

**OPEN JOINT STOCK COMPANY VSMPO-AVISMA CORPORATION  
(FORMERLY, OPEN JOINT STOCK COMPANY VSMPO)**

**CONSOLIDATED FINANCIAL STATEMENTS**

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

**AS AT AND FOR THE YEARS ENDED  
DECEMBER 31, 2005 AND 2004**

**(WITH REPORT OF INDEPENDENT AUDITORS)**

**CONTENTS****PAGES**

Report of Independent Auditors	-
Consolidated Balance Sheets	4
Consolidated Statements of Income and Comprehensive Income	5
Consolidated Statements of Cash Flows	6
Consolidated Statements of Changes in Stockholders' Equity	7
Notes to the Consolidated Financial Statements	8-28

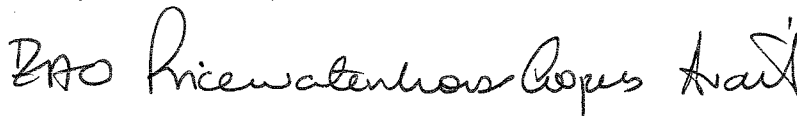
**REPORT OF INDEPENDENT AUDITORS**

**To the Board of Directors and shareholders of OJSC VSMPO-AVISMA Corporation (formerly, OJSC VSMPO)**

We have audited the accompanying consolidated balance sheets of OJSC VSMPO-AVISMA Corporation (formerly, OJSC VSMPO) and its subsidiaries (the "Group") as at December 31, 2005 and 2004, and the related consolidated statements of income and comprehensive income, of cash flows and of changes in stockholders' equity for the years then ended. These consolidated financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Uniti LLC, an equity method investee. As disclosed in Note 6 to the accompanying consolidated financial statements, as at December 31, 2005, the carrying value of the Group's investment in Uniti LLC was US dollar 11,971 thousand, and the Group's share in earnings of the investee for the year then ended was US dollar 8,260 thousand. The financial statements of Uniti LLC were audited by other auditors whose report has been furnished to us, and our opinion expressed herein, insofar as it relates to the amounts included for Uniti LLC, is based solely on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Group as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.



Moscow, Russian Federation

June 4, 2007

VSMPO-AVISMA CORPORATION (FORMERLY, VSMPO)  
Consolidated Balance Sheets  
(in thousands of US\$)

	Notes	December 31, 2005	December 31, 2004
<b>ASSETS</b>			
<b>Current assets</b>			
Cash and cash equivalents	5	29,349	37,478
Restricted cash	5	2,477	2,400
Short-term investments		1,397	601
Short-term loans - related parties	20	986	2,248
Trade accounts receivable, net of provision of US\$ 3,736 (December 31, 2004: US\$ 841)		96,631	73,051
Trade accounts receivable – related parties	20	6,157	9,854
Advances, net of provision of US\$ 538 (December 31, 2004: US\$ 330)		27,190	23,947
Taxes and other receivables	7	71,689	59,591
Inventories, net	8	311,343	215,957
Deferred income taxes	15	2,873	-
Other current assets		6,856	8,680
<b>Total current assets</b>		<b>556,948</b>	<b>433,807</b>
<b>Non – current assets</b>			
Property, plant and equipment, net	9	372,703	272,485
Goodwill	18	57,551	-
Investments	6	13,603	4,078
Other non-current receivables - related parties	20	-	2,089
Other non-current assets		759	995
<b>Total non-current assets</b>		<b>444,616</b>	<b>279,647</b>
Assets held for sale	4	-	30,930
<b>Total assets</b>		<b>1,001,564</b>	<b>744,384</b>
<b>LIABILITIES, STOCKHOLDERS' EQUITY AND MINORITY INTERESTS</b>			
<b>Current liabilities</b>			
Borrowings from third parties	10	(133,924)	(88,957)
Trade accounts payable		(65,453)	(48,500)
Trade accounts payable – related parties	20	(51)	(103)
Income and other taxes payable	11	(41,784)	(16,416)
Restructured taxes, current portion	13	(1,446)	(744)
Other current liabilities	12	(40,761)	(27,755)
Other current liabilities – related parties	20	-	(5,643)
Accrued pension cost	14	(2,015)	(1,602)
Dividends payable	16	(68)	(25)
Deferred income taxes	15	-	(14,449)
<b>Total current liabilities</b>		<b>(285,502)</b>	<b>(204,194)</b>
<b>Non-current liabilities</b>			
Long-term borrowings from third parties	10	(4,286)	-
Long-term borrowings from related parties	20	(2,494)	(1,316)
Restructured taxes	13	(7,708)	(9,497)
Accrued pension cost	14	(16,781)	(14,399)
Other non-current liabilities		(6,579)	-
Deferred revenue		(18)	(166)
Deferred income taxes	15	(33,751)	(21,411)
<b>Total non-current liabilities</b>		<b>(71,617)</b>	<b>(46,789)</b>
Liabilities of operations held for sale	4	-	(358)
<b>Total liabilities</b>		<b>(357,119)</b>	<b>(251,341)</b>
<b>Minority interests</b>	18	(614)	(52,058)
<b>Commitments and contingencies</b>	22	-	-
<b>Stockholders' equity</b>			
Share capital	16	(5,149)	(5,118)
Capital surplus	16	(158,054)	(4,014)
Treasury stock	16	-	74
Other comprehensive income			
Net unrealized gain on a change in valuation of investments		(594)	(480)
Cumulative translation adjustment		(11,174)	(26,024)
<b>Accumulated other comprehensive income</b>		<b>(11,768)</b>	<b>(26,504)</b>
Retained earnings		(468,860)	(405,423)
<b>Total Stockholders' equity</b>		<b>(643,831)</b>	<b>(440,985)</b>
<b>Total liabilities, stockholders' equity and minority interests</b>		<b>(1,001,564)</b>	<b>(744,384)</b>

VSMPO-AVISMA CORPORATION (FORMERLY, VSMPO)  
Consolidated Statements of Income and Comprehensive Income  
(in thousands of US\$)

	Notes	Year ended December 31, 2005	Year ended December 31, 2004
<b>Sales revenue</b>			
Sales of titanium products		489,550	347,064
Sales of titanium products - related parties	20	51,165	33,314
Sales of aluminium products		20,520	19,983
Sales of magnesium and alloys		44,107	51,690
Sales of ferrotitanium		73,767	17,575
Other revenue		49,082	53,102
<b>Total revenue</b>		<b>728,191</b>	<b>522,728</b>
<b>Materials and components used</b>			
Materials and components used		(186,513)	(137,787)
Repairs and maintenance expense		(19,942)	(16,641)
Personnel costs		(91,108)	(68,832)
Utilities		(74,650)	(64,953)
Depreciation		(31,369)	(21,302)
Other production costs		(8,656)	(7,579)
<b>Total production costs</b>		<b>(412,238)</b>	<b>(317,094)</b>
<b>Gross profit</b>		<b>315,953</b>	<b>205,634</b>
<b>Taxes other than on income</b>			
Taxes other than on income		(21,756)	(6,247)
Provision for taxes		(23,030)	(3,868)
Selling, general and administrative expenses	17	(120,020)	(84,370)
Consulting expenses - related parties	20	(4,921)	(5,643)
Commission expenses - related parties	20	(570)	(872)
Management services - related parties	20	(1,668)	-
Social expenses		(13,824)	(11,813)
Loss on disposal of interest in subsidiary		(148)	(4,771)
(Loss)/gain from investments		58	(255)
Share in earnings of joint venture	6	8,260	2,861
<b>Total other operating items</b>		<b>(177,619)</b>	<b>(114,978)</b>
<b>Operating income</b>		<b>138,334</b>	<b>90,656</b>
<b>Interest expense</b>			
Interest expense		(4,841)	(3,211)
Foreign exchange loss		(3,290)	(1,845)
<b>Income before income taxes and minority interest</b>		<b>130,203</b>	<b>85,600</b>
<b>Income tax</b>			
Income tax	15	(50,324)	(27,662)
<b>Income before minority interest</b>		<b>79,879</b>	<b>57,938</b>
<b>Minority interest</b>			
Minority interest	18	(5,266)	(7,651)
<b>Net income</b>		<b>74,613</b>	<b>50,287</b>
<b>Other comprehensive income, net of tax:</b>			
Net change in unrealized gain on a change in valuation of investments		114	480
Translation adjustment		(14,850)	20,923
<b>Comprehensive income</b>		<b>59,877</b>	<b>71,690</b>

**VSMPO-AVISMA CORPORATION (FORMERLY, VSMPO)**  
**Consolidated Statements of Cash Flows**  
(in thousands of US\$)

	Notes	Year ended December 31, 2005	Year ended December 31, 2004
<b>Net Income</b>		74,613	50,287
<b>Adjustments to reconcile net income to net cash generated by operating activities:</b>			
Depreciation		32,083	21,734
Loss on disposal of property, plant and equipment		2,935	455
Loss on disposal of interest in subsidiary		148	4,771
Share in earnings of joint venture	6	(8,260)	(2,861)
Deferred tax benefit	15	(17,985)	(4,825)
Foreign exchange differences on non-operating balances		968	1,150
Bad Debts	17	5,543	179
Inventory provisions	17	167	725
Loss on disposal of long-term promissory notes		-	(694)
Minority interests		5,266	7,651
		<b>95,478</b>	<b>78,572</b>
<b>Changes in operating assets and liabilities, excluding cash and debt:</b>			
Trade accounts receivable		(25,645)	(5,112)
Advances		(3,443)	(11,175)
Taxes and other receivables		(9,886)	(11,506)
Inventories		(101,092)	(49,150)
Other current assets		(805)	(574)
Trade accounts payable and accrued expenses		14,718	26,654
Income and other taxes payable		28,581	3,005
Repayment of restructured tax liabilities		(732)	(507)
Other current liabilities		11,398	8,677
Accrued pension cost		3,424	1,530
<b>Net cash generated by operating activities</b>		<b>11,996</b>	<b>40,414</b>
<b>Investing activities</b>			
Capital expenditures		(78,537)	(49,788)
Loans advanced to related parties		-	(2,051)
Loans repaid by related parties		1,021	33,504
Loans advanced to third parties		(832)	(601)
Disposal of a share in subsidiary		326	3,744
Purchase of additional share in subsidiary		-	(876)
Disposal of non-current assets held for sale	4	29,489	-
Acquisition of subsidiary net of cash acquired	18	(8,990)	-
Change in restricted cash balance		(154)	2,993
<b>Net cash used in investing activities</b>		<b>(57,677)</b>	<b>(13,075)</b>
<b>Financing activities</b>			
Net proceeds from short-term borrowings – third parties		44,467	-
Net repayment of short-term borrowings – third parties		-	(5,921)
Proceeds from long-term borrowings – related parties		1,247	1,268
Net proceeds from long-term borrowings – third parties		3,703	-
Net repayment of long-term borrowings – third parties		-	(250)
Purchase of treasury stock		-	(74)
Proceeds from sale of treasury stock		-	3,059
Dividends paid to minority shareholders of subsidiary		(1,823)	(582)
Dividends paid	16	(10,996)	(3,966)
<b>Net cash generated (used) by (in) financing activities</b>		<b>36,598</b>	<b>(6,466)</b>
Effect of exchange rate changes on cash and cash equivalents		697	410
<b>Net change in cash and cash equivalents</b>		<b>(8,386)</b>	<b>21,283</b>
<b>Cash and cash equivalents at December 31, 2004 (net of restricted cash of US\$ 2,400) and 2003 (net of restricted cash of US\$ 5,200)</b>	<b>5</b>	<b>37,735</b>	<b>16,452</b>
<b>Cash and cash equivalents at December 31, 2005 (net of restricted cash of US\$ 2,477) and 2004 (net of restricted cash of US\$ 2,400)</b>	<b>5</b>	<b>29,349</b>	<b>37,735</b>
<b>Supplemental cash flow information:</b>			
Interest paid, net of amounts capitalized		6,238	4,134
Income taxes paid		57,647	27,253

VSMPO-AVISMA CORPORATION (FORMERLY, VSMPO)  
 Consolidated Statements of Changes in Stockholders' Equity  
 (in thousands of US\$)

	Notes	Share capital	Capital surplus	Treasury stock	Receivable for treasury stock	Cumulative translation adjustment	Net unrealized gain on a change in valuation of investments	Retained earnings	Total stockholders' equity
<b>Balance at December 31, 2003</b>		(5,118)	(3,596)	-	2,641	(5,101)	-	(359,102)	(370,276)
Net income		-	-	-	-	-	-	-	-
Acquired own stock	16	-	-	74	-	-	-	(50,287)	(50,287)
Disposal of treasury stock	16	-	(255)	-	-	-	-	74	74
Receivable for treasury stock		-	(163)	-	(2,641)	-	-	-	(255)
Dividends to stockholders	16	-	-	-	-	-	-	-	(2,804)
								3,966	3,966
<b>Other comprehensive income:</b>									
Net change in unrealized gain on a change in valuation of investments		-	-	-	-	-	(480)	-	(480)
Translation adjustment		-	-	-	-	(20,923)	-	-	(20,923)
<b>Accumulated other comprehensive income</b>									
<b>Balance at December 31, 2004</b>		(5,118)	(4,014)	74	-	(20,923)	(480)	-	(21,403)
<b>Balance at December 31, 2004</b>									
<b>Balance at December 31, 2004</b>									
Net income		-	-	-	-	-	-	(74,613)	(74,613)
Stock issue	16	(31)	(154,040)	-	-	-	-	-	(154,071)
Retirement of treasury stock	16	-	-	(74)	-	-	-	74	-
Dividends to stockholders	16	-	-	-	-	-	-	11,102	11,102
<b>Other comprehensive income:</b>									
Net change in unrealized gain on a change in valuation of investments		-	-	-	-	-	(114)	-	(114)
Translation adjustment		-	-	-	-	14,850	-	-	14,850
<b>Accumulated other comprehensive income</b>									
<b>Balance at December 31, 2005</b>		(5,149)	(158,054)	-	-	(11,174)	(594)	(468,860)	(643,831)

## 1 NATURE OF OPERATIONS

Open joint stock company "VSMPO-AVISMA Corporation" ("VSMPO-AVISMA" or the "Company") and its subsidiaries (collectively the "Group") is one of the world's leading titanium producers. The Company was originally established as a state owned enterprise in 1933 in the Moscow region and re-allocated to Verkhnya Salda (Sverdlovsk region) in 1941. The Company was 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 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 (Note 18) and a legal reorganization, in the form of accession of Avisma into VSMPO, VSMPO and Avisma formed one legal entity with two principal branches VSMPO and AVISMA.

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

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

In November 2005 the Company acquired all the outstanding shares of the Swedish company "Carl.Edblom.titan AB", which held a controlling interest in closed joint-stock company "Plant SETAB Nikopol", a Ukrainian company engaged in production and sale of seamless titanium pipes (Note 18).

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

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

## 2 BASIS OF PREPARATION

### (a) *Statement of compliance*

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

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

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 functional currency of the Company is considered to be the rouble. The functional currency of non-Russian subsidiaries is the US Dollar. The accompanying financial statements have been prepared using the US Dollar ("US\$") as the Group's reporting currency, utilizing period-end exchange rates for assets and liabilities, period weighted average exchange rates for consolidated income statements accounts and historic rates for equity accounts in accordance with the provisions of SFAS No. 52, Foreign currency translation. As a result of these translation procedures, a cumulative translation adjustment of US\$ 11,174 (US\$ 26,024) as at December 31, 2005 and 2004, respectively, which accounts for such gains and losses, was recorded directly in stockholders equity.



## **2 BASIS OF PREPARATION (continued)**

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

The Central Bank of the Russian Federation's closing rates of exchange at December 31, 2005 and 2004 were US\$1 to 28.78 roubles and US\$1 to 27.75 roubles, respectively. The annual weighted average exchange rates were 28.29 and 28.81 roubles to US\$1 for each of the years ended December 31, 2005 and 2004, respectively.

### **(c) Consolidation principles**

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

## **3 SIGNIFICANT ACCOUNTING POLICIES**

The following significant accounting policies have been applied in the preparation of the consolidated financial statements. These accounting policies have been consistently applied by the Group from one reporting period to another with the exception of newly adopted accounting pronouncements.

### **(a) Use of estimates**

The preparation of financial statements in accordance with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and revenue and expenses during the periods reported.

Estimates are used when accounting for certain items such as contingent liabilities, allowances for doubtful accounts; employee compensation programs; depreciation and amortization of property, plant and equipment and intangible assets; impairment of long-lived assets; asset retirement obligations; inventory values; valuations of investments and determining when investment impairments are other than temporary; assets and liabilities assumed in a purchase business combinations and deferred taxes, including valuation allowances. Estimates are based on historical experience, where applicable, and other assumptions that management believes are reasonable under the circumstances. Actual results may differ from those estimates under different assumptions or conditions.

### **(b) Cash and cash equivalents**

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

### **(c) Restricted cash**

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

### **(d) Accounts receivable**

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

### 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

#### (e) Value added taxes (VAT)

Output VAT related to sales of goods and services rendered is payable to the tax authorities upon the collection of receivables from customers. Input VAT is reclaimable against sales VAT upon payment for purchases. The input VAT paid in respect of capital expenditures is reclaimable upon the commissioning of the respective capital assets into operations. The tax authorities permit the settlement of VAT on a net basis. VAT related to sales / purchases of goods and services rendered / used which have not been settled at the balance sheet date (VAT deferred) is recognized in the balance sheet on a gross basis and disclosed separately as a current asset and liability. Where an allowance has been made for doubtful debts, a loss is recorded for the gross amount of the debtor, including VAT. The related VAT liability is maintained until the debtor is written off for tax purposes.

Subsequent to the year end the VAT accounting policy was revised. Output value added tax related to sales of goods (work performance, services provision) is payable to tax authorities upon delivery of the goods (work, services) or property rights to customers. Input VAT on goods and services purchased (received) is generally recoverable against output VAT. VAT related to sales and purchases / services provision and receipt which has not been settled at the balance sheet date (VAT deferred) is recognized in the balance sheet on a gross basis and disclosed separately within current assets or current liabilities. Where a doubtful debt provision has been made, a loss is recorded for the gross amount of the debt, including VAT.

#### (f) Inventories

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

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

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

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

##### *Trading securities*

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

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

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

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

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

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

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

### 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

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

##### *Investments in associates*

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

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

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

#### (i) Property, plant and equipment

##### *Owned assets*

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

##### *Subsequent expenditures*

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

##### *Capitalized interest*

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

##### *Depreciation*

Depreciation is charged on a straight-line basis over the estimated useful lives of individual assets. Subsequent capitalized expenditures are depreciated on a straight-line basis over the estimated remaining useful life of the individual assets. Depreciation commences from the time an asset is put into operation. Depreciation is not charged on assets to be disposed or land. The range of estimated useful lives is as follows:

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

### 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

#### (j) Goodwill and intangible assets

Goodwill represents the excess of purchase price over the fair value of net assets acquired in a business combination. Under SFAS No. 142, Goodwill and Other Intangible Assets, ("SFAS No. 142") goodwill and intangible assets with indefinite useful lives are subject to an impairment test at least annually and on an interim basis when an event occurs or circumstances change between annual tests that would, more likely than not, result in impairment.

Under SFAS No. 142, goodwill is assessed for impairment by using the fair value based method. The Group determines fair value by utilizing discounted cash flows. The impairment test required by SFAS No. 142 includes a two-step approach. Under the first step, companies must compare fair value of a "reporting unit" to its carrying value. A reporting unit is the level at which goodwill impairment is measured and it is defined as an operating segment or one level below it if certain conditions are met. If the fair value of the reporting unit is less than its carrying value, step two is required to determine if goodwill is impaired.

Under step two, the amount of goodwill impairment is measured by the amount, if any, that the reporting unit's goodwill carrying value exceeds its "implied" fair value of goodwill. The implied fair value of goodwill is determined by deducting the fair value of all tangible and intangible net assets of the reporting unit (both recognized and unrecognized) from the fair value of the reporting unit (as determined in the first step).

The Group performs the required annual goodwill impairment test at the end of each calendar year.

The excess of the fair value of net assets acquired over purchase cost is determined as negative goodwill, and is allocated to the acquired non-current assets, except for deferred taxes, if any, until they are reduced to zero.

Intangible assets that have limited useful lives are amortized on a straight-line basis over the shorter of their useful or legal lives.

#### (k) Impairment of long-lived assets

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the asset to the future undiscounted cash flows expected to be generated by the asset. If the carrying amount of the assets is determined to be not recoverable, the impairment to be recognized is measured as the amount by which the carrying amount of the asset exceeds its fair value, generally determined by reference to the discounted future cash flows. Assets held for sale that meet certain criteria are measured at the lower of their carrying account or fair value less cost to sell.

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

The Group follows the Pension and Social Insurance legislation of the Russian Federation, which requires contributions to the Russian Federation Pension Fund by the employer calculated as a percentage of current gross salaries. Such contributions are expensed as incurred. The Group also maintains a non-contributory defined benefit plan for its full-time employees. The pensions earned as well as the interest on the projected benefit obligations are accrued in accordance with FAS 87 "Employers' Accounting for Pensions".

#### (m) Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statements' carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates in the years in which these temporary differences are expected to reverse. The Group provides valuation allowances for deferred tax assets for which it does not consider realization of such assets to be more likely than not.

### **3 SIGNIFICANT ACCOUNTING POLICIES (continued)**

#### **(n) Asset retirement obligations**

A liability for an asset retirement obligation is recorded at fair value in the period in which it is incurred. When the liability is initially recorded, a corresponding cost is capitalized by increasing the carrying amount of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the estimated useful life of the related asset. The Group bears asset retirement obligations in respect of its main production facilities. These obligations have indeterminate settlement dates since the Group currently plans to operate such assets in perpetuity.

#### **(o) Borrowings**

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

#### **(p) Commitments and contingencies**

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

#### **(q) Segment reporting**

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

The Group's exports in monetary terms in 2005 were 75% (2004: 72%) of the total sales.

#### **(r) Dividends**

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

#### **(s) Revenue recognition**

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

#### **(t) Comprehensive income**

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

#### **(u) Environmental expenditures**

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

### 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

#### (v) Financial instruments

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

#### (w) Interest

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

#### (x) Recent accounting pronouncements

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

In November 2005, the FASB issued Statement of Financial Accounting Standards No. 151, Inventory Costs, an Amendment of ARB No. 43, Chapter 4, which is effective for the Group starting January 1, 2006. The Statement amends the guidance in Accounting Research Bulletin (ARB) No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and spoilage. In addition, the standard requires that the allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The Group believes that the adoption of this Statement did not have a material impact on its consolidated financial statements.

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

### 3 SIGNIFICANT ACCOUNTING POLICIES (continued)

#### (x) Recent accounting pronouncements (continued)

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ("FIN 48"). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective in fiscal years beginning after December 15, 2006. The provisions of FIN 48 are to be applied to all tax positions upon initial adoption, with the cumulative effect adjustment reported as an adjustment to the opening balance of retained earnings. The Group is currently evaluating the potential impact, if any, that the adoption of FIN 48 will have on its consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements ("SFAS No. 157"). This Statement defines fair value, establishes a framework for measuring fair value under other accounting pronouncements that permit or require fair value measurements, changes the methods used to measure fair value and expands disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Group is currently evaluating the potential impact, if any, that the adoption of SFAS No. 157 will have on its consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R) ("SFAS No. 158"). This Statement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity. This Statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions, and enhances disclosures in respect of defined benefit postretirement plans. Recognition and related disclosure provisions of SFAS No. 158 become effective for the Group as of December 31, 2006, while the measurement date provisions shall apply as of December 31, 2008. The Group is currently evaluating the potential impact, if any, that the adoption of SFAS No. 158 will have on its consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 158, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 ("SFAS No. 159"). This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. SFAS No. 159 will become effective for the Group on January 1, 2008.

#### (y) Reclassifications

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

### 4 ASSETS HELD FOR SALE

In December 2004 the Group acquired 50.07% of the shares of Tekhnolog, a company which owns certain vacant properties in Moscow, for US\$ 29,454. The Group acquired this asset primarily for investment purposes. In 2005 certain parties related to the significant shareholders entered into binding arrangements with the Group to buy out Tekhnolog. In 2005 the company was sold for a cash consideration of US\$ 29,489. At December 31, 2004 the assets and liabilities relating to Tekhnolog were classified as held for sale in the consolidated balance sheet.

#### 4 ASSETS HELD FOR SALE (continued)

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

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

#### 5 CASH AND CASH EQUIVALENTS

	December 31, 2005	December 31, 2004
Cash at bank - US\$	14,838	25,734
Cash at bank - Russian roubles	2,966	5,381
Cash at bank - Euro, Swiss francs, Pound Sterling	2,680	3,341
Cash in hand	5,698	3,179
Short-term bank deposits	3,009	-
Other cash equivalents	158	100
<b>Total cash and cash equivalents, including amounts classified as assets held for sale</b>	<b>29,349</b>	<b>37,735</b>
Cash and cash equivalents presented as assets held for sales (Note 4)	-	(257)
<b>Total cash and cash equivalents</b>	<b>29,349</b>	<b>37,478</b>
<b>Restricted cash</b>	<b>2,477</b>	<b>2,400</b>

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

Restricted cash as at December 31, 2005 includes a certificate of deposit in the amount of US\$ 2,165. It was pledged as a collateral for a letter of credit issued in the amount of US\$ 2,100 which expired on April 29, 2006. The remaining balance of restricted cash as at December 31, 2005 in the amount of US\$ 312 represents a security deposit for the bank guarantee.

At December 31, 2005 a short-term bank deposit was placed with the International Moscow Bank at 3.9% p.a. with maturity date of January 10, 2006.

#### 6 INVESTMENTS

	December 31, 2005	December 31, 2004
Joint Venture - Uniti LLC	11,971	3,401
Other investments	1,632	677
<b>Total investments</b>	<b>13,603</b>	<b>4,078</b>



## 6 INVESTMENTS (continued)

The Group entered into an agreement on April 29, 2004 with Allegheny Technologies Incorporated to form a joint venture to engage in the marketing and sale of titanium products and conversion services. The joint venture is organized in the form of Uniti LLC, a company registered in the United States of America. The Group owns a 50% interest in the joint venture and accounts for this interest under the equity method.

The Group's share in the earnings of Uniti of US\$ 8,260 and US\$ 2,861 for the years ended December 31, 2005 and 2004, respectively, is included as a component of operating income in the consolidated statements of income and comprehensive income.

## 7 TAXES AND OTHER RECEIVABLES

	December 31, 2005	December 31, 2004
VAT recoverable	62,938	54,131
Prepaid taxes	2,780	747
Prepaid customs duties	623	858
Other non-trade receivables	5,348	3,981
Other non-trade receivables presented as assets held for sale (Note 4)	-	(126)
<b>Total taxes and other receivables</b>	<b>71,689</b>	<b>59,591</b>

## 8 INVENTORIES, NET

	December 31, 2005	December 31, 2004
Raw materials	86,748	63,063
Work in progress	87,000	67,058
Finished products	148,042	96,451
Less: Provision for obsolescence	(10,447)	(10,615)
<b>Total inventory, net</b>	<b>311,343</b>	<b>215,957</b>

Inventory with a carrying value US\$ 23,992 and US\$ 24,001 at December 31, 2005 and 2004, respectively was pledged as collateral for certain borrowings of the Group (Note 10).

## 9 PROPERTY, PLANT AND EQUIPMENT, NET

	December 31, 2005	December 31, 2004
Land	3,395	3,575
Buildings & Constructions	137,189	102,856
Machinery & Equipment	229,213	171,765
Vehicles	11,868	6,996
Transfer devices	21,251	19,815
Other	38,656	58,849
Less: accumulated depreciation	(149,494)	(126,496)
Net book value	292,078	237,360
Intangible assets, net	1,776	533
Construction in progress	56,269	46,346
Advances for construction	22,580	18,793
Less: Buildings presented as assets held for sale (Note 4)	-	(30,547)
<b>Total property, plant and equipment, net</b>	<b>372,703</b>	<b>272,485</b>

Fully depreciated facilities comprise US\$ 33,949 at December 31, 2005 and US\$ 35,034 at December 31, 2004. Idle facilities comprise US\$ 1,005 at December 31, 2005 and US\$ 122 at December 31, 2004.

Carrying and pledge values of property, plant and equipment subject to liens under loan agreements comprise US\$ 49,826 and US\$ 49,626 at December 31, 2005 (US\$ 52,964 and US\$ 61,916 at December 31, 2004) respectively (Note 10).

**10 SHORT AND LONG-TERM BORROWINGS**

	Currency	December 31, 2005	December 31, 2004
<b>SHORT-TERM BORROWINGS</b>			
<b>Bank loans</b>			
Sberbank; interest of 7.5% (Note a)	(3)	-	13,817
Sberbank; interest of 10.0% (Note a)	(2)	-	315
Vneshtorgbank; interest of 10.0% (Note b)	(2)	4,202	14,000
Vneshtorgbank; interest from 7.3 % to 8.0% (Note b)	(1)	19,500	-
International Moscow Bank; interest of LIBOR + from 3.0% to 3.7% (Note c)	(1)	55,743	40,711
Citibank; interest of LIBOR + 3.0% (Note d)	(1)	8,620	19,760
Calion Rusbank; interest of LIBOR + 1.25% (Note e)	(1)	25,000	-
Wachovia Capital Finance Corporation; interest of from 5.9% to 6.1% (Note f)		18,564	-
Prominvestbank; interest from 13.0% to 20.0% (Note g )	(1)	562	-
Prominvestbank; interest from 13.0% to 20.0% (Note g)	(4)	1,707	-
Other		26	354
<b>Total short-term borrowings from third parties</b>		<b>133,924</b>	<b>88,957</b>
<b>LONG-TERM BORROWINGS</b>			
<b>Bank loans</b>			
International Moscow Bank; interest of LIBOR + 3.0% (Note c)	(1)	4,000	-
Prominvestbank; interest from 13.0% to 20.0% (Note g)	(1)	286	-
<b>Total long-term borrowings from third parties</b>		<b>4,286</b>	<b>-</b>

All interest rates are on a per annum basis.

- (1) US\$ denominated loans;
- (2) Russian rouble denominated loans;
- (3) EURO denominated loans;
- (4) Other currencies denominated loans.

Details of significant collateralized loan balances are summarized below:

*(a) Sberbank*

The loans outstanding as at December 31, 2005 were collateralized by pledge of inventories (Note 8). In addition, the Group was required to maintain a settlement account with the bank to accumulate cash collections.

*(b) Vneshtorgbank*

The loans are collateralized by a pledge of inventories (Note 8). In addition, the Group is required to maintain a settlement account with the bank to accumulate cash collections. Under the terms of the agreements the Group is also required to maintain a required level of cash flows through the accounts opened with the bank.

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

*(c) International Moscow Bank*

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

The loans contain certain restrictive covenants in relation to the sale of assets, pledges of property, total amount of borrowings, change of controlling 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 of the bank accounts opened by the Group with the bank for the purpose of loan settlement.

## 10 SHORT AND LONG-TERM BORROWINGS (continued)

The long-term loan matures on October 14, 2007.

### *(d) Citibank*

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

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

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

### *(e) 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, reorganization, 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.

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

On January 14, 2005 VSMPO Tirus US entered into a Loan and Security Agreement with Wachovia Capital Finance Corporation with a term ending three years from that date. The agreement as initially executed enabled VSMPO Tirus US to borrow up to US\$ 25 million in revolving loans, with up to US\$ 10 million of this amount in the form of letter of credit accommodations. On December 29, 2005 the agreement was amended to permit up to US\$ 50 million in revolving loans. The amount available in revolving loans is limited to the lesser of US\$ 50 million or the sum of stated percentages of eligible accounts receivable, finished goods inventory, material in process and scrap. Revolving loans are either designated 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 (including non-current assets of US\$ 13,337 and current assets of US\$ 91,480 at December 31, 2005, at carrying values).

The agreement contains certain restrictive covenants that, among other things, limit or restrict the ability of VSMPO Tirus US to incur debt, incur liens, make investments, pay dividends or redeem common stock; and requires compliance with a minimum tangible net worth covenant. VSMPO Tirus US 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 December 31, 2005, four Eurodollar Rate Loans were outstanding, totaling US\$ 15 million, with interest rates ranging from 5.993% to 6.144%, and one Prime Rate loan was outstanding in the amount of US\$ 3,564. As of December 31, 2005, US\$ 900 was outstanding in letter of credit accommodations.

### *(g) Prominvestbank*

The loans are collateralized by the pledge of property, plant and equipment (Note 9), inventories (Note 8) and sales contracts (US\$ 29,167).

Under the terms of the agreements, the Group is required to maintain a settlement account with the bank to accumulate cash collections. The loans also contain certain restrictive covenants in relation to pledges of property, sale or lease of assets, reorganization, bankruptcy and other.

## 10 SHORT AND LONG-TERM BORROWINGS (continued)

Unused lines of credit comprised US\$ 28,737 and US\$ 15,980 at December 31, 2005 and 2004 respectively.

## 11 INCOME AND OTHER TAXES PAYABLE

	December 31, 2005	December 31, 2004
Deferred VAT	1,187	1,523
Income tax	8,523	7,018
Property tax	873	546
Other taxes	2,069	595
Provision for taxes and duties (Note 22)	29,132	6,734
<b>Income and other taxes</b>	<b>41,784</b>	<b>16,416</b>

## 12 OTHER CURRENT LIABILITIES

	December 31, 2005	December 31, 2004
Advances received	22,533	14,082
Payroll and social tax payable	8,516	8,735
Promissory notes	279	288
Antidumping duties (Note 22)	2,139	920
Other payables	7,294	3,775
Other payables presented as liabilities of operations held for sale (Note 4)	-	(45)
<b>Total other current liabilities</b>	<b>40,761</b>	<b>27,755</b>

## 13 RESTRUCTURED TAXES

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

The Company's entitlement to tax restructuring is conditional on timely payment of both the current and restructured taxes (inclusive of interest). 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 2005 the Company paid the remaining balance of restructured tax liability in full and applied to the tax authorities for a partial or full forgiveness of the respective fines and delayed interest.

## 14 PENSION OBLIGATIONS

The Group has pension plans which are unfunded and non-contributory arrangements. The plans were created during the 1990s recognizing service accrued before those dates. At December 31, 2005 there were 21,498 (December 31, 2004: 22,700) active members and 10,633 (December 31, 2004: 10,815) pensioners. No plan assets are maintained.

An actuarial valuation of the pension plans was performed at December 31, 2001 and was rolled forward to December 31, 2004 and December 31, 2005. The valuation was performed using the Projected Unit Method with a discount rate of 7% (2004: 9.18%).

**14 PENSION OBLIGATIONS (continued)**

	December 31, 2005	December 31, 2004
<b>Pension obligations</b>		
Employees	20,707	16,721
Pensioners	9,033	7,352
	<b>29,740</b>	<b>24,073</b>
<b>Funded status</b>		
Projected benefits obligations	29,740	24,073
<b>Funded status</b>	<b>29,740</b>	<b>24,073</b>
Unrecognized actuarial loss	(3,961)	(1,081)
Unrecognized prior service cost	(6,983)	(6,991)
<b>Accrued pension costs</b>	<b>18,796</b>	<b>16,001</b>
Current accrued pension cost	2,015	1,602
Non-current accrued pension cost	16,781	14,399
<b>Total accrued pension cost</b>	<b>18,796</b>	<b>16,001</b>
<b>Net periodic pension costs</b>		
Service cost	1,414	694
Interest cost	2,121	1,284
Amortization of prior service cost	566	-
<b>Net periodic pension costs</b>	<b>4,101</b>	<b>1,978</b>

**Change in projected benefit obligations**

Projected Benefit Obligation (opening balance)	24,073	14,055
Service cost	1,414	694
Interest cost	2,121	1,284
Actuarial loss	(3,266)	793
Amendments	7,106	6,733
Benefits paid	(672)	(659)
Translation adjustment	(1,036)	1,173
<b>Projected Benefit Obligation (closing balance)</b>	<b>29,740</b>	<b>24,073</b>

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

	Pension benefits
2006	2,015
2007	2,571
2008	2,502
2009	3,023
2010	3,196
Years 2011-2015	17,337

**Assumptions at:**

	December 31, 2005	December 31, 2004
Interest rate for discounting liabilities	7.00%	9.18%
Salary increase rate	8.15%	9.18%

**15 INCOME TAXES**

	Year ended December 31, 2005	Year ended December 31, 2004
Current tax expense	68,309	32,487
Deferred tax benefit	(17,985)	(4,825)
<b>Total income tax expense</b>	<b>50,324</b>	<b>27,662</b>

**15 INCOME TAXES (continued)**

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

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

	December 31, 2005	December 31, 2004
Current deferred tax asset	2,873	-
<b>Total deferred tax liability</b>	<b>2,873</b>	<b>-</b>
Current deferred tax liability	-	(14,449)
Non-current deferred tax liability	(33,751)	(21,411)
<b>Total deferred tax liability</b>	<b>(33,751)</b>	<b>(35,860)</b>
<b>Net deferred tax liability</b>	<b>(30,878)</b>	<b>(35,860)</b>

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

	Year ended December 31, 2005	Year ended December 31, 2004
Income before income taxes and minority interest:	130,203	85,600
Theoretical tax charge at statutory rate of 24%	31,249	20,544
Increase in income tax resulting from:		
Effects of different tax rates	6,648	2,544
Non-deductible expenses and non-taxable income	12,427	4,574
<b>Total income tax expense</b>	<b>50,324</b>	<b>27,662</b>

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

	December 31, 2005	December 31, 2004
<b>Deferred income tax assets:</b>		
Inventory	1,462	1,339
Accounts receivable	677	68
Accounts payables and accruals	6,146	4,414
<b>Total gross deferred income tax assets</b>	<b>8,285</b>	<b>5,821</b>
<b>Deferred income tax liabilities:</b>		
Property, plant and equipment	(33,751)	(21,411)
Inventory	(282)	(7,016)
Accounts receivable	(4,475)	(12,123)
Other assets	-	(201)
Unrealized gain on a change in valuation of investments	(193)	(162)
Accounts payables and accruals	(462)	(768)
<b>Total gross deferred income tax liabilities</b>	<b>(39,163)</b>	<b>(41,681)</b>
<b>Net deferred tax liability</b>	<b>(30,878)</b>	<b>(35,860)</b>

The amount of foreign earnings deemed permanently reinvested was US\$ 37,523 and US\$ 15,378 at December 31, 2005 and December 31, 2004, respectively. At December 31, 2005 the amount of unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries that are essentially permanent in duration was determined as US\$ 5,629 (December 31, 2004: US\$ 6,120).

## 16 SHARE CAPITAL

The share capital of VSMPO is composed of the following:

	Authorized and issued common shares	Par value per common share	Authorized and issued common shares	Par value per common share
	December 31, 2005	December 31, 2005	December 31, 2004	December 31, 2004
VSMPO	11,529,538	1 rouble	10,625,600	1 rouble

On July 1, 2005 legal reorganization of VSMPO and Avisma (Note 1), its subsidiary, was carried out in the form of the accession of Avisma to the Company by issuance of the Company's common stock in exchange for a minority stake in Avisma. In particular, in 2005 the Company issued 904,908 common shares which were exchanged for a minority stake in Avisma in the proportion of 2 to 1 for common stock and 1 to 1 for preferred stock. Minority shareholders, who voted against the reorganization or did not participate in the exchange, sold to Avisma 1,053 common shares and 2,671 preferred shares for roubles 4 253.92 per common share and roubles 2 137.92 per preferred share.

In 2004 VSMPO repurchased 3,673 of its shares, of which 2,703 were subsequently sold realizing a gain of US\$ 255. At December 31, 2004 the Group had 970 shares of VSMPO with a value of US\$ 74 in treasury. In 2005 these shares were retired.

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

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

In 2005 VSMPO declared 2,500,000 privileged shares with par value of 1 Russian rouble per share. No privileged shares were issued.

Reserves available for distribution to shareholders are based on the statutory accounting reports of the Company as a stand-alone entity, which are prepared in accordance with Regulations on Accounting and Reporting of the Russian Federations and which differ significantly from U.S. GAAP. Russian legislation identifies the basis of distribution as net income. For 2005, the current year statutory accumulated retained earnings of VSMPO-AVISMA as reported in its annual statutory accounting report were RR 5,049,524 thousand (unaudited). 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.

In June 2005 VSMPO declared dividends for the year ended December 31, 2004 of 29 Russian roubles per share for the total of US\$ 11,102. In September 2004 VSMPO declared dividends for the year ended December 31, 2003 of 11 Russian roubles per share for the total of US\$ 3,966. Dividends payable amounted to US\$ 68 at December 31, 2005 (December 31, 2004: US\$ 25).

## 17 SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

	Year ended December 31, 2005	Year ended December 31, 2004
Personnel costs	46,729	35,912
VAT expensed	16,114	2,253
Selling expenses	15,207	15,196
Bad debt expense	5,543	179
Insurance	5,012	6,018
Pension Obligations Provision	3,464	1,319
Consulting expenses	3,404	1,928
Utilities	2,656	1,846
Materials	2,132	1,636
Research and development expenses	1,278	4,998
Provision on inventory obsolescence	167	725
Other	18,314	12,360
<b>Total selling, general and administrative expenses</b>	<b>120,020</b>	<b>84,370</b>

## 18 BUSINESS COMBINATIONS AND MINORITY INTEREST

As at December 31, 2004 minority interest relates principally to the Company's 56.97% interest in Avisma. Later the Group sold 38,726 common shares and 117,712 preferred shares of Avisma to third parties for a cash consideration of US\$ 3,744 realizing a gain of US\$ 130 relative to the purchase price of the shares, but an overall loss in these consolidated financial statements of US\$ 4,771 determined as the difference between the cash consideration and the underlying carrying value of the net assets disposed.

In 2005 the Company effected a legal reorganization in the form of the accession of Avisma to the Company by issuance of the Company's common stock in exchange for 43.03% minority stake in Avisma (Note 16). The fair value of the net assets acquired comprised US\$ 98,298 as of the acquisition date. The related goodwill amounted to US\$ 55,774. The cost of the acquisition amounted to US\$ 154,071 based on estimated fair value of the shares issued reflecting value per share issued of US\$ 0.172.

In November 2005 OAO "Corporation VSMPO-AVISMA" acquired 100.0% of the outstanding shares of the Swedish company "Carl.Edblom.titan AB", which held a controlling interest of 50.1% in Closed Joint-Stock Company "Plant SETAB Nikopol", a Ukrainian company engaged in production and sale of seamless titanium tubes, for a cash consideration of US\$ 9,000. The fair value of the net assets acquired comprised US\$ 7,000 as of the acquisition date. The related goodwill amounted to US\$ 2,000. This acquisition was made consistent with Group's vertical integration strategy, aiming for increasing production volumes of high-value-added products. The acquired company is consolidated by the Group for the first time as at the effective date of obtaining control, which management considers to be November 2006. Pro forma results of operations for the year ended December 31, 2005 as though the business combination had been completed at the beginning of this period is as follows: pro forma revenue US\$ 732,559 (unaudited), pro forma net income US\$ 70,528 (unaudited), and December 31, 2004 - US\$ 528,167 (unaudited) and US\$ 45,803 (unaudited), respectively.

The following table summarizes the assigned values of assets acquired and liabilities assumed in this business combination, determined in accordance with SFAS No. 141. The fair values of property, plant and equipment were established by independent appraiser:

Current assets	7,871
Property, plant and equipment	13,054
Other non-current assets	375
Goodwill	2,000
<b>Total assets acquired</b>	<b>23,300</b>
Current liabilities	(10,910)
Deferred income tax liability	(2,368)
Non-current liability	(583)
<b>Total liabilities assumed</b>	<b>(13,861)</b>
Minority interest	(439)
<b>Net assets acquired</b>	<b>9,000</b>
Less: cash acquired	(10)
<b>Net assets acquired, net of cash acquired</b>	<b>8,990</b>



## 19 SALES OF PRODUCTS BELONGING TO THIRD PARTIES

In 2004, the Group sold US\$ 27,214 of products belonging to third parties. As a result, the Group has an obligation to settle in respect of these products. Accordingly, no profit margin was recognized on such sales and a liability equal to the fair value of the products was recorded in the consolidated financial statements. The liability will be marked-to-market until the Group finally settles its liability in respect of these products. The respective liability as at December 31, 2005 amounted to US\$ 32,016. Upon settlement of its liability in respect of the products, the Group will recognize a profit margin equal to the difference between the fair value and the cost of such products to the Group.

## 20 RELATED PARTY TRANSACTIONS

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

Balance sheet captions and statement of income and comprehensive income captions with the parties related to the stockholders for the years ended December 31, 2005 and 2004 comprised of the following:

### Balance sheet captions:

	December 31, 2005	December 31, 2004
Short-term loans (Note a)	986	2,248
Other non-current receivables	-	2,089
<b>Total receivable from related parties</b>	<b>986</b>	<b>4,337</b>
Other current liabilities (Note b)	-	(5,643)
Long-term borrowings (Note d)	(2,494)	(1,316)
<b>Total payable to related parties</b>	<b>(2,494)</b>	<b>(6,959)</b>

### Statement of Income and Comprehensive Income captions:

	Year ended December 31, 2005	Year ended December 31, 2004
Consulting expenses (Note b)	(4,921)	(5,643)
Management services (Note c)	(1,668)	-

#### *(a) Short-term loans*

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

A new loan was advanced in 2005 to the related parties at 4% p.a. and was unsecured. This loan was repaid in 2006.

#### *(b) Other current liabilities and consulting expenses*

Other current liabilities due to related parties as of December 31, 2004 were in respect of certain consultancy services provided in 2002-2004. Consultancy services provided to the Group by related parties in 2005 were fully paid before December 31, 2005.

#### *(c) Management services*

Management services were provided to the Group by related parties in respect of a foreign subsidiary and were fully paid before December 31, 2005.

#### *(d) Long-term borrowings*

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

## 20 RELATED PARTY TRANSACTIONS (continued)

Transactions and balances with Uniti LLC (Note 6) for the years ended December 31, 2005 and 2004 were as follows:

Balance sheet captions:

	December 31, 2005	December 31, 2004
Trade accounts receivable	6,157	9,854
Trade accounts payable	(51)	(103)
<b>Net balance receivable</b>	<b>6,106</b>	<b>9,751</b>

Statement of Income and Comprehensive Income captions:

	Year ended December 31, 2005	Year ended December 31, 2004
Sales of titanium products	51,165	33,314
Commission expenses	(570)	(872)

## 21 RISKS AND UNCERTAINTIES

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

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

### Commercial risks

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

No individual customer comprised more than 10% of the Group's sales during 2005 and 2004. Management does not believe that the Group is reliant on particular customer.

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

Due to its foreign currency denominated assets and liabilities, the Group is subject to the risk arising from foreign exchange rate fluctuations. The net foreign currency position as at December 31, 2005 is as follows:

	US\$	Euro	Other currencies
Cash and cash equivalents	16,683	2,191	971
Accounts receivable	45,630	19,804	8,800
Loans given	-	986	-
Accounts payable and other liabilities	(13,880)	(5,980)	(4,925)
Short-term borrowings	(132,273)	(23)	(1,712)

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

## 22 COMMITMENTS AND CONTINGENCIES

**Capital commitments.** The Group is engaged in construction and equipment renovation programs. The construction programs are subject to periodic reviews and actual construction costs may vary from these estimates for many reasons including, but not limited to, general business conditions; environmental regulations; exchange rate fluctuations; the cost and efficiency of construction labor, equipment and materials; and the availability and cost of capital. At December 31, 2005 capital commitments amount to \$ 23,616 (December 31, 2004: \$ 18,613).

**Taxation.** The Group's principal operations are in Russia. Russian tax, currency and customs legislation is subject to varying interpretations, and changes, which can occur frequently. Management's interpretation of such legislation as applied to the transactions and activity of the Group may be challenged by the relevant local, regional and federal authorities. Notably recent developments in the Russian environment suggest that the authorities in this country are becoming more active in seeking to enforce, through the Russian court system, interpretations of tax legislation, in particular in relation to the use of certain commercial trading structures, which may be selective for particular tax payers and different to the authorities' previous interpretations or practices. Different and selective interpretations of tax regulations by various government authorities and inconsistent enforcement create further uncertainties in the taxation environment in the Russian Federation.

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

As at December 31, 2005 and 2004 management believes that its interpretation of the relevant legislation is appropriate and the Group's tax, currency and customs positions will be sustained. Where management believes it is probable that a position cannot be sustained, an appropriate amount has been accrued for in these consolidated financial statements (Note 11). As at 31 December 2005 management has assessed, based on their interpretation of the relevant legislation, that the other than remote tax exposures approximating US\$ 8,195 (December 31, 2004: US\$ 5,397) exist which the Group believes are not likely to materialize as liabilities. Management will continue to monitor the situation as legislation and practice evolve in the jurisdictions in which the Group operates.

**Non-cancelable lease.** VSMPO Tirus US leases warehouse and office facilities and certain equipment under non-cancelable operating leases. The following is a schedule of minimum rental payments required under these leases as of December 31, 2005 and 2004:

	Year ended December 31, 2005	Year ended December 31, 2004
2005	-	520
2006	782	340
2007	568	335
2008	381	320
2009	200	63
2010	94	-

The rental expense amounted to US\$ 810 and US\$ 721 for the years ended December 31, 2005 and 2004, respectively.

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

## 22 COMMITMENTS AND CONTINGENCIES (continued)

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

**Antidumping.** In 2003 the U.S. Department of Commerce began an investigation of VSMPO Tirus US and Avisma in connection with an antidumping claim against pure and alloy magnesium from Russia. In 2004, VSMPO Tirus US and its legal counsel devoted substantial attention to defending the Group's interest in this case. The case initially resulted in a preliminary determination by the U.S. Department of Commerce of a 10.62% penalty on the cost of magnesium imports starting from October 1, 2004. In March 2005 the U.S. Department of Commerce issued its final determination in this matter which provisionally resulted in a higher rate of 21.71%. The increased penalty rate associated with this determination, however, had no impact on duties paid on imports prior to April 2005. This determination require VSMPO Tirus US to maintain a dumping duty bond or make cash deposits of estimated dumping duties at the time magnesium is imported into the United States. During 2005 dumping duties of 3,469 were charged to cost of goods sold, respectively. As of December 31, 2005, accrued liabilities include US\$ 2,139 for amounts charged against VSMPO Tirus US dumping duty bond. Since October 1, 2004 through December 31, 2005, charges against dumping duty bond and cash deposits made total US\$ 4,316. Estimated deposits are held in escrow until future administrative review proceedings determine the amount of final dumping duties to be assessed, if any. Management continues to vigorously defend the Group's interest in this case, but is unable to predict the outcome of future administrative reviews.

## 23 SUBSEQUENT EVENTS

In September 2006 Rosoboronexport, a federal state owned entity acquired control over 65.8% of the outstanding shares of VSMPO-AVISMA and in November 2006 new Board of directors of VSMPO-AVISMA was elected.

In June 2006 annual general shareholders meeting of VSMPO-AVISMA declared dividends in the amount of 37.88 roubles per share in the total amount of roubles 436,738 thousand (US\$ 15,175 at the exchange rate as at December 31, 2005).

In August 2006 VSMPO-AVISMA concluded a framework agreement with Boeing on set up of a joint venture engaged in forgings tooling. Joint venture Ural Boeing Manufacturing is being set up in Verkhnya Salda (Sverdlovsk region).

In May 2007 the Board of directors recommended to the annual general shareholders meeting of VSMPO-AVISMA to approve dividends in the amount of 50.83 roubles per share in the total amount of roubles 586,046 thousand (US\$ 20,363 at the exchange rate as at December 31, 2005). The annual general shareholders meeting of VSMPO-AVISMA is to be held on June 28, 2007.