, based upon 2007 actual silver prices, amounting to U.S. Dollar 2,250 was paid in 2008.

As a result of the additional contingent payments made and accrued for during 2007, bringing the total consideration to U.S. Dollar 43,726, the Group recorded goodwill of U.S. Dollar 10,183, representing the excess cost of the acquisition over the fair value of net assets acquired of U.S. Dollar 33,543. Goodwill arose in the business combination because the consideration paid effectively included amounts in relation to the benefits of expected synergies, revenue growth and future market development. These benefits are not recognized separately from goodwill as the future economic benefits arising from them cannot be reliably measured.

### JSC Omolon Gold Mining Company

In January 2008, the Group acquired 98.1% of shares in JSC Omolon Gold Mining Company (the "OGMC") from Kinam Magadan Gold Corporation, an unrelated party. OGMC holds four subsoil licenses related to the Kubaka gold mine deposit located in the Magadan region. The Group paid cash consideration of U.S. Dollar 15,000, including payment for shares of U.S. Dollar 0.001 in cash and settlement of the OGMC's liabilities of U.S. Dollar 15,000. In addition, the Group is liable for perpetual deferred payments in the amount of 2% of the revenue derived from production and sales minerals extracted from the deposit. The perpetual deferred payments are uncapped in respect of the size and the timing of such future gold production, sale or other disposal. At the time of the acquisition, the Group recognized an estimated contingent consideration of U.S. Dollar 5,459 (U.S. Dollar 4,523 at the exchange rate as at December 31, 2008).

*(In thousands of U.S. Dollars, except share data)*

In March 2008, the Group acquired the remaining 1.9% of shares in JSC Omolon Gold Mining Company from the Russian Federal Property Fund for U.S. Dollar 811.

This acquisition was accounted for using the purchase method and was as follows:

**Assets acquired and liabilities assumed at the date of acquisition**

| | |
|---|---|
| Deferred tax asset | 17,461 |
| Other current assets | 16,146 |
| Reclamation and mine closure obligation (Note 15) | (9,582) |
| Deferred tax liability | (1,875) |
| Other liabilities | (15,040) |
| **Net assets acquired** | **7,110** |
| Cash paid on acquisition | 15,811 |
| Contingent consideration | 5,459 |
| Intercompany debt | (15,000) |
| **Extraordinary gain – excess of fair value of acquired net assets over cost** | **840** |

Excess of fair value of acquired net assets over cost of U.S. Dollar 840 arose primarily due to the Company's competitive position in negotiations due to the time restriction in the sales process and lack of the ability of the Kinam Magadan Gold Corporation to serve its debts.

## Other acquisitions

In August 2008, the Group acquired 100% of shares in Ural Exploration Enterprise LLC (a development stage enterprise), which holds a license for gold exploration and mining in Degtyarnoe field, from Russian Copper Company, an unrelated party, for U.S. Dollar 6,203. Amounts of mineral rights and attributable deferred tax liabilities acquired amounted to U.S. Dollar 7,989 and U.S. Dollar 1,834, respectively. The residual amount of U.S. Dollar 48 represents other current assets and liabilities.

In September 2007, the Group acquired 100% of Polymetal ESOP Limited, which held 5,540,323 of the Company's shares, from its parent company Nafta Moskva (Cyprus) Limited (see Note 1). The purchase consideration comprised of U.S. Dollar 50. The acquisition of Polymetal ESOP Limited was accounted for as acquisition of treasury shares as it did not constitute a business. These treasury shares were used for distribution among the share option plan participants (see Notes 17 and 18).

During 2007 the Group acquired 100% of shares in Fiano Investment Limited, Imitzoloto Holdings Limited and Eniseyskaya Holdings Limited for U.S. Dollar 8. Net asset of the companies were equal to the purchase price at the date of acquisition.

## Amursky Hydrometallurgy Plant LLC

In April 2007, the Group incorporated a new subsidiary - Amurskiy Hydrometallurgy Plant LLC. The Group plans on building a new plant in the Khabarovsky Region in order to process ore extracted by Albazino Resources LLC.

*(In thousands of U.S. Dollars, except share data)*

## 29. DISPOSAL OF SUBSIDIARIES

In February 2008, the Group contributed 100% of the shares in CJSC Enisey Mining and Geological Company and Imitzoloto LLC, holding Anenskoye and Aprelovskoye gold mining licenses, respectively, to form the joint venture with AngloGold Ashanti Limited (see Note 11).

The book value of the net assets disposed was as follows:

| **Assets and liabilities disposed of as at the date of disposal** | |
|---|---|
| Goodwill | 1,792 |
| Property, plant and equipment | 4,820 |
| Cash and cash equivalents | 13,448 |
| Deferred tax liability | (1,113) |
| Other liabilities | (2,017) |
| **Net assets disposed of** | **16,930** |

In December 2008 the Group sold 100% in CJSC North-Ural Mining Company for U.S. Dollar 55 to an unrelated party. CJSC North-Ural Mining Company did not perform any operations during 2008 and 2007. The amount of net liabilities at the date of disposal comprised U.S. Dollar 264.

## 30. RELATED PARTY TRANSACTIONS

Related parties are considered to include shareholders, affiliates and entities under common ownership and control with the Group and members of key management personnel. In the course of its business the Group entered in the various transactions with related parties.

In June 2007 the Group sold 85% of CJSC GRK Dukat for U.S. Dollar 0.3 to a related party. CJSC GRK Dukat did not perform any operations in 2007. The amount of net assets at the date of disposal comprised U.S. Dollar 0.01.

As at December 31, 2008 and 2007 the amount of outstanding short-term loans provided to related parties comprised U.S. Dollar 334 and U.S. Dollar 126, respectively.

As at December, 2008 and 2007 the amount of outstanding long-term loans provided to related parties comprised U.S. Dollar 8,214 and U.S. Dollar 6,119 respectively (see Note 12). The amount of interest income in 2008 and 2007 amounted to U.S. Dollar 844 and U.S. Dollar 466, respectively.

As at December 31, 2008 the amount of short-term loan provided by related parties comprised U.S. Dollar 136,515 (see Note 13). The amount of interest expense on loans from related parties in 2008 was U.S. Dollar 1,398.

## 31. COMMITMENTS AND CONTINGENCIES

### Operating environment

Whilst there have been improvements in the economic situation in the Russian Federation in recent years, the country 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.

The prospects for future economic stability in the Russian Federation are largely dependent upon the effectiveness of economic measures undertaken by the government, together with legal, regulatory, and political developments.

### Taxation

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 companies of the Group may be challenged by the relevant regional and federal authorities. Recent events within the Russian Federation suggest that the tax authorities may be taking a more assertive position in its interpretation of the legislation and assessments. As a result, significant additional taxes, penalties and interest may be assessed. Fiscal periods remain open to review by the authorities in respect of taxes for three calendar years preceding the year of review. Under certain circumstances reviews may cover longer periods.

Out of the large operating companies of the Group, tax authorities audited JSC Okhotskaya GGC for the period up to 2004, CJSC Zoloto Severnogo Urala for the period up to 2005, and CJSC Serebro Magadana for the period up to 2007. Nevertheless, according to the Russian tax legislation previously conducted audits do not fully exclude subsequent claims relating to the audited period.

The Group has identified contingencies related to taxes other than income tax. Such possible tax contingencies could materialize and require the Group to pay additional amounts of tax. As at December 31, 2008 management estimates such contingencies related to taxes other than income tax to be up to approximately U.S. Dollar 7,395. The Group believes the estimated losses related to these contingencies are not probable and, as such, have not been accrued for as at December 31, 2008.

Transfer pricing legislation, which was introduced from January 1, 1999, provides the possibility for tax authorities to make transfer pricing adjustments and impose additional tax liabilities in respect of all controlled transactions, provided that the transaction price differs from the market price by more than 20%. Controllable transactions include transactions with interdependent parties, as determined under the Russian Tax Code, and all cross-border transactions (irrespective whether performed between related or unrelated parties), where the price applied by a taxpayer differs by more than 20% from the price applied in similar transactions by the same taxpayer within a short period of time, and barter transactions. There is no formal guidance as to how these rules should be applied in practice. The arbitration court practice with this respect is contradictory.

The Group companies occasionally enter into controllable transactions (e.g. intercompany transactions) and based on the terms the Russian tax authorities may qualify them as non-market. Tax liabilities arising from intercompany transactions are determined using actual transaction prices. It is possible with the evolution of the interpretation of the transfer pricing rules in the Russian Federation and the changes in the approach of the Russian tax authorities, that such transfer prices could potentially be challenged in the future. Given the brief nature of the current Russian transfer pricing rules, the impact of any such challenge cannot be reliably estimated although it may be significant.

**Political environment**

The operations and earnings of the Group are affected by political, legislative, fiscal and regulatory developments, including those related to environmental protection. Because of the capital-intensive nature of the industry, the Group is also subject to physical risks of various kinds. The nature and frequency of these developments and events associated with these risks, which generally are not covered by insurance, as well as their effect on future operations and earnings, are not predictable.

**Forward sales commitments**

In connection with the General Framework Credit Line Agreement dated November 2008 entered into between Nomos-Bank and the Company's subsidiaries, CJSC Zoloto Severnogo Urala, CJSC Serebro Magadana and JSC Okhotskaya GGC are required to sell 3,650,000 gram of gold and 120,000,000 gram of silver during 2009; 3,500,000 gram of gold and 60,000,000 gram of silver during 2010; and 3,500,000 gram of gold and 60,000,000 gram of silver during 2011 at the price determined by LBMA.

**Litigation**

During the year, the Group was involved in a number of court proceedings (both as a plaintiff and as a defendant) arising in the ordinary course of business. In the opinion of management of the Group, there are no current legal proceedings or other claims outstanding, which could have a material effect on the result of operations, financial position or cash flows of the Group and which have not been accrued or disclosed in these consolidated financial statements.

**Insurance policies**

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

The Group has entered into insurance contracts to insure property, plant and equipment, and land transport and purchased accident, health and medical insurance for employees. Furthermore, the Group has purchased civil liability coverage for operating entities with dangerous production units.

**Environmental matters**

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

## 32. SUBSEQUENT EVENTS

In January 2009, the Group acquired 10.4% of shares of JSC Artel of prospectors Ayax ("Ayax") from Ovoca Gold Plc, an unrelated party. Ayax holds an exploration and mining license for Goltsovoye silver deposit located in the Magadan region of Russia. The Group paid a total cash consideration of U.S. Dollar 11,697 which included U.S. Dollar 3,043 in cash and settlement of the Ayax's liabilities of U.S. Dollar 8,654. In December 2008, the Group and Verda Financial Ltd. (Seychelles) ("Verda") signed a letter of intent under which the Group will transfer to Verda 7,500,000 of its ordinary shares in exchange for 89.6% of the shares of Ayax which Verda was in process of acquiring. In January 2009, Verda acquired the remaining 89.6% of shares of Ayax. The Group's obligation is secured by a cash deposit of U.S. Dollar 10,000.

In January 2009, the Group signed a long-term loan facility agreement with Gazprombank which allows the Group to borrow up to U.S. Dollar 70,000 to finance its current operations, contract financing, including replenishment of working capital. The facility bears interest of 13% per annum and is payable monthly.

In February 2009, the tax authorities performed an audit of activities of CJSC Serebro Magadana in 2007. As a result of the audit the Group was assessed U.S. Dollar 19,515 of additional income and mining taxes and respective penalties. The management believes that the risk that the Group can't sustain its position in full at court is not probable.

In March 2009, the Extraordinary General Meeting of Shareholders of the Company approved the issuance and placement of 30,000,000 new shares of the Company in the form of a closed subscription.

In March 2009, the Group entered into a Memorandum of Understanding with a group of Russian companies, an unrelated parties, under which the Group commited to acquiring 100% stake of Rudnik Kvartsevyi LLC ("RK") for the total consideration of 10,000,000 of the Company's ordinary shares. RK owns the mining license to the Sopka Kvartsevaya gold-silver deposit and a 100% stake in Vneshstroygroup LLC, owning the mining license to the Dalniy gold-silver deposit, which are located in the Severo-Evensky district of Magadan region of Russia. In addition to the license areas, RK owns a substantial mining fleet as well as infrastructure at the Sopka mine site.

In March 2009, the Group signed a long-term loan facility agreement with Nomos-Bank which allows the Group to borrow up to U.S. Dollar 50,870 (Roubles 1,700,000 thousand as at March 31, 2009) to finance its current operations, contract financing, including replenishment of working capital. The facility bears interest of 18.5% per annum, which is payable monthly.