

**JOINT STOCK COMPANY  
“Corporation “VSMPO-AVISMA”**

**International Financial Reporting Standards  
Special Purpose Consolidated Financial  
Information and Auditor’s Report  
31 December 2007**

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## SPECIAL PURPOSE AUDITOR'S REPORT

To the Board of Directors of Joint Stock Company "Corporation VSMPO-AVISMA"

- 1 We have audited the accompanying preliminary special purpose consolidated financial information of Joint Stock Company "Corporation VSMPO-AVISMA" (the "Company") and its subsidiaries (the "Group") which comprise the consolidated balance sheet as at 31 December 2007 and the consolidated income statement, consolidated statement of cash flows and consolidated statement of changes in equity for the year then ended and a summary of significant accounting policies and other explanatory notes.

### *Management's Responsibility for the Special Purpose Financial Information*

- 2 Management is responsible for the preparation and fair presentation of this special purpose consolidated financial information in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of special purpose consolidated financial information that is free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

### *Auditor's Responsibility*

- 3 Our responsibility is to express an opinion on this special purpose consolidated financial information based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the special purpose consolidated financial information is free from material misstatement.
- 4 An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the special purpose consolidated financial information. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the special purpose consolidated financial information, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the special purpose consolidated financial information in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the special purpose consolidated financial information.
- 5 We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### *Basis for Qualified Opinion*

- 6 International Accounting Standard 24 "Related Party Disclosures" requires that an entity shall disclose the name of its ultimate controlling party, if any. We were unable to satisfy ourselves whether there is an ultimate controlling party and therefore whether such disclosure is required in the accompanying special purpose financial information. Because of this matter we were unable to determine the sufficiency of the disclosures with respect to balances with related parties at 1 January 2007 and 31 December 2007 and transactions for the year ended 31 December 2007.

## SPECIAL PURPOSE AUDITOR'S REPORT

### Opinion

- 7 In our opinion, except for the potential effect on disclosures of the matter set out in the Basis for Qualified Opinion paragraph, as might have been determined to be necessary had we been able to satisfy ourselves whether there is an ultimate controlling party, the accompanying special purpose consolidated financial information as of 31 December 2007, has been prepared, in all material respects, in accordance with the basis set out in Note 2, which describes how IFRS have been applied under IFRS 1 "First-time adoption of International Financial Reporting Standards", including the assumptions management has made about the standards and interpretations expected to be effective, and the policies expected to be adopted, when management prepares its first complete set of IFRS financial statements as at 31 December 2008.
- 8 Without further qualifying our opinion, we draw attention to the fact that Note 2 explains why there is a possibility that the accompanying special purpose financial information may require adjustment before constituting the final comparative 2007 IFRS figures. Moreover, we draw attention to the fact that, under IFRS, only a complete set of financial statements comprising a balance sheet, income statement, statement of changes in net assets attributable to participants, and cash flow statement, together with comparative financial information and explanatory notes, can provide a fair presentation of the Group's financial position, results of operations, and cash flows in accordance with IFRS.

*ZAO PricewaterhouseCoopers Audit*

Moscow, Russian Federation  
4 December 2008

|                                       | 31 December 2007 | 31 December 2006 |
|---------------------------------------|------------------|------------------|
| Defined benefits pension plan         | 18               | 102,710          |
| Terminated lease                      | 22               | 2,214            |
| Other long-term liabilities           |                  | 7,500            |
| Provision for liability               | 23               | 3,490            |
| Other non-current liabilities         |                  | 12,346           |
| Current liabilities                   |                  | 217,201          |
| Accounts payable and accrued expenses | 16               | 1,010,000        |
| Income tax payable                    |                  | 18,470           |
| Manufactured lease                    | 27               | 2,128            |
| Other loans payable                   | 17               | 2,128            |
| Bank loans borrowings                 | 18               | 781,270          |
| Accounts receivable                   |                  | 39,474           |
| Prepaid expenses                      | 19               | 17,232           |
| Other current liabilities             |                  | 221,146          |
| <b>TOTAL LIABILITIES</b>              |                  | <b>781,246</b>   |
| <b>TOTAL LIABILITIES AND EQUITY</b>   |                  | <b>1,301,246</b> |

Reported to the Board of Directors of ZAO PricewaterhouseCoopers Audit on 4 December 2008.

*[Signature]*  
Partner in Charge  
Chief Auditor

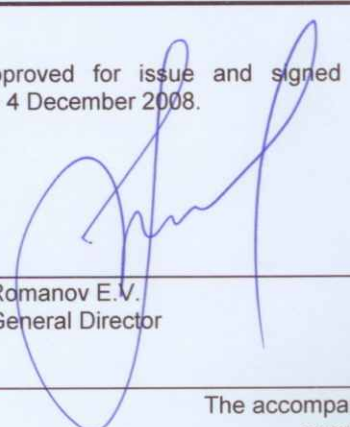
*[Signature]*  
Sergey D. Vys  
Chief Accountant


Joint Stock Company "Corporation "VSMPO - AVISMA"  
 Special Purpose Consolidated Balance Sheet at 31 December 2007  
 (in thousands of US Dollars)



|  | Note | 31 December<br>2007 | 1 January<br>2007<br>(Note 2) |
|--|------|---------------------|-------------------------------|
| <b>ASSETS</b>  |      |                     |                               |
| <b>Non-current assets</b>  |      |                     |                               |
| Property, plant and equipment  | 12   | 722,708             | 512,356                       |
| Goodwill   | 13   | 65,222              | 60,800                        |
| Other Intangible assets, net   |      | 2,198               | 1,808                         |
| Investments in associates and jointly controlled entities                      | 14   | 26,758              | 18,035                        |
| Held-to-maturity investments   |      | 7,831               | 1,954                         |
| Other non-current assets   |      | 1,307               | 423                           |
| <b>Total non-current assets</b>  |      | <b>826,024</b>      | <b>595,376</b>                |
| <b>Current assets</b>  |      |                     |                               |
| Inventories  | 11   | 576,223             | 422,687                       |
| Loans receivable   | 10   | 36,250              | 2,459                         |
| Accounts receivable  | 9    | 472,497             | 290,199                       |
| Cash and cash equivalents  | 8    | 41,317              | 42,632                        |
| Restricted cash  | 8    | 2,362               | 2,248                         |
| Other current assets   |      | 7,112               | -                             |
| <b>Total current assets</b>  |      | <b>1,135,761</b>    | <b>760,225</b>                |
| <b>TOTAL ASSETS</b>  |      | <b>1,961,785</b>    | <b>1,355,601</b>              |
| <b>EQUITY</b>  |      |                     |                               |
| Share capital  | 19   | 22,785              | 22,785                        |
| Share premium  |      | 158,054             | 158,054                       |
| Retained earnings  |      | 865,378             | 646,412                       |
| Cumulative currency translation difference                                     |      | 133,219             | 59,004                        |
| <b>Share capital and reserves attributable to the Company's equity holders</b> |      | <b>1,179,436</b>    | <b>886,255</b>                |
| Minority interest  |      | 1,199               | 2,385                         |
| <b>TOTAL EQUITY</b>  |      | <b>1,180,635</b>    | <b>888,640</b>                |
| <b>LIABILITIES</b>   |      |                     |                               |
| <b>Non-current liabilities</b>   |      |                     |                               |
| Long-term borrowings   | 18   | 165,713             | 67,218                        |
| Defined benefit pension plan   | 15   | 33,251              | 24,927                        |
| Restructured taxes   |      | 2,502               | 4,133                         |
| Other long-term liabilities  |      | 3,490               | 4,243                         |
| Deferred tax liability   | 23   | 12,045              | 12,861                        |
| <b>Total non-current liabilities</b>   |      | <b>217,001</b>      | <b>113,382</b>                |
| <b>Current liabilities</b>   |      |                     |                               |
| Accounts payable and accrued expenses  | 16   | 100,622             | 87,120                        |
| Current income tax payable   |      | 14,407              | 8,392                         |
| Restructured taxes   | 27   | 2,315               | 1,931                         |
| Other taxes payable  | 17   | 5,426               | 34,428                        |
| Short-term borrowings  | 18   | 387,270             | 168,395                       |
| Advances received  |      | 36,474              | 53,238                        |
| Dividends payable  | 19   | 17,635              | 75                            |
| <b>Total current liabilities</b>   |      | <b>564,149</b>      | <b>353,579</b>                |
| <b>TOTAL LIABILITIES</b>   |      | <b>781,150</b>      | <b>466,961</b>                |
| <b>TOTAL LIABILITIES AND EQUITY</b>  |      | <b>1,961,785</b>    | <b>1,355,601</b>              |

Approved for issue and signed in virtue of the mandate and in accordance with the Charter authority on 4 December 2008.

  
 Romanov E.V.  
 General Director

  
 Sannikov D.Yu.  
 Chief Accountant

The accompanying notes on pages 6 to 39 are an integral part of this special purpose consolidated financial information.

**Open Joint Stock Company "Corporation "VSMPO-AVISMA"  
Special Purpose Consolidated Income Statement  
for the year ended 31 December 2007**



(in thousands of US Dollars, except for per share amounts)

|   | Note | 2007           |
|---|------|----------------|
| Revenue   | 6    | 1,310,585      |
| Cost of sales   | 20   | (719,852)      |
| <b>Gross profit</b>   |      | <b>590,733</b> |
| Distribution costs  |      | (30,206)       |
| General and administrative expenses   | 21   | (178,392)      |
| <b>Operating profit</b>   |      | <b>382,135</b> |
| Finance income  |      | 2,348          |
| Interest expense  |      | (23,040)       |
| Foreign exchange losses   |      | (7,116)        |
| Share of result of associate  | 14   | 15,184         |
| <b>Profit before taxation</b>   |      | <b>369,511</b> |
| Income tax expense  | 23   | (129,057)      |
| <b>Net profit for the year</b>  |      | <b>240,454</b> |
| <b>Net profit is attributable to:</b>   |      |                |
| Equity holders of the Company   |      | 241,640        |
| Minority interest   |      | (1,186)        |
| <b>Net profit for the year</b>  |      | <b>240,454</b> |
| Earnings per share for profit for the year attributable to the equity holders of the Company, basic and diluted (expressed in US Dollars per share) | 22   | 20.9583        |

**Open Joint Stock Company "Corporation "VSMPO-AVISMA"  
Special Purpose Consolidated Statement of Cash Flows  
for the year ended 31 December 2007**  
(in thousands of US Dollars)



|  | Note | 2007             |
|--|------|------------------|
| <b>Cash flows from operating activities</b>  |      |                  |
| Profit before taxation   |      | 369,511          |
| <i>Adjustments for:</i>  |      |                  |
| Depreciation and amortization  | 20   | 50,356           |
| Impairment of accounts receivable  | 21   | 22,975           |
| Impairment of property, plant and equipment, net   | 12   | 654              |
| Share of results of associate  | 14   | (15,184)         |
| Interest income  | 10   | (2,348)          |
| Interest expense   |      | 23,040           |
| Change in restricted cash balance  |      | 48               |
| Decrease in provision for write-down on inventory  | 11   | (2,558)          |
| Increase in pension obligations  | 15   | 6,248            |
| <b>Operating cash flows before working capital changes</b>                               |      | <b>452,742</b>   |
| Increase in gross trade receivables  |      | (86,613)         |
| Increase in advances to suppliers  |      | (19,445)         |
| Increase in inventories  |      | (117,757)        |
| Increase in trade payables   |      | 6,878            |
| Decrease in advances from customers  |      | (19,804)         |
| Decrease in restructured taxes liabilities   |      | (1,622)          |
| Decrease in other payables   |      | (855)            |
| Increase in other current assets   |      | (7,645)          |
| Decrease in other long-term liabilities  |      | (1,019)          |
| <b>Cash generated from operations</b>  |      | <b>204,860</b>   |
| Income taxes paid  |      | (153,816)        |
| Interest paid  |      | (23,040)         |
| <b>Net cash provided from operating activities</b>                                       |      | <b>26,889</b>    |
| <b>Cash flows from investing activities</b>  |      |                  |
| Purchase of property, plant and equipment  |      | (217,377)        |
| Loans provided   |      | (39,027)         |
| Deposits issued  |      | (6,373)          |
| Proceeds from loans repaid   |      | 9,986            |
| Prepayment for acquisition of additional interest in associate                           | 14   | (75,000)         |
| <b>Net cash used in investing activities</b>   |      | <b>(327,791)</b> |
| <b>Cash flows from financing activities</b>  |      |                  |
| Dividends paid to shareholders   |      | (5,906)          |
| Distributions from associate   | 14   | 7,876            |
| Net proceeds from short-term borrowings  |      | 231,681          |
| Proceeds from long-term borrowings   |      | 63,001           |
| Repayment of long-term borrowings  |      | (6,544)          |
| <b>Net cash provided from financing activities</b>                                       |      | <b>290,108</b>   |
| Effect of exchange rate changes on cash and cash equivalents                             |      | 9,479            |
| <b>Net decrease in cash and cash equivalents</b>   |      | <b>(1,315)</b>   |
| Cash and cash equivalents at the beginning of the year, net of restricted cash of 2,248  |      | 42,632           |
| <b>Cash and cash equivalents at the end of the year, net of restricted cash of 2,362</b> |      | <b>41,317</b>    |

The accompanying notes on pages 6 to 39 are an integral part of this special purpose consolidated financial information.

**Open Joint Stock Company "Corporation "VSMPO-AVISMA"  
Special Purpose Consolidated Statement of Changes in Equity  
for the year ended 31 December 2007**

(in thousands of US Dollars)



|  | Capital and reserves attributable to the Company's equity holders |                |                   |  | Minority interest | Total equity attributable to participants |
|--|---|----------------|-------------------|--|-------------------|---|
|  | Share capital (Note 19)   | Share premium  | Retained earnings | Cumulative currency translation difference |                   |   |
| <b>Balance at 1 January 2007</b>         | <b>22,785</b>   | <b>158,054</b> | <b>646,412</b>    | <b>59,004</b>                              | <b>2,385</b>      | <b>888,640</b>                            |
| Currency translation differences         | -   | -              | -                 | 74,215                                     | -                 | 74,215                                    |
| Net income recognised directly in equity |   |                |                   |  |                   | <b>74,215</b>                             |
| Profit for the year                      | -   | -              | 241,640           | -  | (1,186)           | 240,454                                   |
| <b>Total recognised income for 2007</b>  |   |                |                   |  |                   | <b>314,669</b>                            |
| Dividends declared (Note 19)             | -   | -              | (22,674)          | -  | -                 | (22,674)                                  |
| <b>Balance at 31 December 2007</b>       | <b>22,785</b>   | <b>158,054</b> | <b>865,378</b>    | <b>133,219</b>                             | <b>1,199</b>      | <b>1,180,635</b>                          |

The accompanying notes on pages 6 to 39 are an integral part of this special purpose consolidated financial information.



## 1 VSMPO Group and its Operations

Open Joint Stock Company "Corporation "VSMPO-AVISMA" ("VSMPO-AVISMA" or the "Company") and its subsidiaries (collectively the "Group" or "VSMPO Group") is one of the world's leading titanium producers. The Company was originally established as a state owned enterprise in 1933 in the Moscow region and re-allocated to Verkhnya Salda (Sverdlovsk region) in 1941. The Company was privatized in the form of a joint stock company in 1992 and registered as an open joint stock company "Verkhnesaldinskoye Metallurgicheskoe Proizvodstvennoe Obyedinenie" ("VSMPO") in accordance with the Law on Joint Stock Companies of the Russian Federation.

In 1998 VSMPO acquired controlling interest in an open joint stock company "Avisma" ("Avisma"). In January 2005 VSMPO was renamed to open joint stock company "VSMPO-AVISMA Corporation". In July 2005 following the acquisition of outstanding minority interest and a legal reorganization, in the form of accession of Avisma into VSMPO, VSMPO and Avisma formed one legal entity. As a result of this reorganization, AVISMA branch was established.

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

Avisma branch's main operations are in Berezniki (Perm region) of the Russian Federation and are subject to the legislative requirements of both the Russian Federation and the Perm regional authorities. Avisma's main products are titanium sponge and primary magnesium.

VSMPO-AVISMA and its subsidiaries form a vertically integrated operation.

The Company's registered address is: Parkovaya St. 1, Verkhnya Salda, Sverdlovsk region, Russia, 624760.

## 2 Basis of Preparation of the Financial Statements

**Basis of preparation.** This special purpose IFRS financial information is prepared solely for the use of management of the Group in order to assist the Group in its conversion to International Financial Reporting Standards ("IFRS") for the year ending 31 December 2008.

The consolidated financial statements of the Group as at 31 December 2006 and for the year then ended, which were issued by the Company on 28 December 2007, were prepared in accordance with the requirements of accounting principles generally accepted in the United States of America ("US GAAP"). These were considered to be the previous GAAP as defined in IFRS 1 "First-time Adoption of International Financial Reporting Standards" for the preparation of the preliminary opening IFRS balance sheet as at 1 January 2007. US GAAP differs in certain respects from IFRS. In preparing this special purpose IFRS financial information management has used its best knowledge of the expected standards and interpretations, facts and circumstances, and accounting policies that will be applied when the Group prepares its first full IFRS financial statements as at 31 December 2008.

Although this special purpose IFRS financial information is based on management's best knowledge of expected standards and interpretations, and current facts and circumstances, this may change. For example, amended or additional standards or interpretations may be issued by International Accounting Standards Board. Therefore, until the Group prepares its first full IFRS financial statements and establishes its transition date as defined by IFRS 1, the possibility cannot be excluded that the accompanying preliminary IFRS financial information may have to be adjusted. The principle accounting policies applied in the preparation of this special-purpose consolidated financial information described below have been developed using the framework and principles of IFRS in force as at 31 December 2008.

In preparing this special purpose IFRS financial information in accordance with IFRS 1, the Company has applied the relevant mandatory exceptions and certain optional exemptions from full retrospective application of IFRS. The Group has elected to take an exemption under IFRS 1 not apply IFRS 3 "Business Combinations" to business combinations that occurred before 1 January 2007. Also, the Group elected to take a similar exemption to measure its investment in jointly controlled entity.

## 2 Basis of Preparation of the Financial Statements (continued)

The Company has applied the following mandatory exception from retrospective application: estimates under IFRS at 1 January 2007 are consistent with estimates made for the same date under US GAAP. All other mandatory exceptions in IFRS 1 were not applicable because there were no significant differences in management's application of US GAAP in these areas.

In accordance with the laws of the Russian Federation the accounting records of the Company are maintained and the Company's statutory financial statements for its stockholders are prepared in Russian roubles ("rouble"). The accounting records of other companies of the Group are maintained in accordance with the laws of the country of domicile. The preliminary special purpose IFRS financial information is based on the statutory records of the companies of the Group, with adjustments and reclassifications recorded for the purpose of fair presentation in accordance with IFRS.

The preliminary special purpose IFRS financial information has been prepared under the historical cost convention. The preparation of the special purpose IFRS financial information requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying the Company's accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the special purpose IFRS financial information are disclosed in Note 4.

The principal accounting policies applied in the preparation of this special purpose consolidated financial information described below have been developed using the framework and principles of IFRS in force as at 31 December 2008.

Reconciliations and descriptions of the adjustments from the 2006 US GAAP financial statements to the IFRS equity as of 1 January 2007 are provided below.

Because the Group is converting to IFRS for the first time, no prior period comparative figures are presented in the accompanying special purpose financial information for the statements of income, cash flows, changes in equity and for the related notes.

**Reconciliation and explanation of adjustments.** The effects of adopting IFRS on the previously reported total equity under US GAAP as of 1 January 2007 are as follows:

|   | Note  | 1 January<br>2007 |
|---|-------|-------------------|
| Total equity as previously reported under US GAAP   |       | 879,487           |
| Adjustments resulting from changes in accounting policies   |       |                   |
| Property, plant and equipment adjustment  | (i)   | (7,137)           |
| IFRS deferred tax   | (ii)  | 1,713             |
| Re-assessment of pension obligation   | (iii) | 17,699            |
| Application of IAS 12 "Income Taxes" – tax effect on unrealised profit in intercompany transactions | (iv)  | (6,075)           |
| Other adjustments resulting from changes in accounting policies                                     |       | 2,953             |
| <b>Total equity restated under IFRS</b>   |       | <b>888,640</b>    |

- i) **Property plant and equipment.** Under US GAAP the property, plant and equipment of VSMPO (a parent company) were recorded at historical cost (Note 3.6). In contrast, under IFRS the property, plant and equipment acquired prior to 1 January 2003 are recorded at cost, restated where applicable in accordance with IAS 29 "Financial Reporting in Hyperinflationary Economies" to the equivalent purchasing power of the Russian Rouble at 31 December 2002.
- ii) **Deferred taxes.** US GAAP prohibits recognition of a deferred tax liability or asset for differences related to assets and liabilities, that, under SFAS 52, *Foreign Currency Translation*, are remeasured from the local currency into the functional currency using exchange rates and that result from (1) change in exchange rate or (2) indexing for tax purpose. In contrast, IAS 12 (revised) "Income Taxes" requires recognition of a deferred tax liability or asset for those temporary differences.

## 2 Basis of Preparation of the Financial Statements (continued)

- iii) **Reassessment of post employment and post retirement program for IFRS purposes.** Difference is due to different rules applicable to post employment and post retirement program run by the Group under US GAAP and IFRS. IAS 19 is similar in many aspects to the equivalent post-employment benefit accounting standards under US GAAP. The actuarial valuation methodology and assumptions are similar under both IFRS and US GAAP.

The main difference is primarily due to differing recognition of funded status on the balance sheet. Under FAS 158, the Group is required to recognise on its balance sheet the funded status, ie present value of pension obligations less plan assets. Changes in funded status, ie unrecognised gains and losses and prior service costs, are recognised as a component of other comprehensive income (OCI). As allowed under IAS 19, the Group has adopted the accounting policy to defer recognition of actuarial gains and losses. The balance sheet liability is the net total of the following amounts: (1) the present value of the defined benefit obligation at the balance sheet date, (2) plus any actuarial gains not yet recognised, (3) minus any past service cost not yet recognised, (4) minus the fair value of plan assets at the balance sheet date (if any).

The difference between pension expense amounts for the Group under IFRS and US GAAP is insignificant.

- iv) **Tax effect on unrealised profit in intercompany transactions.** Under US GAAP and IFRS, unrealized profits resulting from inter-company transactions are eliminated from the carrying amount of assets, such as inventory. In accordance with US GAAP, the Group calculated the tax effect with the reference to the local tax rate in the seller's jurisdiction. However, IAS 12 (revised) "Income Taxes" requires the tax effect to be calculated with the reference to the local tax rate of the company that holds the inventory (the buyer) at period end.

The reconciliation of profit and loss reported under previous GAAP to IFRS is not presented in this special-purpose consolidated financial information, because the Group did not prepare US GAAP consolidated financial statements after 2006.

**Presentation currency.** All amounts in this special purpose consolidated financial information are presented in thousands of US Dollars ("USD"), unless otherwise stated (refer to Note 3.10 "Foreign currency transactions").

## 3 Summary of Significant Accounting Policies

### 3.1 Group accounting

**Subsidiaries.** Subsidiaries are those companies and other entities (including special purpose entities) in which the Group, directly or indirectly, has an interest of more than one half of the voting rights or otherwise has power to govern the financial and operating policies so as to obtain economic benefits. The existence and effect of potential voting rights that are presently exercisable or presently convertible are considered when assessing whether the Group controls another entity. Subsidiaries are consolidated from the date on which control is transferred to the Group (acquisition date) and are de-consolidated from the date that control ceases.

The purchase method of accounting is used to account for the acquisition of subsidiaries except for those acquired as the result of the business combinations under common control. The cost of an acquisition is measured at the fair value of the assets given up, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. The date of exchange is the acquisition date where a business combination is achieved in a single transaction, and is the date of each share purchase where a business combination is achieved in stages by successive share purchases.

The excess of the cost of acquisition over the fair value of the net assets of the acquiree at each exchange transaction represents goodwill. The excess of the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities acquired over cost ("negative goodwill") is recognised immediately in profit or loss. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured at their fair values at the acquisition date, irrespective of the extent of any minority interest.

### 3 Summary of Significant Accounting Policies (continued)

#### 3.1 Group accounting (continued)

Intercompany transactions, balances and unrealised gains on transactions between group companies are eliminated; unrealised losses are also eliminated unless the cost cannot be recovered. The Company and all of its subsidiaries use uniform accounting policies consistent with the Group's policies.

Minority interest is that part of the net results and of the net assets of a subsidiary, including the fair value adjustments, which is attributable to interests which are not owned, directly or indirectly, by the Company. Minority interest forms a separate component of the Group's equity.

**Purchases of minority interests.** Difference, if any, between the carrying amount of a minority interest and the amount paid to acquire it is recorded as gain or loss directly in equity.

**Investments in associates.** Associates are entities over which the Group has significant influence, but not control, generally accompanying a shareholding of between 20 and 50 percent of the voting rights. Investments in associates are accounted for by the equity method of accounting and are initially recognised at cost. The carrying amount of associates includes goodwill identified on acquisition less accumulated impairment losses, if any. The Group's share of the post-acquisition profits or losses of associates is recorded in the special purpose consolidated income statement, and its share of post-acquisition movements in reserves is recognised in reserves. When the Group's share of losses in an associate equals or exceeds its interest in the associate, the Group does not recognise further losses, unless it has incurred obligations or made payments on behalf of the associate.

Unrealised gains on transactions between the Group and its associates are eliminated; unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred.

#### 3.2 Cash and cash equivalents

Cash and cash equivalents includes cash in hand, deposits held at call with banks, and other short-term highly liquid investments with original maturities of three months or less. Cash and cash equivalents are carried at amortised cost using the effective interest method. Bank overdrafts are shown within borrowings in the current liabilities on the balance sheet. Restricted balances are excluded from cash and cash equivalents for the purposes of the cashflow statement. Balances restricted from being exchanged or used to settle a liability for at least twelve months after the balance sheet date are included in other non-current assets.

#### 3.3 Trade and other receivables

Trade and other receivables are carried at amortised cost using the effective interest method. A provision for impairment of receivables is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of receivables. The amount of the provision is the difference between the carrying amount and the recoverable amount, being the present value of estimated future cash flows, discounted at the original effective rate of interest. The amount of the provision is recognised in the income statement. The primary factors that the Group considers whether a receivable is impaired is its overdue status. The following other principal criteria are also used to determine whether there is objective evidence that an impairment loss has occurred:

- any portion of the receivable is overdue and the late payment cannot be attributed to a delay caused by the settlement systems;
- the counterparty experiences a significant financial difficulty as evidenced by its financial information that the Group obtains;
- the counterparty considers bankruptcy or a financial reorganisation;
- there is adverse change in the payment status of the counterparty as a result of changes in the national or local economic conditions that impact the counterparty.

### 3 Summary of Significant Accounting Policies (continued)

#### 3.4 Value added tax

Output value added tax related to sales is payable to tax authorities on the earlier of (a) collection of the receivables from customers or (b) delivery of the goods or services to customers. Input VAT is generally recoverable against output VAT upon receipt of the VAT invoice. The tax authorities permit the settlement of VAT on a net basis. VAT related to sales and purchases which have not been settled at the balance sheet date (VAT deferred) is recognised in the balance sheet on a gross basis and disclosed separately as an asset and liability. Where provision has been made for impairment of receivables, an impairment loss is recorded for the gross amount of the debtor, including VAT.

#### 3.5 Inventories

Inventories are recorded at the lower of cost and net realisable value. Cost of inventory held by production companies of the Group is determined on the weighted average basis; cost of inventory held by distributor companies is on a specific identification basis. The cost of finished goods and work in progress comprises raw materials, direct labour, other direct costs and related production overhead (based on normal operating capacity) but excludes borrowing costs. Net realisable value is the estimated selling price in the ordinary course of business, less the cost of completion and selling expenses.

#### 3.6 Property, plant and equipment

Property, plant and equipment of the Company are recorded at cost, restated where applicable to the equivalent purchasing power of the Russian Rouble at 31 December 2002 for assets acquired prior to 1 January 2003, less accumulated depreciation and provision for impairment, where required. For other companies of the Group acquired in business combinations, the Group has elected to take a business combination exemption under IFRS 1 (Note 2), and therefore all the property plant and equipment items acquired in such business combinations after 1 January 2003 are recognized in opening IFRS balance sheet at the cost equal to their carrying value under previous GAAP.

At each reporting date the management assess whether there is any indication of impairment of property, plant and equipment. If any such indication exists, the management estimates the recoverable amount, which is determined as the higher of an asset's fair value less cost to sell and its value in use. The carrying amount is reduced to the recoverable amount and the difference is recognised as an expense (impairment loss) in the income statement. An impairment loss recognised for an asset in prior years is reversed if there has been a change in the estimates used to determine the assets recoverable amount. Gains and losses on disposals determined by comparing proceeds with carrying amount are recognised in the profit or loss.

Depreciation is calculated to allocate cost of property, plant and equipment to their residual values on a straight-line basis. The depreciation periods, which approximate the estimated useful economic lives of the respective assets, are as follows:

|                             | Number of years |
|-----------------------------|-----------------|
| Buildings and constructions | 25 - 40 years   |
| Plant and equipment         | 15 years        |
| Vehicles                    | 10 years        |
| Transfer devices            | 20 years        |
| Other                       | 3 - 5 years     |

The residual value of an asset is the estimated amount that the Group would currently obtain from disposal of the asset less the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Repair and maintenance expenditure is expensed as incurred. Major renewals and improvements are capitalised and the assets replaced are retired. Gains and losses arising from the retirement or disposal of property, plant and equipment are included in the statement of income as incurred.

Borrowing costs on specific or general funds borrowed to finance the construction of qualifying asset are capitalised, during the period of time that is required to complete and prepare the asset for its intended use. All other borrowing costs are expensed.

### 3 Summary of Significant Accounting Policies (continued)

#### 3.7 Intangible assets

**Goodwill.** Goodwill represents the excess of the cost of an acquisition over the fair value of the acquirer's share of the net identifiable assets, liabilities and contingent liabilities of the acquired subsidiary or associate at the date of exchange.

Goodwill on acquisitions of subsidiaries is presented separately in the special purpose consolidated balance sheet. Goodwill on acquisitions of associates is included in the investment in associates. Goodwill is carried at cost less accumulated impairment losses, if any.

The Group tests goodwill for impairment at least annually and whenever there are indications that goodwill may be impaired. Goodwill is allocated to the acquirer's cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the business combination. Such units or group of units represent the lowest level at which the Group monitors goodwill and are not larger than a segment. Gains or losses on disposal of an operation within a cash generating unit to which goodwill has been allocated include the carrying amount of goodwill associated with the operation disposed of, generally measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit which is retained.

**Research and development.** Research expenditure is recognised as an expense as incurred. Costs incurred on development projects (relating to the design and testing of new or improved products) are recognised as intangible assets when it is probable that the project will be a success considering its commercial and technological feasibility, and costs can be measured reliably. Other development expenditures are recognised as an expense as incurred. Development costs with a finite useful life that have been capitalised are amortised from the commencement of the commercial production of the product on a straight-line basis over the period of its expected benefit, on average over a period not exceeding 5 years.

**Other intangible assets.** All of the Group's other intangible assets have definite useful lives and primarily include capitalised computer software, patents, acquired trademarks and licences. They are capitalised on the basis of the costs incurred to acquire and bring them to use. Intangible assets are amortised using the straight-line method over their useful lives, but not exceeding 20 years.

#### 3.8 Borrowings

Borrowings are stated at amortised cost using the effective yield method; any difference between fair value of the proceeds (net of transaction costs) and the redemption amount is recognised as interest expense over the period of the borrowings. Borrowing costs on specific or general funds borrowed to finance the construction of qualifying asset are capitalised, during the period of time that is required to complete and prepare the asset for its intended use. All other borrowing costs are expensed.

#### 3.9 Income taxes

Income taxes have been provided for in the special purpose consolidated financial information in accordance with the legislation of the countries, where most significant subsidiaries of the Group are located, enacted or substantively enacted by the balance sheet date. The income tax charge comprises current tax and deferred tax and is recognised in the special purpose consolidated income statement unless it relates to transactions that are recognised, in the same or a different period, directly in equity. Corporate profit tax rate is 24% (2006: 24%) for Russia, where the most significant Group subsidiaries are registered.

Current tax is the amount expected to be paid to or recovered from the taxation authorities in respect of taxable profits or losses for the current and prior periods. Taxes, other than on income, are recorded within operating expenses.

### 3 Summary of Significant Accounting Policies (continued)

#### 3.9 Income taxes (continued)

Deferred income tax is provided using the balance sheet liability method for tax loss carry forwards and temporary differences arising between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. In accordance with the initial recognition exemption, deferred taxes are not recorded for temporary differences on initial recognition of an asset or a liability in a transaction other than a business combination if the transaction, when initially recorded, affects neither accounting nor taxable profit. Deferred tax liabilities are not recorded for temporary differences on initial recognition of goodwill and subsequently for goodwill which is not deductible for tax purposes. Deferred tax balances are measured at tax rates enacted or substantively enacted at the balance sheet date which are expected to apply to the period when the temporary differences will reverse or the tax loss carry forwards will be utilised. Deferred tax assets and liabilities are netted only within the individual companies of the Group. Deferred tax assets for deductible temporary differences and tax loss carry forwards are recorded only to the extent that it is probable that future taxable profit will be available against which the deductions can be utilised.

Deferred income tax is provided on post acquisition retained earnings of subsidiaries, except where the Group controls the subsidiary's dividend policy and it is probable that the difference will not reverse through dividends or otherwise in the foreseeable future.

#### 3.10 Foreign currency transactions

**Foreign currency translation.** The functional currency of the Company and its trading subsidiaries is considered to be the rouble. The functional currency of Ukrainian "Plant SETAB Nikopol" company is the US Dollar. The accompanying financial statements have been prepared using the US Dollar ("USD") as the Group's presentation currency, which the management believes is the most useful currency to adopt for users of this special purpose consolidated financial information.

For the Company and its subsidiaries monetary assets and liabilities are translated into each entity's functional currency at the official exchange rate of the Central Bank at the respective balance sheet dates. Foreign exchange gains and losses resulting from the settlement of the transactions and from the translation of monetary assets and liabilities into each entity's functional currency at year-end official exchange rates of the Central Bank are recognised in profit or loss. Translation at year-end rates does not apply to non-monetary items. Effects of exchange rate changes on the fair value of equity securities are recorded as part of the fair value gain or loss.

**Translation from functional to presentation currency.** The results and financial position of each group entity (functional currency of none of which is a currency of a hyperinflationary economy) are translated into the presentation currency as follows:

- (i) assets and liabilities for each balance sheet presented are translated at the closing rate at the date of that balance sheet;
- (ii) income and expenses for each income statement are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions); and
- (iii) all resulting exchange differences are recognised as a separate component of equity.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate. When a subsidiary is disposed of through sale, liquidation, repayment of share capital or abandonment of all, or part of, that entity, relating exchange differences deferred in equity are reclassified to profit or loss.

At 31 December 2007 the principal rate of exchange used for translating foreign currency balances was USD 1 = RR 24.5462 (2006: USD 1 = RR 26.3311). Exchange restrictions and controls exist relating to converting Russian Roubles into other currencies.

### 3 Summary of Significant Accounting Policies (continued)

#### 3.11 Provisions for liabilities and charges

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, and it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount can be made. Where the Group expects a provision to be reimbursed, for example under an insurance contract, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain.

Provisions are evaluated and re-estimated annually, and are included in the financial statements at their expected net present values using discount rates appropriate to the Company or its subsidiaries in applicable economic environment at each balance sheet date.

**Uncertain tax positions.** The Group's uncertain tax positions are reassessed by management at every balance sheet date. Liabilities are recorded for income tax positions that are determined by management as less likely than not to be sustained if challenged by tax authorities, based on the interpretation of tax laws that have been enacted or substantively enacted by the balance sheet date. Liabilities for penalties, interest and taxes other than on income are recognised based on management's best estimate of the expenditure required to settle the obligations at the balance sheet date.

#### 3.12 Shareholders' equity

**Share capital.** Ordinary shares are classified as equity. Incremental costs directly attributable to the issue of new shares are shown in equity as a deduction, net of tax, from the proceeds. Any excess of the fair value of consideration received over the par value of shares issued is presented in the notes as a share premium.

**Treasury shares.** Where any Group company purchases the Company's equity share capital, the consideration paid, including any directly attributable incremental costs (net of income taxes) is deducted from equity attributable to the Company's equity holders until the shares are cancelled, reissued or disposed of. Where such shares are subsequently sold or reissued, any consideration received, net of any directly attributable incremental transaction costs and the related income tax effects, is included in equity attributable to the Company's equity holders.

**Dividends.** Dividends are recognised as a liability and deducted from equity at the balance sheet date only if they are declared before or on the balance sheet date. Dividends are disclosed when they are proposed before the balance sheet date or proposed or declared after the balance sheet date but before the financial statements are authorised for issue.

#### 3.13 Revenue recognition

Revenues from sales of Group's titanium products and related by-products are recognised at the point of transfer of risks and rewards of ownership of the goods, normally when the goods are shipped. If the Group agrees to transport goods to a specified location, revenue is recognised when the goods are passed to the customer at the destination point.

Sales are shown net of VAT, custom duties and discounts, and after eliminating sales within the Group. Revenues are measured at the fair value of the consideration received or receivable. When the fair value of consideration received cannot be measured reliably, the revenue is measured at the fair value of the goods or service given up.

#### 3.14 Employee benefits

Wages, salaries, contributions to the Russian Federation state pension and social insurance funds, paid annual leave and sick leave, bonuses, and non-monetary benefits (such as health services and kindergarten services) are accrued in the year in which the associated services are rendered by the employees of the Group and are included within labour costs in operating expenses.

Employees of subsidiaries located outside Russia are either provided benefits under compulsory programs of the country in which they are domiciled or under optional programs customary for comparable companies in those countries.



### 3 Summary of Significant Accounting Policies (continued)

#### 3.14 Employee benefits (continued)

**Social costs.** The Group incurs significant costs on social activities. These costs include the provision of health services, kindergartens, and the subsidy of worker holidays. These amounts represent an implicit cost of employing principally production workers and other staff and, accordingly, have been charged to operating expenses.

**Pension costs.** The Group operates defined benefit pensions and other post-employment benefits (such as additional material support to former employees, lump-sum payments upon death or retirement, jubilee benefits). The program is unfunded: the Group pay benefits on pay-as-you-go basis. The pension accounting costs are assessed using the projected unit credit method. Under this method, the cost of providing pensions is charged to the income statement, so as to attribute the total pension cost over the service life of employees, in accordance with the benefit formula of the plan. Actuarial gains and losses are amortised over the remaining working lives of employees, to the extent to which these exceed 10% of the greater of defined benefit obligation and plan assets. Past service cost is recognized immediately to the extent the benefits are already vested, or otherwise is amortized on a straight-line basis over the average period until the benefits become vested.

#### 3.15 Financial assets and liabilities

**Classification of financial assets.** The Group classifies its financial assets into the following measurement categories: available-for-sale, held to maturity and loans and receivables.

Loans and receivables are unquoted non-derivative financial assets with fixed or determinable payments other than those that the Group intends to sell in the near term.

Held to maturity classification includes quoted non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group has both the intention and ability to hold to maturity. Management determines the classification of investment securities held to maturity at their initial recognition and reassesses the appropriateness of that classification at each balance sheet date.

**Initial recognition of financial instruments.** Financial assets and liabilities are initially recorded at fair value plus transaction costs. Fair value at initial recognition is best evidenced by the transaction price. A gain or loss on initial recognition is only recorded if there is a difference between fair value and transaction price which can be evidenced by other observable current market transactions in the same instrument or by a valuation technique whose inputs include only data from observable markets.

All purchases and sales of financial assets that require delivery within the time frame established by regulation or market convention ("regular way" purchases and sales) are recorded at trade date, which is the date that the Group commits to deliver a financial asset. All other purchases and sales are recognised on the settlement date with the change in value between the commitment date and settlement date not recognised for assets carried at cost or amortised cost; and recognised in equity for assets classified as available for sale.

**Derecognition of financial assets.** The Group derecognises financial assets when (i) the assets are redeemed or the rights to cash flows from the assets have otherwise expired or (ii) the Group has transferred substantially all the risks and rewards of ownership of the assets or (iii) the Group has neither transferred nor retained substantially all risks and rewards of ownership but has not retained control. Control is retained if the counterparty does not have the practical ability to sell the asset in its entirety to an unrelated third party without needing to impose additional restrictions on the sale.

**Available-for-sale investments.** Available-for-sale investments are carried at fair value. Interest income on available for sale debt securities is calculated using the effective interest method and recognised in profit or loss. Dividends on available-for-sale equity instruments are recognised in profit or loss when the Group's right to receive payment is established. All other elements of changes in the fair value are deferred in equity until the investment is derecognised or impaired at which time the cumulative gain or loss is removed from equity to profit or loss.

### 3 Summary of Significant Accounting Policies (continued)

#### 3.15 Financial assets and liabilities (continued)

Impairment losses are recognised in profit or loss when incurred as a result of one or more events ("loss events") that occurred after the initial recognition of available-for-sale investments. A significant or prolonged decline in the fair value of an equity security below its cost is an indicator that it is impaired. The cumulative impairment loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that asset previously recognised in profit or loss – is removed from equity and recognised in profit or loss. Impairment losses on equity instruments are not reversed through profit or loss. If, in a subsequent period, the fair value of a debt instrument classified as available for sale increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss, the impairment loss is reversed through current period's profit or loss.

**Held to maturity investments.** Held to maturity investments are carried at amortised costs using the effective interest method, net of a provision for incurred impairment losses.

#### 3.16 Finance lease liabilities

Where the Group is a lessee in a lease which transferred substantially all the risks and rewards incidental to ownership to the Group, the assets leased are capitalised in property, plant and equipment at the commencement of the lease at the lower of the fair value of the leased asset and the present value of the minimum lease payments. Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate on the finance balance outstanding. The interest cost is charged to the income statement over the lease period using the effective interest method. The assets acquired under finance leases are depreciated over their useful life or the shorter lease term if the Group is not reasonably certain that it will obtain ownership by the end of the lease term.

#### 3.17 Earnings per share

Basic earnings per share is determined by dividing the profit or loss attributable to equity holders of the Company by the weighted average number of ordinary shares outstanding during the reporting year.

### 4 Critical Accounting Estimates, and Judgements in Applying Accounting Policies

The Group makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgements are continually evaluated and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Management also makes certain judgements, apart from those involving estimations, in the process of applying the accounting policies. Judgements that have the most significant effect on the amounts recognised in the financial statements and estimates that can cause a significant adjustment to the carrying amount of assets and liabilities within the next financial year include:

**Estimated impairment of goodwill.** The Group tests goodwill for impairment at least annually. The recoverable amounts of cash-generating units have been determined based on the higher of the fair value less cost to sale or value-in-use calculations. There is no impairment provision required as at 31 December 2007, as a result of these calculations. Refer to Note 13.

**Tax legislation.** Russian tax, currency and customs legislation is subject to varying interpretations. Refer to Note 24.

**Useful lives of property, plants and equipment.** The estimation of the useful lives of items of property, plant and equipment is a matter of judgement based on the experience with similar assets. The future economic benefits embodied in the assets are consumed principally through use. However, other factors, such as technical or commercial obsolescence and wear and tear, often result in the diminution of the economic benefits embodied in the assets. Management assesses the remaining useful lives in accordance with the current technical conditions of the assets and estimated period during which the assets are expected to earn benefits for the Group. The following primary factors are considered: (a) expected usage of the assets; (b) expected physical wear and tear, which depends on operational factors and maintenance programme; and (c) technical or commercial obsolescence arising from changes in market conditions. The impact on depreciation for the period would be to increase it by USD 4,700 or decrease it by USD 4,736 were the estimated useful lives to differ by 10% from management's estimates.

#### 4 Critical Accounting Estimates, and Judgements in Applying Accounting Policies (continued)

**Impairment provision for accounts receivable.** The impairment provision for accounts receivable is based on the Group's assessment of the collectability of specific customer accounts. If there is deterioration in a major customer's creditworthiness or actual defaults are higher or lower than the estimates, the actual results may differ from these estimates. The charges and releases for impairment of accounts receivable may be significant. Refer to Note 9.

#### 5 New Accounting Pronouncements

Certain new standards and interpretations have been published that are mandatory for the Group's accounting periods beginning on or after 1 January 2009 or later periods and which the entity has not early adopted:

**IFRS 8, Operating Segments (effective for annual periods beginning on or after 1 January 2009).** The standard applies to entities whose debt or equity instruments are traded in a public market or that file, or are in the process of filing, their financial statements with a regulatory organisation for the purpose of issuing any class of instruments in a public market. IFRS 8 requires an entity to report financial and descriptive information about its operating segments and specifies how an entity should report such information. The Group is currently assessing the impact of the standard on its special purpose consolidated financial information.

**IAS 23, Borrowing Costs (revised March 2007; effective for annual periods beginning on or after 1 January 2009).** The revised IAS 23 was issued on March 2007. The main change in IAS 23 is the removal of the option of immediately recognizing as an expense borrowing costs that relate to assets that take a substantial period of time to get ready for use or sale. The revised standard applies prospectively to borrowing costs relating to qualifying assets for which the commencement date for capitalization is on or after 1 January 2009. The Group expects the revised IAS 23 has no impact on the financial statements as the Group's accounting policies historically complied with it.

**IAS 1, Presentation of Financial Statements (revised September 2007; effective for annual periods beginning on or after 1 January 2009).** The main change in IAS 1 is the replacement of the income statement by a statement of comprehensive income which will also include all non-owner changes in equity, such as the revaluation of available-for-sale financial assets. Alternatively, entities will be allowed to present two statements: a separate income statement and a statement of comprehensive income. The revised IAS 1 also introduces a requirement to present a statement of financial position (balance sheet) at the beginning of the earliest comparative period whenever the entity restates comparatives due to reclassifications, changes in accounting policies, or corrections of errors. The Group expects the revised IAS 1 to affect the presentation of its financial statements but to have no impact on the recognition or measurement of specific transactions and balances.

**IAS 27, Consolidated and Separate Financial Statements (revised January 2008; effective for annual periods beginning on or after 1 July 2009).** The revised IAS 27 will require an entity to attribute total comprehensive income to the owners of the parent and to the non-controlling interests (previously "minority interests") even if this results in the non-controlling interests having a deficit balance (the current standard requires the excess losses to be allocated to the owners of the parent in most cases). The revised standard specifies that changes in a parent's ownership interest in a subsidiary that do not result in the loss of control must be accounted for as equity transactions. It also specifies how an entity should measure any gain or loss arising on the loss of control of a subsidiary. At the date when control is lost, any investment retained in the former subsidiary will have to be measured at its fair value. The Group is currently assessing the impact of the amended standard on its special purpose consolidated financial information.

## 5 New Accounting Pronouncements (continued)

**IFRS 3, Business Combinations (revised January 2008; effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009).** The revised IFRS 3 will allow entities to choose to measure non-controlling interests using the existing IFRS 3 method (proportionate share of the acquiree's identifiable net assets) or on the same basis as US GAAP (at fair value). The revised IFRS 3 is more detailed in providing guidance on the application of the purchase method to business combinations. The requirement to measure at fair value every asset and liability at each step in a step acquisition for the purposes of calculating a portion of goodwill has been removed. Instead, goodwill will be measured as the difference at acquisition date between the fair value of any investment in the business held before the acquisition, the consideration transferred and the net assets acquired. Acquisition-related costs will be accounted for separately from the business combination and therefore recognised as expenses rather than included in goodwill. An acquirer will have to recognise at the acquisition date a liability for any contingent purchase consideration. Changes in the value of that liability after the acquisition date will be recognised in accordance with other applicable IFRSs, as appropriate, rather than by adjusting goodwill. The revised IFRS 3 brings into its scope business combinations involving only mutual entities and business combinations achieved by contract alone. The Group is currently assessing the impact of the amended standard on its special purpose consolidated financial information.

**Vesting Conditions and Cancellations – Amendment to IFRS 2, Share-based Payment (issued in January 2008; effective for annual periods beginning on or after 1 January 2009).** The amendment clarifies that only service conditions and performance conditions are vesting conditions. Other features of a share-based payment are not vesting conditions. The amendment specifies that all cancellations, whether by the entity or by other parties, should receive the same accounting treatment. Amendment to IFRS 2, *Share-based Payment* is not currently applicable to the Group as it has no such payments.

**Improvements to International Financial Reporting Standards (issued in May 2008).** In 2007, the International Accounting Standards Board decided to initiate an annual improvements project as a method of making necessary, but non-urgent, amendments to IFRS. The amendments issued in May 2008 consist of a mixture of substantive changes, clarifications, and changes in terminology in various standards. The substantive changes relate to the following areas: classification as held for sale under IFRS 5 in case of a loss of control over a subsidiary; possibility of presentation of financial instruments held for trading as non-current under IAS 1; accounting for sale of IAS 16 assets which were previously held for rental and classification of the related cash flows under IAS 7 as cash flows from operating activities; clarification of definition of a curtailment under IAS 19; accounting for below market interest rate government loans in accordance with IAS 20; making the definition of borrowing costs in IAS 23 consistent with the effective interest method; clarification of accounting for subsidiaries held for sale under IAS 27 and IFRS 5; reduction in the disclosure requirements relating to associates and joint ventures under IAS 28 and IAS 31; enhancement of disclosures required by IAS 36; clarification of accounting for advertising costs under IAS 38; amending the definition of the fair value through profit or loss category to be consistent with hedge accounting under IAS 39; introduction of accounting for investment properties under construction in accordance with IAS 40; and reduction in restrictions over manner of determining fair value of biological assets under IAS 41. Further amendments made to IAS 8, 10, 18, 20, 29, 34, 40, 41 and to IFRS 7 represent terminology or editorial changes only, which the IASB believes have no or minimal effect on accounting. Most of the amendments are effective annual periods beginning on or after 1 January 2009. The Group is currently assessing what impact the amendments will have on its special purpose consolidated financial information.

**Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate – IFRS 1 and IAS 27 Amendment (revised May 2008; effective for annual periods beginning on or after 1 January 2009).** The amendment allows first-time adopters of IFRS to measure investments in subsidiaries, jointly controlled entities or associates at fair value or at previous GAAP carrying value as deemed cost in the separate financial statements. The amendment also requires distributions from pre-acquisition net assets of investees to be recognised in profit or loss rather than as a recovery of the investment. The amendments will not have an impact on the Group's special purpose consolidated financial information.

**Other new standards or interpretations.** The Group has not currently adopted the following other new standards or interpretations:

- IFRIC 11, IFRS 2 – *Group and Treasury Share Transactions* (effective for annual periods beginning on or after 1 March 2007);
- IFRIC 12, *Service Concession Arrangements* (effective for annual periods beginning on or after 1 January 2008);
- IFRIC 14, IAS 19 – *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* (effective for annual periods beginning on or after 1 January 2008);

## 5 New Accounting Pronouncements (continued)

- IFRIC 15, IAS 11, IAS 18 – *Agreements for the Construction of Real Estate* (effective for annual periods beginning on or after 1 January 2009);
- IFRIC 16, IAS 39 – *Hedges of a Net Investment in a Foreign Operation* (effective for annual periods beginning on or after 1 October 2008).

Unless otherwise described above, the new standards and interpretations are not expected to significantly affect the Group's financial statements.

## 6 Segment Information

The Group has one primary reportable segment, which is manufacturing and sale of titanium products which have similar risks and rewards. The Group evaluates performance and makes investment and strategic decisions based upon review of profitability for the Group as a whole.

Sales are based on the geographical area in which the customer is located. There are no sales or other transactions between the segments. Production and majority of assets and liabilities of the Group are located in the Russian Federation.

|                     | 2007             |
|---------------------|------------------|
| <u>Revenue</u>      |                  |
| Russia              | 468,270          |
| Other CIS countries | 19,224           |
| North America       | 478,149          |
| Europe              | 229,047          |
| Asia                | 81,011           |
| Other countries     | 34,884           |
|                     | <u>1,310,585</u> |

## 7 Balances and Transactions with Related Parties

Related parties are defined in IAS 24 "Related Party Disclosures". Parties are generally considered to be related if one party has the ability to control the other party, is under common control, or can exercise significant influence or joint control over the other party in making financial and operational decisions.

Related parties may enter into transactions which unrelated parties may not, and transactions between related parties may not be effected on the same terms, conditions and amounts as transactions between unrelated parties. In considering each possible related party relationship, attention is directed to the substance of the relationship, not merely the legal form.

The nature of the related party relationships for those related parties with whom the Group entered into significant transactions or had significant balances outstanding at 31 December 2007 and 1 January 2007 are detailed below.

### *Government*

The Government of the Russian Federation is the ultimate controlling party of the Group and has a controlling interest via indirect ownership of over 50% of the shares issued. The Government does not prepare financial statement for public use. Governmental economic and social policies affect the Group's financial position, results of operations and cash flows.

### *Parties under control of the Government*

In the normal course of business, the Group enters into transactions with other entities under the Government control. Bank loans are provided on the basis of market rates. Taxes are accrued and settled in accordance with Russian tax legislation.

## 7 Balances and Transactions with Related Parties (continued)

The following turnovers and balances arise from transactions with related parties:

### i Balances with related parties

| Balance sheet caption            | Note | Relationship                     | 31 December<br>2007 | 1 January<br>2007 |
|----------------------------------|------|----------------------------------|---------------------|-------------------|
| Bank balances                    | 8    | Parties under Government control | 9,347               | 7,947             |
| Trade receivables                | 9    | Parties under common control     | 590                 | 8,689             |
| Trade receivables                | 9    | Parties under Government control | 41,355              | 9,265             |
| Customs duties prepaid           |      | Government                       | 1,665               | 2,255             |
| Current income tax prepayments   |      | Government                       | 2,305               | 7,677             |
| VAT recoverable                  |      | Government                       | 98,753              | 87,809            |
| Borrowings                       | 18   | Parties under Government control | (136,864)           | -                 |
| Trade payables                   |      | Parties under common control     | -                   | (145)             |
| Current income tax payable       |      | Government                       | (6,313)             | (1,780)           |
| Property and other taxes payable | 17   | Government                       | (2,983)             | (1,874)           |
| Unified social tax payable       | 17   | Government                       | (1,979)             | (1,929)           |
| VAT payable                      |      | Government                       | (464)               | (311)             |

### ii Transactions with related parties

| Income statement caption | Note | Relationship                     | 2007     |
|--------------------------|------|----------------------------------|----------|
| Revenue                  |      | Parties under common control     | 20,939   |
| Revenue                  |      | Parties under Government control | 275,199  |
| Current income tax       |      | Government                       | (84,544) |
| Property and other taxes | 21   | Government                       | (11,740) |
| Unified social tax       | 21   | Government                       | (37,252) |
| Custom duties            |      | Government                       | (2,495)  |
| Interest expense         |      | Parties under Government control | (2,048)  |

Refer to Note 15 for information on post-employment benefit plan.

### iii Key management personnel compensation

Compensation of key management personnel consists of remuneration paid to the members of the Management Boards of the Group's main subsidiaries and to members of Boards of Directors of the Company and its main subsidiaries. Compensation is made up of an annual remuneration and a performance bonus depending on operating results.

Total key management personnel' short-term benefits included in general and administrative expenses in the special purpose income statement for the year ended 31 December 2007 amounted to USD 2,961. Related state pension and social security costs for the year ended 31 December 2007 amounted to USD 101. There were no significant post-employment or other long-term benefits.

## 8 Cash and Cash Equivalents

|  | 31 December<br>2007 | 1 January<br>2007 |
|--|---------------------|-------------------|
| Cash on hand and bank balances denominated in RR               | 19,542              | 13,263            |
| Cash on hand and bank balances denominated in USD              | 8,793               | 11,533            |
| Cash on hand and bank balances denominated in other currencies | 2,051               | 17,722            |
| Short-term bank deposits, denominated in RR                    | -                   | 93                |
| Short-term bank deposits, denominated in USD                   | 5,418               | -                 |
| Short-term bank deposits, denominated in other currencies      | 1,490               | -                 |
| Other cash equivalents   | 4,023               | 21                |
| <b>Total cash and cash equivalents</b>                         | <b>41,317</b>       | <b>42,632</b>     |
| <b>Restricted cash</b>   | <b>2,362</b>        | <b>2,248</b>      |

## 8 Cash and Cash Equivalents (continued)

Restricted cash consists of a Certificate of Deposit in the amount of USD 2,362 and USD 2,248 as of 31 December and 1 January 2007, respectively. It is pledged as collateral for a letter of credit issued in the amount of USD 2,100 which expired 30 April 2008, and was renewed to 31 October 2008.

Short-term bank deposits were classified as cash equivalents based on their maturities not exceeding 3 months from reporting date.

The fair value of cash and cash equivalents are equal to their carrying amount. All bank balances and term deposits are neither past due nor impaired. Analysis of the credit quality of Group's cash and cash equivalents is as follows:

|                    | 31 December<br>2007 |
|--------------------|---------------------|
| Cash on hand       | 196                 |
| Rated BB and above | 41,121              |
| Rated B and below  | -                   |
| Unrated            | -                   |
| <b>Total</b>       | <b>41,317</b>       |

\* Based on the credit ratings of independent rating agency Standard & Poor's and their equivalents by Fitch and Moody's, where S&P rating is not available.

Sovereign credit rating of the Russian Federation by international scale in foreign currency, published by Standard and Poor's is BBB+

## 9 Accounts Receivable

|                                    | 31 December<br>2007 | 1 January<br>2007 |
|------------------------------------|---------------------|-------------------|
| Trade accounts receivable          | 256,553             | 159,061           |
| Other accounts receivable          | 89,231              | 16,046            |
| Less: impairment provision         | (42,538)            | (23,567)          |
| <b>Total financial receivables</b> | <b>303,246</b>      | <b>151,540</b>    |
| Advances to suppliers              | 69,079              | 42,224            |
| Value-added tax recoverable        | 98,753              | 87,809            |
| Current income tax prepayments     | 2,305               | 7,677             |
| Other taxes receivable             | 5,283               | 1,114             |
| Less: impairment provision         | (6,169)             | (165)             |
| <b>Total accounts receivable</b>   | <b>472,497</b>      | <b>290,199</b>    |

The fair value of accounts receivable does not differ significantly from their carrying amounts.

As of 31 December 2007, trade and other accounts receivable of USD 42,538 (2006: USD 23,567) were individually impaired and an impairment provision was recognized. The individually impaired receivables mainly relate to customers that are in unexpectedly difficult economic situations.

The ageing of these receivables is as follows:

|   | 31 December<br>2007 | 1 January<br>2007 |
|---|---------------------|-------------------|
| Less than 3 months  | 2,220               | 8,323             |
| From 3 to 6 months  | 1,752               | 6,122             |
| From 6 to 12 months                                       | 14,962              | 2,013             |
| Over 12 months  | 23,604              | 7,109             |
| <b>Total gross amount of impaired accounts receivable</b> | <b>42,538</b>       | <b>23,567</b>     |

## 9 Accounts Receivable (continued)

The movements in the provision for impairment of financial accounts receivable are as follows:

|  | 2007              |                           |
|--|-------------------|---------------------------|
|  | Trade receivables | Other accounts receivable |
| Provision for impairment at 1 January          | 23,567            | -                         |
| Impairment loss recognized                     | 20,318            | 3,900                     |
| Provision reversed                             | (5,247)           | -                         |
| <b>Provision for impairment at 31 December</b> | <b>38,638</b>     | <b>3,900</b>              |

The other classes within accounts receivable do not contain impaired assets.

As of 31 December 2007, trade receivables of USD 75,337 were past due but not impaired. The ageing analysis of these trade receivables from past due date is as follows:

|  | 31 December 2007 |
|--|------------------|
| Less than 3 months                                     | 57,079           |
| From 3 to 6 months                                     | 12,893           |
| From 9 to 12 months                                    | 5,365            |
| Over 12 months   | -                |
| <b>Trade accounts receivable past due not impaired</b> | <b>75,337</b>    |

Analysis by credit quality of trade and other receivables is as follows:

|   | 31 December 2007  |                   |
|---|-------------------|-------------------|
|   | Trade receivables | Other receivables |
| <i>Current and not impaired – exposure to:</i>                                |                   |                   |
| - Foreign customers – large engineering plants                                | 98,727            | 2,390             |
| - Local customers and other debtors   | 119,188           | 7,941             |
| - Prepayment for acquisition of additional interest in associate (Note 14.ii) |                   | 75,000            |
| <b>Total current and not impaired</b>   | <b>217,915</b>    | <b>85,331</b>     |

## 10 Loans Receivable

Loans receivable contain neither impaired nor overdue assets as of 31 December and 1 January 2007. No provision for impairment was created for loans receivable as of the respective dates.

At 31 December and 1 January 2007 short-term loans to third parties totalled USD 29,365 and USD 2,459, respectively, at interest rates in the range of (LIBOR + 0.1%) to (LIBOR + 2.35%). The loans were unsecured.

At 31 December 2007 loan to "Mining Company Uralskoye zoloto" LLC amounted to USD 6,885 (refer to Note 14.ii).

In 2007 the Group accrued interest income of USD 2,348.



## 11 Inventories

|                               | 31 December<br>2007 | 1 January<br>2007 |
|-------------------------------|---------------------|-------------------|
| Raw materials and spare parts | 183,736             | 134,347           |
| Work in progress              | 134,894             | 89,921            |
| Finished products             | 257,593             | 198,419           |
|                               | <b>576,223</b>      | <b>422,687</b>    |

Raw materials are shown net of impairment provision of USD 14,854 (1 January 2007: USD 16,333). At 31 December 2007, inventory with a net book value of USD 177,261 (1 January 2007: USD 106,189) had been pledged as security for certain borrowings of the Group (Note 18).

## 12 Property, Plant and Equipment

|                                    | Buildings and<br>constructions | Plant and<br>equipment | Transport      | Transfer<br>devices | Other           | Assets under<br>construction | Total            |
|------------------------------------|--------------------------------|------------------------|----------------|---------------------|-----------------|------------------------------|------------------|
| <b>Cost</b>                        |                                |                        |                |                     |                 |                              |                  |
| <b>Balance at</b>                  |                                |                        |                |                     |                 |                              |                  |
| <b>1 January 2007</b>              | 284,397                        | 487,471                | 18,743         | 49,108              | 64,476          | 127,846                      | <b>1,032,041</b> |
| Additions                          | -                              | 1,849                  | 2,809          | 802                 | 20,213          | 200,730                      | <b>226,403</b>   |
| Transfers                          | 4,139                          | 40,802                 | -              | -                   | -               | (44,941)                     | -                |
| Disposals                          | (4,087)                        | (2,746)                | (230)          | (102)               | (12,480)        | -                            | <b>(19,645)</b>  |
| Translation difference             | 20,682                         | 37,095                 | 1,472          | 3,601               | 5,013           | 15,839                       | <b>83,702</b>    |
| <b>Balance at</b>                  |                                |                        |                |                     |                 |                              |                  |
| <b>31 December 2007</b>            | <b>305,131</b>                 | <b>564,471</b>         | <b>22,794</b>  | <b>53,409</b>       | <b>77,222</b>   | <b>299,474</b>               | <b>1,322,501</b> |
| <b>Accumulated Depreciation</b>    |                                |                        |                |                     |                 |                              |                  |
| <b>Balance at</b>                  |                                |                        |                |                     |                 |                              |                  |
| <b>1 January 2007</b>              | (154,163)                      | (287,044)              | (8,667)        | (36,307)            | (33,504)        | -                            | <b>(519,685)</b> |
| Depreciation charge                | (14,049)                       | (26,159)               | (790)          | (3,309)             | (3,052)         | -                            | <b>(47,359)</b>  |
| Disposals                          | 2,765                          | 1,992                  | 192            | 54                  | 2,371           | -                            | <b>7,374</b>     |
| Translation difference             | (11,684)                       | (21,888)               | (656)          | (2,776)             | (2,465)         | -                            | <b>(39,469)</b>  |
| <b>Balance at</b>                  |                                |                        |                |                     |                 |                              |                  |
| <b>31 December 2007</b>            | <b>(177,131)</b>               | <b>(333,099)</b>       | <b>(9,921)</b> | <b>(42,338)</b>     | <b>(36,650)</b> | -                            | <b>(599,139)</b> |
| <b>Accumulated Impairment Loss</b> |                                |                        |                |                     |                 |                              |                  |
| <b>Balance at</b>                  |                                |                        |                |                     |                 |                              |                  |
| <b>1 January 2007</b>              | -                              | -                      | -              | -                   | -               | -                            | -                |
| Additions                          | -                              | (654)                  | -              | -                   | -               | -                            | <b>(654)</b>     |
| Reversal                           | -                              | -                      | -              | -                   | -               | -                            | -                |
| Translation difference             | -                              | -                      | -              | -                   | -               | -                            | -                |
| <b>Balance at</b>                  |                                |                        |                |                     |                 |                              |                  |
| <b>31 December 2007</b>            | -                              | <b>(654)</b>           | -              | -                   | -               | -                            | <b>(654)</b>     |
| <b>Net Book Value</b>              |                                |                        |                |                     |                 |                              |                  |
| <b>Balance at</b>                  |                                |                        |                |                     |                 |                              |                  |
| <b>1 January 2007</b>              | <b>130,234</b>                 | <b>200,427</b>         | <b>10,076</b>  | <b>12,801</b>       | <b>30,972</b>   | <b>127,846</b>               | <b>512,356</b>   |
| <b>Balance at</b>                  |                                |                        |                |                     |                 |                              |                  |
| <b>31 December 2007</b>            | <b>128,000</b>                 | <b>230,718</b>         | <b>12,873</b>  | <b>11,071</b>       | <b>40,572</b>   | <b>299,474</b>               | <b>722,708</b>   |

At 31 December 2007, buildings, machinery and equipment with a net book value of USD 56,248 (2006: USD 50,892) had been pledged as security for short and long-term loans (Note 18).

Impairment loss recognised in 2007 is due to past performance of and performance forecasts for VSMPO-AVISMA Tube Works Plant, located in Ukraine.

### 13 Goodwill

|                                       |               |
|---------------------------------------|---------------|
| Balance as at 1 January 2007          | 60,800        |
| Cumulative translation adjustment     | 4,422         |
| <b>Balance as at 31 December 2007</b> | <b>65,222</b> |

Goodwill was originally determined as a result of AVISMA division acquisition, and allocated to this cash-generating unit (CGU) in full. Cash-generating units represent the lowest level within the Group at which the goodwill is monitored by management.

The recoverable amount of CGU was determined based on value-in-use calculations. These calculations use cash flow projections based on financial budgets approved by management covering a five-year period. Cash flows beyond the five-year period are extrapolated using the estimated growth rates stated below. The growth rates do not exceed the long-term average growth rate for the business sector of the economy in which the CGU operates.

Based on the results of these calculations the Group concluded that no impairment charge was required.

The key assumptions used for value-in-use at 31 December 2007 are as follows:

|                               | AVISMA |
|-------------------------------|--------|
| Growth rate beyond five years | 0%     |
| Discount rate                 | 8%     |

Management determined budgeted gross margin based on past performance and its expectations of market development. The weighted average growth rates used are consistent with the forecasts included in industry reports. The discount rates used are pre-tax and reflect specific risks relating to the relevant segments.

### 14 Investments in Associates and Jointly Controlled Entities

#### i) Uniti LLC

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

In accordance with the agreement, income or losses are allocated based on the percentage interest in the goods and services provided by the partners that were included in Uniti's sales. Percentage interest is defined as the ratio of each partner's transfer price charged for all goods and services included in Uniti's cost of goods sold for any given period. Therefore 44.3% of the profit earned by the joint venture was allocated to the Group in 2007.

The following information is a summary of the Uniti balance sheet as of 31 December and 1 January 2007:

|                             | 31 December<br>2007 | 1 January<br>2007 |
|-----------------------------|---------------------|-------------------|
| Current assets              | 87,886              | 55,647            |
| Property and equipment, net | 119                 | 140               |
| Other assets                | 9                   | 31                |
| <b>Total assets</b>         | <b>88,014</b>       | <b>55,818</b>     |
| Current liabilities         | 21,472              | 14,441            |
| <b>Total liabilities</b>    | <b>21,472</b>       | <b>14,441</b>     |
| <b>Equity</b>               | <b>66,542</b>       | <b>41,377</b>     |

## 14 Investments in Associates and Jointly Controlled Entities (continued)

### i) Uniti LLC (continued)

Total net revenues of Uniti LLC for the year ended 31 December 2007 were USD 273,366. Total net income of Uniti LLC for the year ended 31 December 2007 was USD 40,164. The Group's equity in earnings of Uniti LLC of USD 15,184 for the year ended 31 December 2007 is included as a component of operating income in the special purpose consolidated statement of income.

The Group had sales to Uniti LLC of USD 112,000 during 2007.

The Group pays a commission to Uniti LLC related to direct shipments from the Group to Uniti LLC customers. Commission expense for such sales in 2007 was USD 1,204.

As part of the consideration provided when Uniti LLC was established, the Group agreed to provide sufficient titanium sponge, at a fixed price, to an affiliate of ATI so that this affiliate could produce titanium products which it is required to supply to Uniti LLC. This agreement to supply titanium sponge terminates upon the dissolution of Uniti LLC. Losses totalling USD 182 from the sale of this sponge were incurred in 2007.

Income of USD 2,611 on 2007 sales of product to Uniti was deferred as the related product was still in Uniti's inventory as of 31 December 2007, and was reflected as a reduction of equity in earnings of joint venture. During 2007, the Group received cash distributions from Uniti LLC totalling USD 7,876.

### ii) "Mining Company Uralskoye zoloto" LLC

In October 2007 the Group acquired a 33% interest in "Mining Company Uralskoye zoloto" LLC ("UralGold" ) for USD 0.2, which subsequently acquired a license for geological survey, exploration and production of molybdenum ore in Yuzhno-Shameiskoye field. The license contains certain requirements relating to volume, types and time of survey, exploration and production stages, as well as certain ecological and social commitments and asset retirement obligations. Amortisation of the license was not accrued, since production process did not start.

The following information is a summary of the UralGold's balance sheet as of 31 December 2007:

|                          | 31 December<br>2007 |
|--------------------------|---------------------|
| Current assets           | 154                 |
| Intangible assets, net   | 13,734              |
| Other assets             | 18                  |
| <b>Total assets</b>      | <b>13,906</b>       |
| Loans payable            | 13,952              |
| <b>Total liabilities</b> | <b>13,952</b>       |
| <b>Equity</b>            | <b>(46)</b>         |

UralGold did not perform any active operations in 2007. The loan provided to UralGold to finance the acquisition of the license mentioned above amounted to USD 6,885 (refer to Note 10). Related interest was capitalised.

In December 2007, the Group reached a preliminary agreement to acquire an additional 18% interest in UralGold, estimated a preliminary purchase price of USD 75,000 and transferred the purchase consideration to escrow account as a prepayment in accordance with the provisions of the preliminary agreement. The funds will be transferred to the seller, and the Company will take the possession of the interest acquired after the Federal Antimonopoly Service of the Russian Federation approves the transaction. Such approval has not been received as at the date of approval of this special-purpose financial information.

## 15 Pensions

The post employment and post retirement program of the Group consists of lump-sum benefits upon death and retirement, an occupational pension plan and additional material support provided by the company to its retired employees. The pension benefits are dependent on participants' past service. The lump sum benefits upon retirement are based on the monthly base wage ("oklad") and are further dependent on a participant's past service at retirement. There were 21,796 employees participating in some part of the post employment and post retirement program of the company, 10,275 pensioners and 2,336 retired former employees, who received additional material support from the company as at 31 December 2007 (as at 1 January 2007: 21,386 employees, 10,507 pensioners and 2,303 recipients of additional material support).

The defined benefit pension plan provides old age retirement pension and disability pension. At AVISMA employees are also provided with a jubilee benefit.

The Group does not provide any defined contribution pension arrangements.

The last independent actuarial valuation of pension and other post employment and post retirement benefits for the purpose of IFRS was performed in May 2008, with valuation date 31 December 2007.

For the purposes of that valuation, census data as at the valuation dates was collected for the Group.

Amounts recognised in the Balance Sheet are as follows:

|  | <b>31 December<br/>2007</b> |
|--|-----------------------------|
| Present value of defined benefit obligations (DBO) | 58,166                      |
| Fair value of plan assets                          | -                           |
| Present value of unfunded obligations              | 58,166                      |
| Unrecognised prior service (cost)/asset            | (12,361)                    |
| Unrecognised actuarial gains/(losses)              | (12,554)                    |
| <b>Net liability in balance sheet</b>              | <b>33,251</b>               |

Amounts recognised in the Income Statement are as follows:

|   | <b>2007</b>  |
|---|--------------|
| Service cost  | 1,871        |
| Interest cost   | 2,955        |
| Expected return on plan assets                        | -            |
| Amortisation of prior service cost                    | 1,169        |
| Net actuarial losses/(gains) recognised in year       | 176          |
| Immediate recognition of vested prior service cost    | 2,032        |
| <b>Net expense recognised in the income statement</b> | <b>8,203</b> |

Movements in the net liability recognised in the balance sheet are as follows:

|  | <b>2007</b>   |
|--|---------------|
| Net liability at start of period                         | 24,927        |
| Net expense recognised in the income statement (Note 20) | 8,203         |
| Cumulative translation adjustment                        | 2,076         |
| Contributions  | (1,955)       |
| <b>Net liability at end of period</b>                    | <b>33,251</b> |

## 15 Pensions (continued)

The program is not funded and it does not have any pension assets:

|                                    | 2007     |
|------------------------------------|----------|
| Account value at period start      | -        |
| Actual return on plan assets       | -        |
| Contributions by employer          | 1,955    |
| Contributions by employees         | -        |
| Payments                           | (1,955)  |
| <b>Account value at period end</b> | <b>-</b> |

Reconciliation of opening and closing balances of the present value of the defined benefit obligation are as follows:

|  | 2007          |
|--|---------------|
| Present value of defined benefit obligations (DBO) at beginning of period  | 42,626        |
| Service cost   | 1,871         |
| Interest cost  | 2,955         |
| Plan participants' contributions   | -             |
| Actuarial loss   | 5,599         |
| Prior service cost   | 3,468         |
| Benefits paid  | (1,955)       |
| Cumulative translation adjustment  | 3,602         |
| <b>Present value of defined benefit obligations (DBO) at end of period</b> | <b>58,166</b> |

The funded status and gains/losses arising of experience adjustments on assets and liabilities are as follows:

|  | 2007     |
|--|----------|
| Present value of defined benefit obligations (DBO)                     | 58,166   |
| Fair value of plan assets  | -        |
| Deficit in plan  | 58,166   |
| Losses arising of experience adjustments on plan liabilities           | (3,303)  |
| <b>Gains/(losses) arising of experience adjustments on plan assets</b> | <b>-</b> |

Key actuarial assumptions used were as follows:

|                                    | 31 December<br>2007                           | 1 January<br>2007                             |
|------------------------------------|---|---|
| Discount rate                      | 6.60% p.a.                                    | 7.00% p.a.                                    |
| Expected return on plan assets     | n/a   | n/a   |
| Salary and benefit basis increases | 9.20% p.a.                                    | 9.20% p.a.                                    |
| Pension in pay increase            | 5.00% p.a.                                    | 5.00% p.a.                                    |
| Staff turnover                     | up to age 49: 5% p.a.<br>from age 50: 0% p.a. | up to age 49: 5% p.a.<br>from age 50: 0% p.a. |
| Mortality                          | Russian population<br>1998                    | Russian population<br>1998                    |

## 16 Accounts Payable

|  | 31 December<br>2007 | 1 January<br>2007 |
|--|---------------------|-------------------|
| Trade accounts payable                             | 48,128              | 66,122            |
| <b>Total financial payables</b>                    | <b>48,128</b>       | <b>66,122</b>     |
| Payroll and social tax payable                     | 29,202              | 13,826            |
| Accrued liabilities and other creditors            | 23,292              | 7,172             |
| <b>Total accounts payable and accrued expenses</b> | <b>100,622</b>      | <b>87,120</b>     |

## 17 Other Taxes Payable

|                                  | 31 December<br>2007 | 1 January<br>2007 |
|----------------------------------|---------------------|-------------------|
| Value-added tax payable          | 464                 | 311               |
| Payroll taxes                    | 1,979               | 1,929             |
| Property and other taxes payable | 2,983               | 1,874             |
| Provision for taxes and duties   | -                   | 30,314            |
|                                  | <b>5,426</b>        | <b>34,428</b>     |

Release of provision for taxes and duties is mainly due to the repayment of fines and penalties in 2007.

## 18 Short-Term and Long-Term Borrowings

The details of the significant short-term and long-term loan balances are summarized below:

|  | Currency | 31 December<br>2007 | 1 January<br>2007 |
|--|----------|---------------------|-------------------|
| <b>SHORT-TERM BORROWINGS</b>   |          |                     |                   |
| <b>Bank loans</b>  |          |                     |                   |
| Sberbank; interest from 6.8% to 8% (Note a)  | RR       | 136,864             | -                 |
| Unicredit (former name: International Moscow Bank); interest of LIBOR + from 2.2% to 3.0% (Note b) | USD      | 66,000              | 74,300            |
| Unicredit; interest from 7.85% to 7.95% (Note b)   | RR       | 10,496              | -                 |
| Wachovia Capital Finance Corporation; interest from 6.59% to 7.25% (Note c)                        | USD      | 48,758              | 36,853            |
| Calion Rusbank; interest of LIBOR + 1.1% (Note d)  | USD      | 50,000              | 13,894            |
| Raiffeisenbank; interest of LIBOR + from 2.15% to 2.5% (Note e)                                    | USD      | 37,480              | 27,480            |
| Raiffeisenbank; interest of RUBOR + 2.5% (Note e)  | RR       | 16,428              | 11,437            |
| Raiffeisenbank; interest of MOSPRIME + 2.0% (Note e)   | USD      | 10,000              | -                 |
| Raiffeisenbank; interest of MOSPRIME + 2.0% (Note e)   | RR       | 10,482              | -                 |
| Kredit-Dnepr   |          | -                   | 3,935             |
| Other  |          | 762                 | 496               |
| <b>Total short-term borrowings from third parties</b>  |          | <b>387,270</b>      | <b>168,395</b>    |
| <b>LONG-TERM BORROWINGS</b>  |          |                     |                   |
| <b>Bank loans</b>  |          |                     |                   |
| Unicredit (former name: International Moscow Bank); interest of LIBOR + 2.2 to 2.5% (Note b)       | USD      | 78,000              | 42,043            |
| Unicredit; interest from 9% to 9.15% (Note b)  | RR       | 10,430              | -                 |
| RaiffeisenBank; interest of LIBOR + from 2.15% to 3.0% (Note e)                                    | USD      | -                   | 25,070            |
| Amsterdam Trade Bank, interest 9% (Note f)   | USD      | 77,000              | -                 |
| Other  |          | 283                 | 105               |
| <b>Total long-term borrowings from third parties</b>   |          | <b>165,713</b>      | <b>67,218</b>     |

## **18 Short-Term and Long-Term Borrowings (continued)**

All interest rates are on a per annum basis.

Details of significant secured loan balances are summarised below:

### *(a) Sberbank*

The loans include five credit lines, which are collateralized by the pledge of inventory (Note 11). Under the terms of the credit lines agreements, the Group is required to maintain the account opened with the bank.

The loans contain certain restrictive covenants in relation to the unauthorized use of credit facilities, bankruptcy initiation, deterioration of financial health of the Group, improper execution of obligations, etc.

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

All credit lines were fully utilized as at 31 December 2007.

### *(b) Unicredit Bank*

The loans are collateralized by the pledge of property, plant and equipment (Note 12).

The loans contain certain restrictive covenants in relation to the sale of assets, pledges of property, total amount of borrowings, change of controlling stockholders, changes in the Group's management, default on liabilities to third parties (including the bank), bankruptcy and other.

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

The long-term loans mature in June-December 2009.

### *(c) Wachovia Capital Finance Corporation*

The loans are collateralized by the pledge of inventory (Note 11).

On 14 January 2005 VSMPO Tirus US, a subsidiary ("US Company"), entered into a Loan and Security Agreement with Wachovia Capital Finance Corporation with a term ending three years from that date. In 2007, this term was extended through 31 January 2011. The Agreement as initially executed enabled US Company to borrow up to USD 25,000 in Revolving Loans, with up to USD 10,000 of this amount in the form of letter of credit accommodations. In 2007, the Agreement was amended to permit up to USD 65,000 in Revolving Loans. The amount available in Revolving Loans is limited to the lesser of USD 65,000 or the sum of stated percentages of eligible accounts receivable, finished goods inventory, material in process and scrap. Revolving loans are either designated, at VSMPO Tirus US discretion, as Prime Rate Loans or Eurodollar Rate Loans. Borrowings under the Agreement are collateralized by a security interest in all the assets of VSMPO Tirus US. The Agreement contains certain restrictive covenants that, among other things, limit or restrict the ability of US Company to incur debt, incur liens, make investments, pay dividends or redeem common stock; and requires compliance with a minimum tangible net worth covenant. The US Company is also required to maintain a lockbox arrangement whereby daily net cash receipts are used to reduce outstanding borrowings. Accordingly, outstanding loan balances are classified as a current liability.

The Interest on Prime Rate Loans is payable at the Prime Rate. Interest on Eurodollar Rate Loans is payable at a rate equal to the Adjusted Eurodollar Rate plus 1.75% per annum. As of 31 December 2007 and 1 January 2007, four Eurodollar Rate Loans were outstanding, totaling USD 44,000 and USD 30,000, respectively, with interest rates ranging from 6.59% to 6.70% in 2007 (7.073% to 7.126% in 2006), and one Prime Rate loan was outstanding in the amount of USD 4,758 and USD 6,853. Interest is paid at the end of each month for the month then ended. As of 31 December 2007 and 1 January 2007, USD 4,300 and USD 1,200, respectively, was outstanding in letter of credit accommodations; and the amount of unused Revolving Loan availability as of 31 December 2007 was USD 11,942.

## 18 Short-Term and Long-Term Borrowings (continued)

### (d) Calion Rusbank

Under the terms of the agreements the Group is required to maintain a required level of cash flows through the accounts opened with the bank. The loans contain certain restrictive covenants in relation to sale of assets, pledges of property, export contracts, change of management structure and controlling stockholders, reorganisation, default on tax and other liabilities, bankruptcy and other.

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

### (e) Raiffeisenbank

Under the terms of the agreements the Group is required to maintain a required level of cash flows through the accounts opened with the bank. The loans contain certain restrictive covenants in relation to sale of assets, pledges of property, total amount of borrowings, change of controlling stockholders or business, default on tax and other liabilities, unfavourable court decisions, bankruptcy and other.

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

All credit lines were fully utilized as at 31 December 2007

### (f) Amsterdam Trade Bank

The loans contain certain restrictive covenants in relation to sale of assets, pledges of property, total amount of borrowings, commencement of significant court proceedings, significant change of management or business, unauthorized use of credit facilities, default on tax and other liabilities, bankruptcy and other.

Unused credit lines available under the agreement with the bank amount to USD 93,000

The long-term loan matures in July 2009.

## 19 Shareholders' Equity

Total number of outstanding shares comprises:

|                            | No. of<br>outstanding<br>ordinary shares | No. of<br>treasury<br>shares | Total<br>share<br>capital | Treasury<br>share<br>capital | Outstanding<br>share<br>capital |
|----------------------------|--|------------------------------|---------------------------|------------------------------|---------------------------------|
| <b>At 1 January 2007</b>   | 11,529,538                               | -                            | <b>22,785</b>             | -                            | <b>22,785</b>                   |
| <b>At 31 December 2007</b> | 11,529,538                               | -                            | <b>22,785</b>             | -                            | <b>22,785</b>                   |

A dividend was declared in 2007 in respect of 2006 to holders of ordinary shares of RR 50.83 per ordinary share (equivalent to 1.967 USD per share translated at exchange rate prevailing at the date of declaration), to the total of USD 22,674.

In accordance with Russian legislation, the Company distributes profits as dividends or transfers them to reserves (fund accounts) on the basis of financial statements prepared in accordance with Russian Accounting Rules. The statutory accounting reports of the Company are the basis for profit distribution and other appropriations. Russian legislation identifies the basis of distribution as the net profit. For 2007, the current year net statutory profit for the Company as reported in the published annual statutory reporting forms was RR 6,250 million (equivalent to USD 244,351 translated at average exchange rate for 2007) and the closing balance of the accumulated profit including the current year net statutory profit totalled RR 19,272 million (equivalent to USD 841,119 translated at closing exchange rate for 2007). 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 disclosed.



## 20 Cost of Sales

The components of cost of sales were as follows:

|  | 2007           |
|--|----------------|
| Materials and components used                                | 404,546        |
| Staff costs  | 120,992        |
| Unified social tax   | 32,157         |
| Utilities  | 90,331         |
| Depreciation and amortization                                | 50,356         |
| Repairs and maintenance                                      | 5,037          |
| Pension costs (Note 15)                                      | 8,203          |
| Production overheads   | 5,017          |
| Reversal of provision for inventory obsolescence             | (2,558)        |
| Other costs  | 26,692         |
| Change in inventories of finished goods and work in progress | (20,921)       |
|  | <b>719,852</b> |

## 21 General and Administrative Expenses

|  | 2007           |
|--|----------------|
| Personnel costs                                | 59,814         |
| Unified social tax                             | 5,095          |
| Social costs                                   | 26,748         |
| Provision for impairment of receivables        | 22,975         |
| Loss on property, plant and equipment disposal | 11,954         |
| Taxes other than income tax                    | 11,740         |
| Insurance                                      | 7,141          |
| Materials                                      | 6,887          |
| Research and development expenses              | 2,880          |
| Business trips                                 | 1,358          |
| Consulting expenses                            | 1,262          |
| Repair and maintenance                         | 848            |
| Other expenses                                 | 19,690         |
|  | <b>178,392</b> |

## 22 Earnings per Share

Basic earnings per share are calculated by dividing the profit or loss attributable to equity holders of the Company by the weighted average number of ordinary shares in issue during the year, excluding treasury shares. The Company has no dilutive potential ordinary shares, therefore, the diluted earnings per share equal the basic earnings per share.

|   | 31 December<br>2007 |
|---|---------------------|
| Weighted average number of shares outstanding   | 11,529,538          |
| <b>Profit attributable to the equity holders of the Company</b>   | <b>241,640</b>      |
| <b>Basic and diluted earnings per share (in US Dollars) attributable to the equity holders of the Company</b> | <b>20.9583</b>      |

## 23 Income Taxes

|   | 2007           |
|---|----------------|
| Income tax expense – current  | 130,738        |
| Deferred tax charge – origination and reversal of temporary differences | (1,681)        |
| <b>Income tax charge</b>  | <b>129,057</b> |

Profit before taxation for financial reporting purposes is reconciled to tax expense as follows:

|   | 2007           |
|---|----------------|
| <b>Profit before taxation</b>   | <b>369,511</b> |
| Theoretical tax charge at statutory rate of 24% thereon                           | 88,682         |
| Increase in income tax due to different effective tax rates in subsidiaries       | 14,570         |
| Tax effect of items which are not deductible or assessable for taxation purposes: |                |
| Social costs and auxiliary expenses   | 9,263          |
| Pension costs   | 1,969          |
| Other non-deductible expenses   | 14,573         |
| <b>Income tax charge</b>  | <b>129,057</b> |

In the context of the Group's current structure, tax losses and current tax assets of different group companies may not be offset against current tax liabilities and taxable profits of other group companies and, accordingly, taxes may accrue even where there is a consolidated tax loss. Therefore, deferred tax assets and liabilities are offset only when they relate to the same taxable entity. Differences between financial reporting and Russian and other countries statutory taxation regulations give rise to temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and their tax bases. The tax effect of the movements in these temporary differences is detailed below and is recorded for major Russian subsidiaries at the rate of 24% (1 January 2007: 24%).

|   | 1 January<br>2007 | (Charged)/<br>credited to profit<br>or loss | Translation<br>difference | 31 December<br>2007 |
|---|-------------------|---|---------------------------|---------------------|
| <b>Tax effects of taxable temporary differences:</b>    |                   |   |                           |                     |
| Property, plant and equipment                           | 33,289            | (10,531)                                    | 1,981                     | 24,739              |
| Accounts payable  | 2,363             | (1,727)                                     | 99                        | 735                 |
| Inventories   | -                 | 9,029                                       | 379                       | 9,408               |
| Other temporary differences                             | 422               | 55  | 33                        | 510                 |
| <b>Tax effects of deductible temporary differences:</b> |                   |   |                           |                     |
| Inventories   | (2,254)           | 1,342                                       | (108)                     | (1,020)             |
| Unrealised profit on inventory                          | (6,859)           | (4,666)                                     | (695)                     | (12,220)            |
| Accounts receivable                                     | (10,325)          | 5,222                                       | (532)                     | (5,635)             |
| Accounts payable  | (3,775)           | (405)                                       | (292)                     | (4,472)             |
| <b>Recognized net deferred tax liability</b>            | <b>12,861</b>     | <b>(1,681)</b>                              | <b>865</b>                | <b>12,045</b>       |

Substantially all deferred tax liabilities presented in the balance sheet are expected to be realised within a period exceeding 12 months from the balance sheet date.

## **24 Contingencies, Commitments and Operating Risks**

### **i Contractual commitments and guarantees**

As at 31 December 2007 the Group had outstanding capital commitments in relation to acquisition and construction of property, plant and equipment for amount of USD 209,945 (1 January 2007: USD 32,988).

The Group has already allocated the necessary resources in respect of these commitments. The Group believes that future net income and funding will be sufficient to cover this and any similar such commitments.

### **ii Legal proceedings**

From time to time and in the normal course of business, claims against the Group are received. On the basis of its own estimates and both internal and external professional advice the Management is of the opinion that no material losses will be incurred in respect of claims in excess of provisions that have been made in this special purpose consolidated financial information.

### **iii Compliance with covenants**

The Group is subject to certain covenants related primarily to its borrowings. Non-compliance with such covenants may result in negative consequences for the Group including growth in the cost of borrowings and declaration of default. During 2007 the Group breached certain covenants of the bank loans, including covenants which require the Group to maintain its debt at certain level. However, the Group received waivers from the respective banks which confirmed that the banks had no intention to demand immediate payments as a consequence of the breaches.

### **iv Taxation**

Russian tax and customs legislation is subject to varying interpretations, and changes, which can occur frequently. Management's interpretation of such legislation as applied to the transactions and activity of the Group may be challenged by the relevant authorities.

The Russian tax authorities may be taking a more assertive position in their interpretation of the legislation and assessments, and it is possible that transactions and activities that have not been challenged in the past may be challenged. In October 2006, the Supreme Arbitration Court issued guidance to lower courts on reviewing tax cases providing a systemic roadmap for anti-avoidance claims, and it is possible that this will significantly increase the level and frequency of tax authorities scrutiny.

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.

Russian transfer pricing legislation introduced 1 January 1999 provides the possibility for tax authorities to make transfer pricing adjustments and impose additional tax liabilities in respect of all controllable 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, all cross-border transactions (irrespective whether performed between related or unrelated parties), transactions 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. In the past, the arbitration court practice with this respect has been contradictory.

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; however, it may be significant to the financial condition and/or the overall operations of the entity.

## 24 Contingencies, Commitments and Operating Risks (continued)

### iv Taxation (continued)

Management estimates that the Group has possible obligations from exposure to other than remote tax risks of USD 10,865 (1 January 2007: USD 5,847), mainly relating to deductibility of certain expenses for profits tax purposes.

The Group's management believes that its interpretation of the relevant legislation is appropriate and the Group's tax, currency legislation and customs positions will be sustained. Accordingly, at 31 December 2007 no provision for potential tax liabilities had been recorded (2006: no provision).

### v Environmental matters

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

### vi Operating environment

The Group, through its operations, has a significant exposure to the economy and financial markets of the Russian Federation.

**Russian Federation.** The Russian Federation displays certain characteristics of an emerging market, including relatively high inflation and strong economic growth. Management is unable to predict all developments which could have an impact on the metals sector and consequently what effect, if any, they could have on the financial position of the Group.

The tax, currency and customs legislation within the Russian Federation is subject to varying interpretations and frequent changes, and other legal and fiscal impediments contribute to the challenges faced by entities currently operating in the Russian Federation. The future economic direction of the Russian Federation is largely dependent upon the effectiveness of economic, financial and monetary measures undertaken by the Government, together with tax, legal, regulatory, and political developments.

**Recent volatility in global and Russian financial markets.** The ongoing global liquidity crisis which commenced in the middle of 2007 has resulted in, among other things, a lower level of capital market funding, lower liquidity levels across the Russian banking sector, and higher interbank lending rates. The uncertainties in the global financial market have also led to bank failures and bank rescues in the United States of America, Western Europe and in Russia. Such circumstances could affect the ability of the Group to obtain new borrowings and re-finance its existing borrowings at terms and conditions similar to those applied to earlier transactions. The debtors of the Group may also be affected by the lower liquidity situation which could in turn impact their ability to repay their amounts owed. Deteriorating operating conditions for debtors may also have an impact on Management's cash flow forecasts and assessment of the impairment of financial and non-financial assets. To the extent that information is available, Management has reflected revised estimates of expected future cash flows in its impairment assessments.

The uncertainty in the global markets combined with other local factors has during 2008 led to very high volatility in the Russian stock markets and at times much higher than normal interbank lending rates.

Management is unable to reliably estimate the effects on the Group's financial position of any further deterioration in the liquidity of the financial markets and the increased volatility in the currency and equity markets. Management believes it is taking all the necessary measures to support the sustainability and growth of the Group's business in the current circumstances.

## 24 Contingencies, Commitments and Operating Risks (continued)

### vii Non-cancellable lease

The Company leases warehouse and office facilities and certain equipment under noncancellable operating leases. The following is a schedule of minimum rental payments required under these leases as of 31 December 2007:

|            | Year ended<br>31 December<br>2007 |
|------------|-----------------------------------|
| 2008       | 1,002                             |
| 2009       | 693                               |
| 2010       | 539                               |
| 2011       | 435                               |
| 2012       | 109                               |
| Thereafter | -                                 |

Rent expense, including certain amounts classified in cost of goods sold, amounted to USD 910 for the year ended 31 December 2007.

### viii Warranties

The Group bears an obligation that the products sold to the customers are of specified quality. If the product fails to meet the warranty at delivery or later on processing stage, it has to be repaired or replaced by the Group. Also, the Group bears an obligation to deliver the goods in due course, and may be charged a limited fee if it is not the case. Such remedies were rare and insignificant in 2007 and in prior years. Based on the track record of warranty claims registered by the Group, management believes the Group's obligation for such warranty claims is insignificant. Furthermore, the Group insures its potential obligation in relation to damage of the aircrafts caused by Group's aviation products, and related grounding liability.

### ix Antidumping

On 11 September 2007, the U.S. Department of Commerce issued the final results of its magnesium anti-dumping review for the period 4 October 2004 through 31 March 2006 (the "Review Period"). This review concluded that anti-dumping margins for the Group were de minimis. These results eliminated the requirement for additional dumping duty deposits starting in September 2007. Based on preliminary 2004 review results, VSMPO Tirus US had been required to obtain a dumping duty bond for USD 2,100, and to make additional cash deposits that totaled USD 3,700 during the Review Period. As a consequence of these final results, VSMPO Tirus US has applied for a release of the USD 2,100 bond and for reimbursement of dumping duty deposits made during the Review Period, less the actual dumping duty of USD 171, which is based on an assessment rate of 0.51%. As it was not possible to determine the actual amount of dumping duties VSMPO Tirus US would be subject to prior to the final review results, the bonded amount and cash deposits made were charged to cost of sales during the Review Period. VSMPO Tirus US has recorded a credit to cost of sales in 2007 of USD 5,600 for the amount of the bond and cash deposits made less the actual assessed dumping duty of USD 171, for which a USD 3,500 receivable has been recorded.

Dumping duty deposits assessed at 21.7%, totaling USD 5,700, have also been made and charged to cost of sales during the period April 2006 through September 2007. The actual amount of dumping duties due for this period, if any, will be based on separate reviews by the US Department of Commerce. The review covering imports from 1 April 2006 through 31 March 2007, commenced in 2007 and will be finalized in 2008. A review covering imports from 1 April 2007 through 31 March 2008 will commence during 2008.

Management is unable to predict the outcome of these reviews at this time, and accordingly has not recorded any amount receivable for potential refunds.

## 24 Contingencies, Commitments and Operating Risks (continued)

### x Duty Drawback

VSMPO Tirus US has participated in a duty drawback program offered by U.S. Customs and Border Protection ("U.S. Customs"). Under the program, VSMPO Tirus US made claims for refunds of import duties on products imported against products sold and ultimately exported to foreign countries, either directly or through its customers. Due to the complexity of the program, VSMPO Tirus US engaged a licensed U.S. customs broker specializing in duty drawback claims ("Agent"). The Agent was responsible for performing the administration of the process which included collecting and maintaining various forms of supporting evidence for each claim as well as preparing and submitting the refund claims.

VSMPO Tirus US recognizes a credit to cost of sales when it receives payment on claims made. For the years 2003 through 2007, it recognized a reduction to cost of sales totalling USD 2,600 associated with the refunds of duty received, net of commissions and other charges paid to the Agent. In June 2007, VSMPO Tirus US received notice from U.S. Customs that it was under formal investigation for the claims filed by the Agent on its behalf. The investigation relates to an alleged failure to provide supporting documentation for claims filed and alleged overclaims on certain products. The Company has terminated the Agent's authority and is fully cooperating with U.S. Customs to determine to what extent any claims may not be supported with adequate documentation or are invalid. The Company is also aware of claims made by its former Agent on behalf of several of its customers where it was by agreement entitled to a share of duty drawback refunds as importer. These claims are also being investigated by US Customs.

In July 2007, VSMPO Tirus US engaged a new licensed U.S. customs broker specializing in duty drawback claims. The customs broker has performed a review of all claims filed with U.S. Customs, including those made for customers where the Company was the importer and received a share of the claims paid. Based on this review, VSMPO Tirus US has recorded charges of USD 2,700 to cost of sales in 2007. These charges represent VSMPO Tirus US current best estimate of probable loss. Of this amount, U.S. Customs has requested repayment of and VSMPO Tirus US has repaid USD 1,600, and USD 1,100 has been recorded as a current liability, including USD 700 for its share of claims filed by its customers where it received a refund share. While the ultimate outcome of the U.S. Customs investigation is not yet known, based on current facts, the Group management believes there is minimal risk of additional loss, exclusive of any amounts that may be imposed for interest and penalties which cannot be quantified at this time.

## 25 Financial and Capital Risk Management

### Financial risk management

The Group's activities expose it to a variety of financial risks: market risk (including foreign currency exchange risk, interest rate risk and price risk), credit risk and liquidity risk. The overall risk management programme seeks to minimize potential adverse effects on the financial performance of the Group.

#### (a) Market risk

##### (i) Foreign currency risk

Foreign currency risk is the risk of losses resulting from adverse movements in different currency exchange rates against the Group functional currency. Foreign currency risk arises from the international operations of the Group, future commercial transactions in foreign currencies, including repayment of foreign currency denominated borrowings and recognition of assets and liabilities denominated in a currency which is not a functional currency of the Group.

The objective of the Group's foreign exchange risk management activities is to minimise the volatility of the Group's financial results by matching the same foreign currency denominated assets and liabilities. The Group does not currently hedge foreign exchange exposure using financial instruments. Group entities are prohibited from borrowing and investing in foreign currencies on a speculative basis.

The Group's policies for attracting foreign exchange denominated borrowings depend on current and forward rates of foreign currencies to Russian rouble. Funds borrowed are mainly nominated in USD, being the currency of general export trade contracts.

## 25 Financial and Capital Risk Management (continued)

### Financial risk management (continued)

#### (a) Market risk (continued)

##### (i) Foreign currency risk (continued)

The Group relies on export sales to generate foreign currency earnings. As the Group sales outside the Russian Federation form a significant portion of its production, it is exposed to foreign currency risk arising primarily on volatility of US dollar rate, in which major export sales are denominated.

The tables below summarise the Group's exposure to foreign currency exchange rate risk at the balance sheet date:

|  | US Dollar        | EURO          | Other foreign currencies |
|--|------------------|---------------|--------------------------|
| <b>At 31 December 2007</b>             |                  |               |                          |
| <b>Monetary financial assets:</b>      |                  |               |                          |
| Cash and cash equivalents              | 13,444           | 212           | 1,839                    |
| Accounts receivable                    | 104,855          | 77,974        | 861                      |
| Loans receivable                       | 27,198           | -             | -                        |
| <b>Monetary financial liabilities:</b> |                  |               |                          |
| Accounts payable and other liabilities | (4,469)          | (4,679)       | (1,203)                  |
| Borrowings and notes payable           | (367,521)        | -             | -                        |
| <b>Net balance sheet position</b>      | <b>(226,493)</b> | <b>73,507</b> | <b>1,497</b>             |
| <b>At 1 January 2007</b>               |                  |               |                          |
| <b>Monetary financial assets:</b>      |                  |               |                          |
| Cash and cash equivalents              | 11,551           | 16,173        | 1,549                    |
| Accounts receivable                    | 72,406           | 48,741        | 10,785                   |
| Loans receivable                       | -                | -             | -                        |
| <b>Monetary financial liabilities:</b> |                  |               |                          |
| Accounts payable and other liabilities | (25,564)         | (6,074)       | (8,945)                  |
| Borrowings and notes payable           | (219,745)        | -             | -                        |
| <b>Net balance sheet position</b>      | <b>(161,352)</b> | <b>58,840</b> | <b>3,389</b>             |

The above analysis includes only monetary assets and liabilities.

The foreign exchange rate sensitivity is calculated by aggregation of the net foreign exchange risk exposure and primarily arises from US dollar denominated trade receivables, loans receivable, cash and cash equivalents, borrowings and accounts payable.

|  | 2007     |
|--|----------|
| <i>Impact on post-tax profit and on equity of:</i> |          |
| US Dollar strengthening by 20%                     | (45,299) |
| US Dollar weakening by 20%                         | 45,299   |
| Euro strengthening by 20%                          | 14,701   |
| Euro weakening by 20%                              | (14,701) |

Since the Group does not hold any foreign currency denominated equity securities and other financial instruments revalued through equity, the effect of a change in the exchange rate on equity would be the same as that on the post-tax profit.

##### (ii) Interest rate risk

Interest rate risk arises from movements in interest rates which could affect the Group's financial results or the value of the Group's equity. A change in interest rates may cause variations in interest income and expense.

## 25 Financial and Capital Risk Management (continued)

### Financial risk management (continued)

#### (a) Market risk (continued)

##### (ii) Interest rate risk (continued)

The Group's objective when managing interest rate risk is to protect net results as regards interest. Interest rate risk management function is performed by the finance and treasury department of the Group.

The dynamics data of market interest rates are monitored and the Group's positions as regards interest bearing borrowings are analysed by the treasury and finance departments of the Group under the interest rate risk management framework. The monitoring is performed taking into account current terms of refinancing, renewal of existing positions and alternative funding. The Group does not apply interest hedging since it has mainly short-term borrowings and works with top banks that may provide loans with a lower interest rate.

The Group interest rate risk arises from various long-term debt facilities. Borrowings at variable rates expose the Group's cash flow to an interest rate risk. At 31 December 2007 and 1 January 2007 borrowings at variable rates amounted to USD 268,390 and USD 194,224, respectively (Note 18).

At 31 December 2007, if interest rates at that date had been 5% higher with all other variables held constant, profit for the year would have been USD 1,120 lower, mainly as a result of higher interest expense on variable interest liabilities.

The effect of a change for the year in the interest rate on equity would be the same as that on post-tax profit.

#### (b) Credit risk

Credit risk management is aimed at preventing losses of liquid assets placed on deposit or invested into financial institutions or decreasing value of accounts receivable.

The maximum exposure to credit risk related to the financial assets equals the carrying value of the Group's financial assets including loans receivable and excluding investments into equity instruments. The Group has no other significant concentrations of credit risk.

The treasury department of the Group monitors and controls the credit risk.

The credit quality of the clients and borrowers is measured taking into account their financial position, prior experience and other factors. The Group deals with new customers and the clients that do not meet creditability criteria only on the basis of prepayment. Standard terms of delivery of goods may be changed under the condition of a good history of relationship with the customer.

Although the collection of receivables could be influenced by economic factors, management believes that there is no significant risk of loss to the Group beyond the provision already recorded (Note 9). Also refer to Note 8 for analysis of credit quality of Group's cash and cash equivalents.

#### (c) Liquidity risk

The Group's approach to liquidity risk management involves ensuring an adequate amount of reserves that can be quickly converted into cash to meet liquidity requirements at any time.

The Group Treasury conducts liquidity planning on a weekly basis and reports to the management. Beyond cash management, the Group mitigates liquidity risk by keeping committed credit lines available.

The Group controls meeting the minimum requirements for cash balances for short-term payments. Such cash balances include current balances in bank accounts and bank deposits. The Group's policy as regards working capital funding is aimed at maximum utilisation of the Group's operating cash flows including obtaining short-term bank loans, borrowings and other external funding sources to maintain adequate level of liquidity.



## 25 Financial and Capital Risk Management (continued)

### Financial risk management (continued)

#### (c) Liquidity risk (continued)

The table below analyses the Group's financial liabilities into the relevant maturity groupings based on the time remaining from the balance sheet date to the contractual maturity date.

|  | Demand and<br>less than<br>3 months | From<br>3 to 12<br>months | From<br>12 months<br>to 2 years | From<br>2 years to<br>5 years | Over 5<br>years | Total          |
|--|-------------------------------------|---------------------------|---------------------------------|-------------------------------|-----------------|----------------|
| <b>As of 31 December 2007</b>  |                                     |                           |                                 |                               |                 |                |
| Term loans   | 86,081                              | 330,700                   | 173,497                         | -                             | -               | 590,278        |
| Trade payables   | 48,128                              | -                         | -                               | -                             | -               | 48,128         |
| <b>Total future payments,<br/>including future principal and<br/>interest payments</b> | <b>134,209</b>                      | <b>330,700</b>            | <b>173,497</b>                  | <b>-</b>                      | <b>-</b>        | <b>638,406</b> |
| <b>As of 1 January 2007</b>  |                                     |                           |                                 |                               |                 |                |
| Term loans   | 28,024                              | 133,926                   | 58,219                          | 37,934                        | -               | 258,103        |
| Trade payables   | 66,122                              | -                         | -                               | -                             | -               | 66,122         |
| <b>Total future payments,<br/>including future principal and<br/>interest payments</b> | <b>94,146</b>                       | <b>133,926</b>            | <b>58,219</b>                   | <b>37,934</b>                 | <b>-</b>        | <b>324,225</b> |

\* The table above shows undiscounted cash outflows for financial liabilities (including interest together with the borrowings) based on conditions existing as of 31 December 2007 and 1 January 2007, respectively.

Unused credit lines available at 31 December 2007 were USD 104,942.

### Capital risk management

The Group's objectives when managing capital are to safeguard the Group's ability to continue as a going concern in order to provide returns for shareholders and benefits for other stakeholders, as well as to maintain the required level of financial resources for investing activities and to maintain an optimal capital structure to reduce the cost of capital.

The Group monitors capital on the basis of the gearing ratio. This ratio is calculated as total liabilities divided by total capital under management. The Group considers total capital under management to be equity as shown in the consolidated balance sheet according to IFRS. This is considered more appropriate than alternatives, such as the value of equity shown in the statutory financial (accounting) reports. In 2007, the Group's strategy was to maintain the gearing ratio at the levels below 1 to 1.5 (so that total liabilities are less than 40% of the total capital).

The gearing ratio as of 31 December 2007 and 1 January 2007 is shown in the table below:

|                             | 31 December<br>2007 | 1 January<br>2007 |
|-----------------------------|---------------------|-------------------|
| Current liabilities         | 564,149             | 353,579           |
| Non-current liabilities     | 217,001             | 113,382           |
| <b>Total liabilities</b>    | <b>781,150</b>      | <b>466,961</b>    |
| <b>Shareholders' equity</b> | <b>1,180,635</b>    | <b>888,640</b>    |
| <b>Gearing ratio</b>        | <b>1 : 1.511</b>    | <b>1 : 1.903</b>  |

The Group's capital management includes compliance with the externally imposed minimum capital requirements arising from the Group's borrowings (Note 18) and imposed by the statutory legislation of the Russian Federation.

## 26 Fair Value of Financial Instruments

Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation, and is best evidenced by an active quoted market price.

The estimated fair values of financial instruments have been determined by the Group using available market information, where it exists, and appropriate valuation methodologies. However, judgement is necessarily required to interpret market data to determine the estimated fair value. The Russian Federation continues to display some characteristics of an emerging market and economic conditions continue to limit the volume of activity in the financial markets. Market quotations may be outdated or reflect distress sale transactions and therefore not represent fair values of financial instruments. Management has used all available market information in estimating the fair value of financial instruments.

**Financial instruments carried at fair value.** Cash and cash equivalents are carried at amortised cost, which approximates current fair value.

**Financial assets carried at amortised cost.** The fair value of floating rate instruments is normally their carrying amount. The estimated fair value of fixed interest rate instruments is based on estimated future cash flows expected to be received discounted at current interest rates for new instruments with similar credit risk and remaining maturity. Discount rates used depend on credit risk of the counterparty. Carrying amounts of trade receivables approximate fair values.

**Liabilities carried at amortised cost.** The fair value of floating rate liabilities is normally their carrying amount. The fair value is based on quoted market prices, if available. The estimated fair value of fixed interest rate instruments with stated maturity, for which a quoted market price is not available, was estimated based on expected cash flows discounted at current interest rates for new instruments with similar credit risk and remaining maturity. At 31 December 2007 and 2006 the fair value of the current and non-current borrowings is not materially different from their carrying amounts.

## 27 Restructured taxes

Prior to 1 January 2002 the Company had been granted a 10-year restructuring of its tax liability (including fines and delayed interest) from the tax authorities. This tax liability is to be settled by equal quarterly instalments by 31 December 2011. The Company's entitlement to tax restructuring is conditional on timely payment of both the current and restructured taxes (inclusive of interest). If the tax liability is settled ahead of schedule, the Company receives a right to partial or full forgiveness of the related fines and delayed interest. In 2006 the Company settled the original tax liability on profit taxes in full and applied to the tax authorities for a partial or full forgiveness of the respective fines and delayed interest.

The Company was granted the permission for forgiveness in June 2007 so it released the respective obligation for fines and delayed interests relating to profit tax as of 1 January 2007.

## 28 Subsequent Events

### **Dividends declared by the Company**

In June 2008 the annual general shareholders' meeting declared dividends for the year ended 31 December 2007 in the amount of RR 53.92 per share to the total amount of USD 26,502

### **Insurance of aviation products and grounding liability**

In August 2008 the Group entered into renewed 1-year insurance of aviation products and grounding liability contract, increasing its insurance coverage to USD 500 million (limited for grounding liability to USD 125 million). This insurance supports the sales of titanium products to the largest world-wide aviation producers.

### **Bank loans and bonds**

Subsequent to 31 December 2007 the Group obtained additional bank loans of USD 1,249,619 and repaid existing bank loans of USD 902,252.