Open Joint Stock Company “Russian Railroads”

Consolidated Financial Statements
prepared in accordance
with International Financial Reporting Standards

As of 31 December 2005 and for the year then ended

Open Joint Stock Company "Russian Railroads"

Consolidated Financial Statements

Year ended 31 December 2005

Contents

Open Joint Stock Company "Russian Railroads"

Consolidated Balance Sheet

(All amounts are in millions of Russian Rubles)

	Notes	31 December 2005	2004
ASSETS			
Non-current assets			
Property, plant and equipment, net	**3**	**1,028,028**	893,101
Negative goodwill	**2**	**–**	(568)
Intangible assets		**4,624**	2,386
Investments, net	**4**	**1,198**	97
Deferred tax asset, net	**21**	**42,706**	44,793
Other investments, net	**5**	**1,294**	2,165
VAT, long-term portion	**7**	**–**	6,849
Other non-current assets		**2,972**	1,308
Total non-current assets		**1,080,822**	950,131
Current assets			
Inventories, net	**6**	**45,470**	38,135
Prepayments and other current assets, net	**7**	**68,851**	52,846
Receivables, net	**8**	**15,582**	11,676
Cash and cash equivalents	**9**	**12,200**	10,645
Total current assets		**142,103**	113,302
Total assets		**1,222,925**	1,063,433
EQUITY AND LIABILITIES			
Equity			
Share capital	**20**	**1,535,700**	1,535,700
Accumulated deficit		**(757,977)**	(834,349)
Net profit for the year		**114,359**	76,633
		892,082	777,984
Minority interest in subsidiaries	**2**	**208**	203
Total equity		**892,290**	778,187
Non-current liabilities			
Long-term borrowings	**12**	**50,739**	8,064
Finance lease obligations, net of current portion	**16**	**24,170**	10,645
Employee benefit obligations	**14**	**53,744**	47,393
Other long-term debt	**13**	**13,311**	20,662
Total non-current liabilities		**141,964**	86,764
Current liabilities			
Payables	**10**	**75,004**	77,243
Finance lease obligations, current portion	**16**	**5,557**	2,477
Taxes and similar charges payable	**11**	**27,549**	20,656
Short-term borrowings	**12**	**18,092**	20,969
Accrued and other liabilities	**15**	**62,469**	77,137
Total current liabilities		**188,671**	198,482
Total equity and liabilities		**1,222,925**	1,063,433

Andreev F.B. Senior Vice-President

Kraft G.V. Chief Accountant

12 September 2006

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

Open Joint Stock Company "Russian Railroads"

Consolidated Statement of Income

(All amounts are in millions of Russian Rubles)

	Notes	Years ended 31 December 2005	2004
Revenues			
Cargo revenues		**584,716**	529,912
Passenger revenues		**94,578**	69,094
Other revenues		**69,955**	53,327
Total revenues		**749,249**	652,333
Operating expenses			
Wages, salaries and related contributions		**(249,914)**	(214,273)
Materials, repairs and maintenance		**(134,654)**	(133,902)
Fuel		**(43,214)**	(30,633)
Electricity		**(44,968)**	(39,881)
Depreciation and amortization	**3**	**(64,153)**	(61,751)
Negative goodwill amortization	**2**	**–**	142
Taxes other than income tax, net	**17**	**2,451**	3,108
Commercial expenses		**(5,368)**	(5,710)
Bad debt expense		**(2,965)**	(2,571)
Social expenses	**18**	**(8,581)**	(17,834)
Other operating expenses		**(56,684)**	(59,332)
Total operating expenses		**(608,050)**	(562,637)
Operating profit before compensation from federal and municipal budgets		**141,199**	89,696
Compensation of transportation losses from federal and municipal budgets		**1,628**	2,656
Compensation of social expenses from federal and municipal budgets		**18**	64
Income from operations after compensation from federal and municipal budgets		**142,845**	92,416
Interest expense and similar items, net		**(5,213)**	(2,638)
Changes in fair value and recoverable amounts of investments		**922**	135
Other (expenses) / income, net	**19**	**(258)**	3,676
Foreign exchange (loss) / gain, net		**(186)**	113
Income before taxation		**138,110**	93,702
Income taxes			
Current taxes charge		**(21,613)**	(18,492)
Deferred taxes (charge) / credit		**(2,087)**	1,593
Total income taxes	**21**	**(23,700)**	(16,899)
Net income for the year		**114,410**	76,803
Attributable to:			
Equity holders of the parent		**114,359**	76,633
Minority interests in subsidiaries		**51**	170

Andreev F.B. — Senior Vice-President

Kraft G.V. — Chief Accountant

12 September 2006

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

Open Joint Stock Company "Russian Railroads"

Consolidated Statement of Changes in Equity

(All amounts are in millions of Russian Rubles, except share amounts)

		Share capital					
	Notes	**Quantity of common shares**	**Amount**	**(Accumulated deficit)**	**Total**	**Minority interests**	**Total equity**
As at 1 January 2004		**1,535,700,00**	**1,535,70**	**(833,762**	**701,93**	**33**	**701,97**
Dividends paid		–	–	(587)	(587)	–	(587)
Net income for the year		–	–	76,63	76,63	170	76,80
As at 31 December 2004		**1,535,700,00**	**1,535,70**	**(757,716**	**777,98**	**203**	**778,18**
Change in accounting policies: derecognition of negative goodwill	**2**	–	–	**568**	**568**	–	**568**
As at 1 January 2005		**1,535,700,00**	**1,535,70**	**(757,148**	**778,55**	**203**	**778,75**
Acquisition of minority interest in existing subsidiary		–	–	46	46	(46)	–
Dividends paid		–	–	(875)	(875)	–	(875)
Net income for the year		–	–	114,35	114,35	51	114,41
As at 31 December 2005		**1,535,700,00**	**1,535,70**	**(643,618**	**892,08**	**208**	**892,29**

Andreev F.B. Senior Vice-President

Kraft G.V. Chief Accountant

12 September 2006

Open Joint Stock Company "Russian Railroads"

Consolidated Statement of Cash Flows

(All amounts are in millions of Russian Rubles)

	Years ended 31 December 2005	2004
Cash flows from operating activities		
Income before taxation and minority interests	**138,110**	93,702
Adjustments to reconcile income to cash generated from operations		
Depreciation and amortisation	**64,153**	61,751
Negative goodwill amortisation	**–**	(142)
Change in fair value and recoverable amounts of investments	**(922)**	(96)
Bad debt expense	**2,965**	2,571
Loss on disposal of property, plant, equipment	**11,592**	5,767
Impairment of abandoned construction-in-progress projects	**4,967**	13,573
Interest expense and similar items, net	**5,213**	2,638
Provision for obsolescence and write-off of other assets	**1,685**	2,823
(Reversal) / accrual of provision for legal claims	**(2,170)**	3,973
(Reversal) of provision for tax risks	**(16,335)**	(20,931)
Gain on release of penalties related to tax restructuring	**(4,491)**	(1,771)
Operating income before working capital changes	**204,767**	163,858
(Increase) / decrease in receivables	**(4,191)**	705
(Increase) in prepayments and other current assets	**(11,836)**	(11,295)
(Increase) in inventories	**(9,020)**	(4,044)
(Decrease) / increase in payables	**(2,711)**	10,673
Increase / (decrease) in taxes and similar charges payable including restructured taxes	**7,137**	(9,910)
Increase / (decrease) in accrued and other liabilities	**3,936**	(622)
Increase in employee benefit obligations	**6,351**	3,716
(Increase) in other non-current assets	**(1,664)**	(1,397)
Net cash from operating activities before income taxes	**192,769**	151,684
Income taxes paid	**(24,717)**	(20,667)
Net cash from operating activities	**168,052**	131,017
Cash flows from investing activities		
Capital expenditures	**(193,756)**	(149,205)
Proceeds from disposal of property, plant and equipment	**572**	140
Purchase of intangibles, net	**(3,031)**	(743)
Proceeds from disposal of marketable securities, loans given, net	**1,400**	–
(Purchase) / proceeds from disposal of investments	**(236)**	696
Interest received	**–**	200
Net cash (used in) investing activities	**(195,051)**	(148,912)
Cash flows from financing activities		
Repayment of finance lease obligations	**(4,569)**	(1,771)
Proceeds from long-term borrowings	**42,675**	8,000
(Repayment of) / proceeds from short-term borrowings, net	**(2,809)**	8,661
Repayment of long-term borrowings	**–**	(193)
Interest paid	**(6,743)**	(3,162)
Dividends paid	**(875)**	(587)
Government grants	**875**	705
Net cash from financing activities	**28,554**	11,653
Net increase / (decrease) in cash and cash equivalents	**1,555**	(6,242)
Cash and cash equivalents at the beginning of the year	**10,645**	16,887
Cash and cash equivalents at the end of the year	**12,200**	10,645

Andreev F.B. Senior Vice-President

Kraft G.V. Chief Accountant

12 September 2006

1. Description of Business and Russian Environment

Formation and Operations of the Company

The Ministry of Railways of the Russian Federation (hereinafter “MPS”) was established in January 1992 as a successor of the Ministry of Railway Transportation of the USSR under decree No. 28 of the President of the Russian Federation.

Through 30 September 2003 MPS had combined the function of a federal agency executing regulation of railway transportation in the territory of Russia and the function of a commercial entity. Pursuing the objective of (1) segregation of the regulatory functions of MPS and its commercial activities; and (2) development of competition in the transportation market, the Russian government commenced implementation of the Program of railway transportation restructuring during the period 2001-2010 (“the Program”) developed by MPS, the Ministry of Economic Development and Trade of the Russian Federation, the Antimonopoly Ministry of Russian Federation, Ministry of State Property of the Russian Federation and certain other ministries. This Program’s ultimate purpose is the attraction of capital investments necessary to upgrade and replace existing property, plant and equipment.

As the first significant step of the Program, a new company – open joint stock company “Russian Railroads” (“RZD” or “the Company”) was established on 1 October 2003 as a successor to MPS in its capacity as a commercial entity pursuant to Decree of the Russian Government No. 585 “On Foundation of Joint Stock Company RZD” dated 18 September 2003. The company is 100% owned by the Russian government. MPS as a governmental body retained tariffs regulating and other policy-setting functions. In July, 2004 these functions were transferred to the Ministry of Transport of the Russian Federation.

As a result of the reorganization of MPS, RZD retained all operating assets, infrastructure and employees of MPS as well as its commercial operations, and the Russian government became a direct holder of the stock of RZD. The reorganization of MPS and transfer of assets and liabilities to RZD was treated by management as reorganization of entities under common control, and was reported as though the reorganization and transfer of net assets occurred as of 1 January 2003. The Company has reflected all assets and liabilities transferred from MPS to RZD at the predecessor’s accounting basis in the accompanying financial statements.

Further, as part of the reorganization a part of MPS’s social assets (primarily living houses) were transferred to the local municipalities. RZD assumed a liability related to repair and renovation of such social assets upon transfer. This liability as of 31 December 2005, in the amount of Rbls 2,515 (2004: Rbls 4,411) was included in “Accrued and other liabilities” in the accompanying consolidated balance sheet with the corresponding expenses included in “Social expenses” in the consolidated statement of income (refer to Notes 15 and 18). Further, the Company committed to continue financing costs related to maintenance of the assets referred to above during 2006 (refer to Note 23 for further details).

In addition, the Government contributed land occupied by the Company’s facilities as in-kind contribution to the newly established share capital of RZD (refer to Note 3).

1. Description of Business and Russian Environment (continued)

Formation and Operations of the Company (continued)

RZD is comprised of the following departments:

a) Railways:

Oktiabrskaya;
Moskovskaya;
Severo-Kavkazskaya;
Privolzhskaya;
Uzhnouralskaya;
Vostochno-Sibirskaya;
Kaliningradskaya;
Gorkovskaya;
Ugo-Vostochnaya;
Kuibyshevskaya;
Zapadno-Sibirskaya;
Zabaikalskaya;
Severnaya;
Sverdlovskaya;
Krasnoyarskaya;
Sakhalinskaya;
Dalnevostochnaya.

b) Operating organizations:

Railway traffic control centre;
Firm service centre of transportation;
Main information processing centre;
Central telecommunication centre;
Refservice;
Roszheldorsnab;
Railway transport construction Directorate.

c) Industrial organizations:

Electro technical plants;
Passenger car repair plants;
Locomotives and wagons repair plants;
Concrete sleeper manufacturing plants;
Specialized plants.

d) Medical and healthcare institutions

RZD activities will be focused solely on provision of transportation services and maintenance of railroads infrastructure. Under the terms of the Program it is planned that auxiliary business activities and the related facilities currently owned by RZD will be further transferred to independent newly established entities.

RZD employed approximately 1.3 million people in 2005 and 2004.

Corporate Information

The legal address of RZD is Novaya Basmannaya Street 2, 107174 Moscow, the Russian Federation.

The accompanying consolidated financial statements were authorised for issue by RZD’s directors on 12 September 2006.

(All amounts are in millions of Russian Rubles, unless stated otherwise)

1. Description of Business and Russian Environment (continued)

Consolidated Subsidiaries

Details of RZD's entities included in the consolidation as of 31 December 2005 and for the year then ended are as follows:

Name of Company	Registered offices	Legal form	Nature of business	Parent Company	Equity interest
TransTelecom	Moscow	Closed Joint Stock Company	Fiber-optic cable construction	RZD	100%
Arena 2000	Yaroslavl	Closed Joint Stock Company	Hockey stadium operations	RZD	99.9%
Elteza	Moscow	Open Joint Stock Company	Production of electrical engineering equipment	RZD	100% - 1 common share
Remputmash	(A)	(A)	Repair works	RZD	100% - 1 common share
Zhilsotsipoteka	Moscow	Limited Liability Company	Residential construction	RZD	100%
Zheldoripoteka	Moscow	Closed Joint Stock Company	Residential construction	RZD	100%

(A) These entities were established by RZD during 2005 on the basis of branches previously existing and comprise auxiliary business activities and the related facilities. "Remputmash" comprises 9 separate legal entities. All entities are established as open joint stock companies.

In addition, during 2005 RZD established a number of medical organizations and sanatoriums, which are also included in the consolidation as of 31 December 2005 and for the year then ended.

Details of RZD's entities included in the consolidation as of 31 December 2004 and for the year then ended are set out below:

Name of Company	Registered offices	Legal form	Nature of business	Parent Company	Equity interest
TransTelecom	Moscow	Closed Joint Stock Company	Fiber-optic cable construction	RZD	100%
Arena 2000	Yaroslavl	Closed Joint Stock Company	Hockey stadium operations	RZD	99.9%
Zhilsotsipoteka	Moscow	Limited Liability Company	Residential construction	RZD	100%
Zheldoripoteka	Moscow	Closed Joint Stock Company	Residential construction	RZD	100%

1. Description of Business and Russian Environment (continued)

Consolidated Subsidiaries (continued)

Further, the Company has equity investments in approximately 115 (2004: 122) various subsidiaries and associated undertakings not listed above. The aggregate amount of such investments (before provision for diminution of value) equated to Rbls 4,600 as of 31 December 2005 (2004: Rbls 5,006). For details of such investments - refer to Note 4.

Management believes that the financial position and results of operations of these entities are not likely to be material, individually or in aggregate, to the Company's consolidated financial statements. In particular, based on management assessment, the aggregate amount of assets, liabilities, revenues and net income of such unconsolidated entities do not exceed 1% of the consolidated assets, liabilities, revenues and profits of the Company as of 31 December 2005 and 2004 and for the years then ended.

On this basis, the above entities have been excluded from the scope of consolidation and / or application of equity method of accounting. Investments in such entities are reflected at historical cost of acquisition net of provision for diminution in value (refer to Notes 2 and 4).

Factors Affecting Financial Position of the Company

Economic environment in Russia

Whilst there have been improvements in the Russian economic situation, such as an increase in gross domestic product and a reduced rate of inflation, Russia continues economic reforms and development of its legal, tax and regulatory frameworks as required by a market economy. The future stability of the Russian economy is largely dependent upon these reforms and developments and the effectiveness of economic, financial and monetary measures undertaken by the government.

Pricing policy

<u>Tariffs for domestic cargo transportation</u>

Domestic cargo transportation is a natural monopoly subject to regulation in accordance with Federal Law No.147-FZ on Natural Monopolies of 17 August 1995.

The list of tariffs for domestic cargo transportation services is included in the Statutory Price List 10-01 approved by the Federal Energy Commission of the Russian Federation in June 2003 that superseded the Statutory Price List 10-01 approved by the State Committee on Prices of the USSR and the Ministry of Railways of the USSR in March 1989.

Domestic cargo tariffs are denominated in Russian Rubles and are subject to inflation adjustments in line with a change of consumer prices. Indexation of tariffs is performed by the Federal Agency for Tariffs and the government of the Russian Federation based on the forecast of economic development of the Russian Federation provided by the Ministry of Economic Development and Trade.

1. Description of Business and Russian Environment (continued)

Factors Affecting Financial Position of the Company (continued)

Tariffs for domestic transportation of passengers and baggage

Domestic transportation of passengers and baggage is a natural monopoly subject to regulation in accordance with Federal Law No.147-FZ on Natural Monopolies of 17 August 1995.

The list of tariffs for transportation of passengers and baggage is included in the Statutory Price List 10-02-16 approved by the State Committee on Prices of the Russian Federation effective since March 1993.

Federal and local authorities subsidize part of the rural passenger transportation losses under cooperation agreements with the Company.

Tariffs for international transportation of cargo and passengers

(1) CIS rail tariffs

CIS rail tariffs apply to:

- cargo transit via CIS railways;
- third country cargo transportation to/from the CIS;
- cargo transportation between CIS rail terminals.

Tariffs for cargo transit are based on the International Rail Transit Tariff and Unified Transit Tariff denominated in Swiss francs with the exception of container transit services where tariffs are denominated in US dollars. The tariffs are approved by CIS Rail Transport Tariff Conference every year and the adopted tariffs are applied to settlements with forwarding companies. Tariffs for third country cargo transportation to/from the CIS and cargo transportation between CIS rail terminals are based on the Statutory Price List 10-01 approved by the Federal Energy Commission of the Russian Federation in June 2003.

The interstate passenger tariffs applicable to settlements for interstate passenger transportation services are approved by the CIS Rail Transport Tariff Conference.

(2) Tariffs for Western Europe, Baltic countries and Russia

International Transit Tariff used in cases when a cargo owner pays for the transportation services directly, as well as the "East-West" tariffs for transportation through Russia to European countries, which are not members of the CIS, are determined by the CIS Rail Transport Tariff Conference.

(3) Tariffs for Asian countries

Unified Transit Tariff and International Passenger Tariff applied in international railway transportation are determined by an intergovernmental agreement of the Amalgamated Union of Railways, which includes the members of the CIS and Baltic countries, North Korea, China and other countries of South-East Asia.

(All amounts are in millions of Russian Rubles, unless stated otherwise)

1. Description of Business and Russian Environment (continued)

Currency Exchange and Control

Foreign currencies, in particular the US dollar, play a significant role in the underlying economics of many business transactions in Russia. The following table summarizes the exchange rate of the Ruble to 1 US dollar for the years ended 31 December 2005, 2004 and 2003:

As of 31 December	Exchange rate
2005	28.78
2004	27.75
2003	29.45

As of 12 September 2006 the exchange rate was Rubles 26.80 to 1 US dollar.

Government Subsidies

Under the current cooperation agreements between the Company and federal and local governments, part of the losses from certain activities are covered by subsidies from such authorities. Further, a part of the Company's social costs is also subsidized. These compensations are shown as a separate item in the consolidated statement of income.

Liquidity

As of 31 December 2005, the Company's current liabilities exceeded its current assets by Rbls 46,568 (as of 31 December 2004: Rbls 85,180). As a result, uncertainties exist as to the Company's liquidity.

The Company is investing in expansion, modernization and maintenance of its property, plant and equipment. The Company financed investment activities through cash generated from operations and current and non-current liabilities. The Company also requires access to debt financing.

Management is addressing the Company's liquidity needs by implementing the following measures:

- Continuous negotiations with the government of the Russian Federation regarding the increase in transportation tariffs,
- Maintaining the system of collection of prepayments for transportation services,
- If needed, certain investment projects may be deferred or curtailed in order to fund the Company's current operating needs,
- Attracting borrowings from lending institutions.

Through 2006, management believes that there will be sufficient funding from (a) existing cash balances, (b) cash generated from operations, and (c) other financing from lending institutions.

2. Summary of Significant Accounting Policies

Basis of Presentation

The Company and its subsidiaries maintain their accounting records and prepare their statutory accounting reports in Russian Rubles and in accordance with the Regulations on Accounting and Reporting in the Russian Federation. The accompanying consolidated financial statements are based upon the statutory accounting records, which are maintained under the historical cost convention, except for the statutory revaluation of property, plant and equipment. The statutory accounting reports have been restated through adjustments and reclassifications to present these consolidated financial statements in accordance with International Financial Reporting Standards (“IFRS”). The principle adjustments relate to revenues recognition, valuation of property, plant and equipment, provisions, deferred income taxes and accounting for subsidiaries and associates.

Principles of Consolidation

1. In accordance with IAS 27 “Consolidated Financial Statements and Accounting for Investments in Subsidiaries” (“IAS 27”), subsidiary undertakings are defined as those entities over which a reporting entity exercises control directly or indirectly and normally holds a voting interest of 50% or more.

2. The purchase method of accounting is used for acquired businesses. Companies acquired and disposed of during the year are included in the consolidated financial statements from the date of acquisition to the date of disposal. The equity and income attributable to minority shareholders’ interests are shown under “Minority interest in subsidiaries” in the consolidated balance sheet and consolidated statement of income, respectively. Minority interests as of 31 December 2005 and 2004 and for the years then ended represent the interests in TransTelecom, not held by the Company.

3. All significant balances and transactions between the Company and material subsidiary undertakings included in the consolidation are eliminated, as are costs and revenues recognised on intercompany transactions (e.g. entities providing services within the Company) and the unrealised profits within the Company.

4. When there is other than temporary diminution in value of the investment the carrying amount of the investment is reduced to the recoverable amount to recognise this decline.

In accordance with IAS 28 “Accounting for Investments in Associates” (“IAS 28”), associates are defined as those entities over which a reporting entity exerts significant influence and normally holds a voting interest of between 20% and 50% and are accounted for using the equity method.

As commented in Note 1, management assessed that the financial position and the results of operations of these entities were not material, individually or in aggregate, for the Company’s consolidated financial statements. Investments in companies not included in the consolidation are stated at cost in the consolidated balance sheet (refer to Notes 4 and 5).

2. Summary of Significant Accounting Policies (continued)

Comparative Information

Certain reclassifications were made to comparative financial information for the year ended 31 December 2004 to comply with the current year presentation.

Changes in Accounting Policies

The accounting policies adopted are consistent with those of the previous financial year except that the Company has adopted those new/revised standards mandatory for financial years beginning on or after 1 January 2005.

The changes in accounting policies result from adoption of the following new or revised standards:

IFRS 2 “Share-Based Payment”;
IFRS 5 “Non-current Assets Held for Sale and Discontinued Operations”;
IAS 1 (revised) “Presentation of Financial Statements”;
IAS 2 (revised) “Inventories”;
IAS 8 (revised) “Accounting Policies, Changes in Accounting Estimates and Errors”;
IAS 10 (revised) “Events after the Balance Sheet Date”;
IAS 16 (revised) “Property, Plant and Equipment”;
IAS 17 (revised) “Leases”;
IAS 24 (revised) “Related Party Disclosures”;
IAS 27 (revised) “Consolidated and Separate Financial Statements”;
IAS 28 (revised) “Investments in Associates”;
IAS 31 (revised) “Interests in Joint Ventures”;
IAS 32 (revised) “Financial Instruments: Presentation and Disclosure”;
IAS 39 (revised) “Financial Instruments: Recognition and Measurement”.

The principal effects of these changes in policies are discussed below.

IAS 1 (revised) “Presentation of Financial Statements” and IAS 27 “Consolidated and Separate Financial Statements”

Minority interests in the net assets of the Company’s subsidiaries are presented within equity, separately from parent shareholders’ equity. Previously, minority interests were presented separately from liabilities and equity in the Company’s consolidated balance sheet.

IFRS 3 “Business Combinations”, IAS 36 “Impairment of Assets” and IAS 38 “Intangible Assets”

IFRS 3 applies to accounting for business combinations for which the agreement date is on or after 31 March 2004. The adoption of IFRS 3 and IAS 36 has resulted in the Company ceasing annual amortisation of negative goodwill, and derecognised its carrying amount with a corresponding adjustment to the retained earnings balance as of 1 January 2005.

2. Summary of Significant Accounting Policies (continued)

Changes in Accounting Policies (continued)

IFRS 5 “Non-Current Assets Held for Sale and Discontinued Operations”

The Company adopted IFRS 5 prospectively in accordance with the transitional provisions of IFRS 5, which has resulted in a change in accounting policy on the recognition of assets held for sale. An item is classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. The result of this change in accounting policy is that assets and liabilities of a disposal group classified as held for sale are recorded in the consolidated balance sheet separately from other assets, within current assets.

IAS 39 “Financial Instruments: Recognition and Measurement” (amended 2004)

The gains and losses on re-measurement of financial assets available-for-sale to fair value are recognised as a separate component of equity. A gain or loss on an available-for-sale financial asset is recognised directly in equity, except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity is recognised in profit or loss. However, interest calculated using the effective interest method is recognised in profit or loss. Dividends on an available-for-sale equity instrument are recognised in profit or loss when the Company’s right to receive payment is established.

IFRSs and IFRIC Interpretations not yet effective

The Company has not applied the following IFRSs and IFRIC Interpretations that have been issued but are not yet effective:

- IAS 19 (amended 2004) “Employee Benefits”;
- IAS 39 (amended 2005) “Financial Instruments: Recognition and Measurement”;
- IFRS 6 “Exploration for and Evaluation of Mineral Resources”;
- IFRS 7 “Financial Instruments: Disclosures”;
- IFRIC 4 “Determining whether an Arrangement contains a Lease”;
- IFRIC 5 “Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds”.

The Company expects that the adoption of the pronouncements listed above will not have a significant impact on the Company’s financial statements in the period of initial application.

Measurement Currency

Based on the economic substance of the underlying events and circumstances relevant to the Company the measurement currency of the Company has been determined to be the Russian Ruble.

2. Summary of Significant Accounting Policies (continued)

Accounting for the Effects of Inflation

Before 2003 the Russian economy was considered hyperinflationary as defined by International Accounting Standard ("IAS") 29 "Financial Reporting in Hyperinflationary Economies". The effect of applying IAS 29 is that non-monetary items, including components of equity, were restated to the measuring units current as of 31 December 2002, based on the Russian general consumer price indices (CPI), issued by the State Statistical Committee of the Russian Federation, and these restated values were used as a basis for accounting in subsequent periods.

Use of Management Estimates

The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenues and costs during the reporting period.

As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgments based on the latest available, reliable information. An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience.

The most significant estimates relate to the realisability and depreciable lives of property, plant and equipment, the realisability of long-term financial investments, allowance for doubtful accounts, provision for obsolete inventory, provision for tax contingencies and deferred taxation. Actual results could differ from these estimates.

Judgements

In the process of applying the Company's accounting policies, management has made the following judgements, apart from those involving estimates, which have the most significant effect on the amounts recognised in the consolidated financial statements:

Accounting for non-production property, plant and equipment

Included in property, plant and equipment are social infrastructure and other non-production assets. Management believes that expenditures incurred in respect of acquisition or construction of such assets qualify for the recognition as an asset on the premises that such expenditures are capable of contributing indirectly to the flow of cash and cash equivalents to the Company through a reduction of cash outflows related primarily to wages and salaries expenses. This is driven by the fact that such non-production assets are employed by the Company to provide in-kind benefits to its employees, which replace cash outflows on wages and salaries.

2. Summary of Significant Accounting Policies (continued)

Property, Plant and Equipment

Initial recognition of property, plant and equipment

In accordance with IAS 16 "Accounting for Property, Plant and Equipment" property, plant and equipment, which qualifies for recognition as an asset is initially recognised at its historical cost.

Subsequent to initial recognition, property, plant and equipment are carried at a revalued amount, being their fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment loss. Revaluations are made with sufficient regularity such that the carrying amount of property, plant and equipment does not differ materially from that, which would be determined using the fair value at the balance sheet date.

Revaluation to fair value as of 31 December 1998

As of 31 December 1998, the Company performed a revaluation of its property, plant and equipment and reported these assets at their fair values.

For the purposes of determination of the fair values of property, plant and equipment, the Company engaged a consortium of independent appraisal companies to perform an appraisal of such fair values of a major part of property, plant and equipment as of 1 January 2000. The results of the appraisal performed were rolled backed to eliminate the effect of the changes in the market values of 1999, which were limited to inflation effects only, to arrive at fair value data as of 31 December 1998. Further, accumulated depreciation was eliminated against the gross carrying amount of related assets. The increase of Rbls 590,799 in the carrying amount of property, plant and equipment resulting from such revaluation was credited directly to equity as a revaluation surplus as of 31 December 1998.

Revaluation to fair value as of 1 January 2004

In 2004 the Company engaged an independent appraiser to determine the fair value of its property, plant and equipment as of 1 January 2004. The Company planned to complete this revaluation and report its property, plant and equipment at their fair values in its consolidated financial statements in 2005 by adjusting as needed the financial data for comparative financial statements as of 31 December 2004 and for the year then ended. However, this work has not yet been finalized. The Company is considering a revision of the date of revaluation to 1 January 2005, so that the fair values of property, plant and equipment could be reported in its consolidated financial statements in 2006 by adjusting as needed the financial data for comparative financial statements as of 31 December 2005 and for the year then ended.

2. Summary of Significant Accounting Policies (continued)

Property, Plant and Equipment (continued)

Impairment of property, plant and equipment

On the basis of the analysis of external and internal sources of information management concluded that certain indications of property, plant and equipment impairment existed as of 1 January 1999 and 31 December 1999. Accordingly, MPS estimated the recoverable amount of its property, plant and equipment as of 1 January 1999, which is the higher of net selling price and value in use. In the absence of sufficient and reliable information regarding market prices in respect of MPS's property, plant and equipment, value in use was used for the purpose of determining the recoverable amount of property, plant and equipment. In accordance with this method, MPS determined the recoverable amount of its property, plant and equipment as a value of future discounted cash flows from continuing use of property, plant and equipment. A 13% p.a. pre-tax discount rate was used in the calculation of the present value of future cash flows, as management believed that this rate reflected the current market assessments of the time value of money and the risks specific to the assets as of 1 January 1999.

The value in use, as determined above, was lower than re-valued amount of property, plant and equipment as of 1 January 1999 as determined by a consortium of independent appraisal companies (refer above).

Based on these factors, an impairment loss related to the carrying value of the property, plant and equipment was recognised as of 1 January 1999 in the amount of Rbls 554,235. The impairment loss was recorded as a reduction to a previously established revaluation reserve.

The reduced carrying amount of property, plant and equipment is depreciated over the assets' remaining useful lives in respect of depreciable assets as of 1 January 1999 (see Depreciation of property, plant and equipment below).

At each balance sheet date in periods subsequent to the year ended 31 December 1999, MPS analyzed the recoverable amount of its property, plant and equipment to determine whether any revision had to be made to the impairment loss recognised as of 1 January 1999. Based on the results of such assessment management concluded that although certain indicators of improvement of the Company's performance existed as of the above dates, which, consequently, may be supportive of a conclusion that an impairment loss for its assets recognised in previous years as discussed above may no longer exist or might have decreased, the continuation of such indicators in the future could not be ascertained. Accordingly, management concluded that no revisions should be made to the amount of the impairment loss referred to above.

(All amounts are in millions of Russian Rubles, unless stated otherwise)

2. Summary of Significant Accounting Policies (continued)

Property, Plant and Equipment (continued)

Impairment of property, plant and equipment (continued)

Due to significant uncertainties regarding future changes in the tariff-setting policy and further implementation of the Program of railway transportation restructuring, as more fully described in Note 23, a reliable basis for re-assessment of the recoverable amount of the Company's property, plant and equipment as of 31 December 2005 and 2004 was absent. Management believes that impairment loss recognised as of 1 January 1999 is the best estimate in the current economic situation. Management cannot predict what effect changes in fiscal and political policies may have on the Company's remaining investment or ability to make future investments in property, plant and equipment, which may affect the recoverable amount of such investments. Management plans to revisit such an assessment at the time more certainty regarding factors outlined above exist and upon completion of property, plant and equipment revaluation. Accordingly, the amount of impairment loss may be revised.

However, as of 31 December 2005 and 2004 management identified a number of property items and construction-in-progress projects, which the Company decided to discontinue. An impairment loss was recognised with regard to such projects during 2005 and 2004 (refer to Note 3).

Depreciation of property, plant and equipment

For depreciable assets as of 1 January 1999 ("the base assets") the new basis as determined above after taking into consideration the effects of inflation is depreciated on a straight-line basis over the asset's remaining useful life. Depreciation is charged to operating expenses in the respective period. Depreciation for base assets is charged over the assets' average remaining useful life since 1 January 1999. Depreciation for property, plant and equipment acquired after 1 January 1999 is charged over the assets' useful life when placed in operation. The overall remaining useful lives used to calculate depreciation starting from 1 January 1999 are as follows (years):

Property, Plant and Equipment	Assets put into operation after 1 January 1999	Base assets
Buildings	80	46
Constructions	50	27
Sub-grade	100	60
Superstructure	21	10
Locomotives	25	7
Transport, passenger	28	10
Transport, cargo	25	7
Operating equipment	15	7
Non-production assets	61	44
Other fixed assets	20	14

The residual values, useful lives and depreciation methods are reviewed and adjusted as appropriate at each financial year end.

2. Summary of Significant Accounting Policies (continued)

Property, Plant and Equipment (continued)

Depreciation of property, plant and equipment (continued)

When assets are sold or retired, their carrying value is eliminated from the accounts and any gain or loss resulting from their disposal is included in the statement of income.

Land occupied by MPS’s facilities was owned by the Russian Federation as of 31 December 2002 and was not included in Property, Plant and Equipment. In 2003, such land was contributed as in-kind contribution to the Company’s newly established share capital (refer to Note 20) and, consequently, was included in Property, Plant and Equipment as of 31 December 2005 and 2004. The land is not depreciated.

Construction in progress comprises costs directly related to construction and acquisition of property, plant and equipment plus an appropriate allocation of directly attributable variable and fixed overheads that are incurred in construction. Construction in progress is depreciated once the asset is put into operation.

Property, plant and equipment - subsequent expenditures

Subsequent expenditures relating to an item of property, plant and equipment, which qualify for recognition as assets in accordance with provisions of IAS 16, are capitalized.

Major renewals and improvements are capitalised, and the assets replaced are retired. Gains and losses arising from the retirement of property, plant and equipment are included in the statement of income as incurred. When each major inspection is performed, its cost is recognised in the carrying amount of the plant and equipment as a replacement if the recognition criteria are satisfied.

Costs other than those referred to above are recognised as an expense when incurred.

Intangible Assets

Intangible assets (primarily software) are measured at cost. Intangible assets are recognised if it is probable that the future economic benefits attributable to the asset will flow to the enterprise. After initial recognition, intangible assets are measured at cost less accumulated amortization and any accumulated impairment losses. The useful lives of intangible assets are assessed to be either finite or indefinite. Intangible assets with finite lives are amortized on a straight-line basis over the estimated useful lives of the related assets. An average useful life of 10 years is used in regard to all intangible assets. Amortisation periods and methods for intangible assets with finite useful lives are reviewed at least at each financial year-end. Changes in the expected useful life or the expected pattern of consumption of future economic benefits embodied in the asset is accounted for by changing the amortisation period or method, as appropriate, and treated as changes in accounting estimates.

2. Summary of Significant Accounting Policies (continued)

Intangible Assets (continued)

Intangible assets with indefinite useful lives are not amortised, but tested for impairment annually either individually or at the cash-generating unit level. The useful life of an intangible asset with an indefinite life is reviewed annually to determine whether indefinite life assessment continues to be supportable. If not, the change in the useful life assessment from indefinite to finite is made on a prospective basis.

Investments

The Company’s investments are classified as either loans and receivables, held-to-maturity investments, and available-for-sale investments, as appropriate. When investments are recognised initially, they are measured at fair value. The Company determines the classification of its investments after initial recognition. All purchases and sales of investments are recognised on the settlement date, which is the date that the investment is delivered to or by the Company.

Non-derivative financial assets with fixed or determinable payments and fixed maturity are classified as held-to-maturity when the Company has the positive intention and ability to hold to maturity. During the period the Company did not held any investments in this category.

Available-for-sale investments are those non-derivative financial assets that are designated as available-for-sale or are not classified in any other of the preceding categories. After initial recognition available-for-sale investments are measured at fair value with gains or losses being recognised as a separate component of equity until the investment is derecognised or until the investment is determined to be impaired, at which time the cumulative gain or loss previously reported in equity is included in the statement of income. Reversals of impairment losses in respect of equity instruments are not recognised in the statement of income. Impairment losses in respect of debt instruments are reversed through profit or loss if the increase in fair value of the instrument can be objectively related to an event occurring after the impairment loss was recognised in the statement of income.

The fair value of investments that are actively traded in organised financial markets is determined by reference to quoted market bid prices at the close of business on the balance sheet date. For investments where there is no active market, fair value is generally determined using valuation techniques. Such techniques include using recent arm’s length market transactions; reference to the current market value of another instrument, which is substantially the same; discounted cash flow analysis. When due to the nature of the investment, the reliable determination of its fair value is impracticable by applying valuation techniques, such investments are stated at cost.

2. Summary of Significant Accounting Policies (continued)

Investments (continued)

1. Equity investments

The Company holds equity interests in various Russian legal entities (see Note 1). These investments are classified as available-for-sale.

Investments in unconsolidated subsidiaries and associated companies

Investments in companies not included in the consolidation are stated at cost in the consolidated balance sheet (refer to Note 4). When such cost, after considering effects of inflation, exceeded the amount of net assets of such subsidiaries and associated companies attributable to the Company, which were assessed on the basis of available financial information, limited generally to tax bases of assets and liabilities of such subsidiaries and associated companies, management considered such an excess as a permanent diminution in the value of the investment. Accordingly, the carrying amount of the investment was reduced to the estimated recoverable amount.

Other equity investments

Other equity investments represent entities in which the Company holds less than 20% ownership interest and does not exert significant influence. Other equity investments are recorded at acquisition cost.

2. Other investments

1) The Company holds investments in Government bonds traded in liquid markets. Such investments are classified as available-for-sale and are stated at their fair market values. A gain or loss on these investments arising from a change in their fair value is included in net profit or loss for the period in which it arises.

2) Long-term loans originated by the Company that have a fixed maturity are stated at amortized cost using the effective interest rate method. Gains and losses are recognised in the statement of income when the loans are derecognised or impaired, as well as through the amortization process.

When there is a diminution in value of equity or other investments that is other than temporary, the carrying amount of such investments is reduced to the estimated recoverable amount.

Inventories

Inventories, which include materials, fuel and spare parts, are valued at the lower of cost as determined by the weighted average method or net realizable value. Inventories are reported net of reserves for slow moving or obsolete items.

2. Summary of Significant Accounting Policies (continued)

Receivables

Receivables are stated at face value, after provision for doubtful accounts, which was estimated, based on known relevant factors affecting collectability. Ultimate losses may vary from the current estimates. These estimates are reviewed periodically, and as adjustments become necessary, they are reported as expense (income) in the period in which they become known.

Cash and Cash Equivalents

Cash consists of cash on hand and balances with banks. Cash equivalents comprise highly liquid investments with original maturities of three months or less.

Income Tax

Tax expense (tax income) is the aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

Current tax liabilities (assets) for the current and prior periods are measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantially enacted by the balance sheet date.

Deferred income taxes are determined utilizing the balance sheet liability method. This method gives consideration to the future tax consequences associated with the differences between the carrying amounts of assets and liabilities for financial reporting purposes and their tax bases.

Deferred income taxes are provided for all temporary differences arising between the tax bases of assets and liabilities and their carrying values for financial reporting purposes except where the deferred income tax arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss. The principal temporary differences arise in respect of property, plant and equipment.

A deferred tax asset is recorded only to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilized. Valuation allowances are provided for deferred tax assets that are not expected to be realised.

Deferred tax assets and liabilities are measured at tax rates that are expected to apply to the period when the asset is realized or the liability settled, based on tax rates that have been enacted or substantively enacted at the balance sheet date.

Deferred tax liabilities relating to undistributed earnings of subsidiaries and associated undertakings are provided when it is probable that such earnings will be remitted to the Company in the foreseeable future.

2. Summary of Significant Accounting Policies (continued)

Income Tax (continued)

Current tax and deferred tax are charged or credited directly to equity if the tax relates to items that are credited or charged, in the same or a different period, directly to equity, for example, changes in carrying amount arising from the revaluation and impairment of property, plant and equipment.

Tax effects related to the revaluation of tax base of assets and liabilities are credited or charged to equity in case such revaluation for tax purposes is related to an accounting revaluation. Otherwise, tax effects are recognised in the statement of income.

Deferred tax assets and liabilities are not discounted.

Revenue and Expense Recognition

Revenues are recognised when it is probable that the economic benefits associated with the transaction will flow to the enterprise and the amount of revenues can be measured reliably.

Revenues and expenses are accounted for at the time the actual flow of related goods and services occurs and transfer of risks and rewards has been completed, regardless of when cash or its equivalent is received or paid, and are reported in the statement of income in the period to which they relate.

In respect of services related to cargo transportation, revenue is recognised by reference to the stage of completion of the transportation at the balance sheet date provided that the stage of completion of the transportation and the amount of revenue can be measured reliably. In the event that either of the conditions above is not met as of the balance sheet date, the recognition of revenue is deferred to the date when transportation is completed, i.e. cargo delivered to the place of destination. The stage of completion is determined as a percentage of services performed to date to total services to be performed.

Any deliveries, which have been previously collected from the clients, initiated and not completed as of the date of the accompanying consolidated financial statements are reported as liabilities in respect of services in transit under the payables caption in the accompanying consolidated balance sheets (refer to Note 10). The amount of liabilities is reduced for the amount of revenues recognised by reference to the stage of completion of the delivery.

Mutual Offset and Barter

A portion of sales is settled through mutual offset and barter arrangements. Mutual offset and barter transactions are measured at the fair value of the goods and services received or given up, whichever is most reliably measured.

Management estimated that for the year ended 31 December 2005 and 2004 not more than approximately 1% of the Company’s sales were performed on a barter (offset) basis.

2. Summary of Significant Accounting Policies (continued)

Borrowing Costs

Borrowing costs generally are expensed as incurred. Borrowing costs are capitalised if they are directly attributable to the acquisition, construction or production of a qualifying asset. Capitalisation of borrowing costs commences when the activities to prepare the asset are in progress and expenditures and borrowing costs are being incurred. Borrowing costs are capitalised until the assets are ready for their intended use. If the resulting carrying amount of the asset exceeds its recoverable amount, an impairment loss is recorded. Borrowing costs include the interest charge and other costs incurred in connection with the borrowing of funds.

Foreign Currency

Monetary assets and liabilities denominated in foreign currencies at the year-end are reported at the rates of exchange of the Central Bank of Russia prevailing at the year-end.

Any gain or loss arising from a change in exchange rates subsequent to the date of the transaction is included as an exchange gain or loss in the statement of income.

Government Grants

Government grants related to income are recognised as income over the periods necessary to match them with the related cost, which they are intended to compensate. Grants received are treated as deferred income in the accompanying consolidated financial statements. Income relating to government grants is presented separately as a credit in the statement of income. Grants contributed towards the acquisition of property, plant and equipment are deducted from the cost of those assets.

Employee Benefits

Defined benefit plans

The Company operates two defined benefit pension plans. The obligation and cost of benefits under the plans are determined separately for each plan using the projected unit credit method. This method considers each year of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation. The cost of providing pensions is charged to the statement of income, so as to attribute the total pension cost over the service lives of employees in accordance with the benefit formula of the plan. This obligation is measured at the present value of estimated future cash flows using a discount rate that is similar to the interest on government bonds where the currency and terms of these bonds are consistent with the currency and estimated terms of the defined benefit obligation. Actuarial gains and losses are recognised as income or expense in full as they arise.

In addition, the Company provides certain other retirement and post retirement benefits to its employees. These benefits are unfunded.

Upon introduction of a new plan or improvement of an existing plan past service costs are recognised on a straight-line basis over the average period until the amended benefits become vested. To the extent that the benefits are already vested immediately, past service cost is immediately expensed.

2. Summary of Significant Accounting Policies (continued)

Employee Benefits (continued)

Defined contribution plans

In addition to the defined benefit plans described above, the Company also sponsors a defined contribution plan for certain of its employees. The plan covers active employees and provides for contributions ranging from 1.2% to 7.9% of salary. The Company's contributions relating to the defined contribution plan are charged to income in the year to which they relate.

State Plan

In addition, the Company is legally obligated to make contributions to the Russian Pension Fund, managed by the Russian Federation Social Security (a multi-employer defined contribution plan). The Company's only obligation is to pay the contributions as they fall due. As such, the Company has no legal obligation to pay and does not guarantee any future benefits to its Russian employees. The Company's contributions to the Russian Pension Fund relating to defined contribution plans are charged to income in the year to which they relate.

Contribution to the Russian Pension Fund together with other social contributions are included within a unified social tax ("UST"), which is calculated by the application of a regressive rate from 26% to 2% to the annual gross remuneration of each employee. UST is allocated to three social funds (including the Russian Pension Fund), where the rate of contributions to the Russian Pension Fund varies from 20% to 2%, respectively, depending on the annual gross salary of each employee.

Leases

Finance leases, which transfer to the Company substantially all the risks and benefits incidental to ownership of the leased item, are capitalized at the inception of the lease at the fair value of the leased property or, if lower, at the present value of the minimum lease payments. Lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are charged directly against income. Capitalized leased assets are depreciated on a straight-line basis over the shorter of the estimated useful life of the asset or the lease term unless there is a reasonable certainty that the Company will obtain ownership by the end of the lease term, in which case the assets are depreciated over their estimated useful lives.

Leases where the lessor retains substantially all the risks and benefits of ownership of the asset are classified as operating leases. Operating lease payments are recognised as an expense in the statement of income on a straight-line basis over the lease term.

2. Summary of Significant Accounting Policies (continued)

Research and Development Costs

Research costs are expensed as incurred. Development expenditure incurred on an individual project is carried forward when its future recoverability can reasonably be regarded as assured. Any expenditure carried forward is amortized over the period of expected future sales from the related project. The carrying value of development costs is reviewed for impairment annually when the asset is not yet in use or more frequently when an indication of impairment arises during the reporting year.

Provisions

A provision is recognised when the Company has a present obligation (legal or constructive) as a result of a past event and it is more likely than not that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligations. Provisions are reviewed at each balance sheet date and adjusted to reflect the current best estimate of management.

If the effect of time value of money is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognised as a borrowing cost.

Contingencies

Contingent liabilities are not recognised in the financial statements. They are disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.

Contingent assets are not recognised in the financial statements. Where an inflow of economic benefits is probable, they are disclosed.

Contractual Commitments

Contractual commitments comprise legally binding trading or purchase agreements with stated amount, price and date or dates in the future.

The Company discloses significant contractual commitments in the Notes to the financial statements.

The asset or liability under contractual commitments are not recognised in the financial statement until any of the parties performs in accordance with the contract and until any of the parties became legally liable to pay or entitled to receive the payment under the terms of the contract.

2. Summary of Significant Accounting Policies (continued)

Subsequent Events

Post-year-end events that provide additional information about the Company's position at the balance sheet date (adjusting events) are reflected in the financial statements. Post-year-end events that are not adjusting events are disclosed in the notes when material.

Segment Reporting

The Company's primary reporting format is business segments – cargo and passenger transportation. The operating businesses are organized and managed separately according to the nature of services provided, with each segment representing a strategic business unit that offers different products and serves different markets. Management believes that the Company operates in one geographical segment.

In addition, certain Company's branches and subsidiaries provide auxiliary services (repair and maintenance, energy re-sale, telecommunication and construction services) to external customers and other companies within the Company. None of these operations are of a sufficient size to be reported separately.

There are no sales or other transactions between the business segments.

Unallocated costs represent corporate expenses.

Segment assets consist primarily of property, plant and equipment, inventories, receivables and operating cash, and mainly exclude investments, intangible assets, deferred tax assets, tax prepayments and assets used for the enterprise as a whole.

Segment liabilities comprise operating liabilities and exclude items such as taxation, certain corporate borrowings and other liabilities pertaining to the enterprise as a whole.

Capital expenditure comprises additions to property, plant and equipment. Impairment loss and provisions relate only to those charges made against allocated assets.

(All amounts are in millions of Russian Rubles, unless stated otherwise)

2. Summary of Significant Accounting Policies (continued)

Segment Reporting (continued)

The following table presents revenue and profit and certain assets and liabilities information regarding the Company's business segments:

Year ended 31 December 2005

	Cargo	Passenger	Other	Total
Sales to third parties	584,716	94,578	69,955	749,249
Total revenue	**584,716**	**94,578**	**69,955**	**749,249**
Segment expenses	(378,025)	(110,011)	(60,029)	(548,065)
Segment result	**206,691**	**(15,433)**	**9,926**	**201,184**
Unallocated corporate expenses				(58,339)
Operating profit				**142,845**
Other income/(expenses), net				664
Interest expense, net				(5,213)
Foreign exchange loss, net				(186)
Income tax				(23,700)
Net profit				**114,410**

	Cargo	Passenger	Other	Total
Segment assets	839,390	252,920	75,559	1,167,869
Unallocated corporate assets				55,056
Consolidated total assets				**1,222,925**
Segment liabilities	131,522	32,874	10,696	175,092
Unallocated corporate liabilities				155,543
Consolidated total liabilities				**330,635**
Capital expenditure	153,798	48,292	13,328	215,418
Fixed assets	754,051	236,768	65,347	1,056,166
Provision for impairment	(22,540)	(5,598)	–	(28,138)
Depreciation of fixed assets	(47,257)	(13,302)	(2,801)	(63,360)

(All amounts are in millions of Russian Rubles, unless stated otherwise)

2. Summary of Significant Accounting Policies (continued)

Segment Reporting (continued)

Year ended 31 December 2004

	Cargo	Passenger	Other	Total
Sales to third parties	529,912	69,094	53,327	652,333
Total revenue	**529,912**	**69,094**	**53,327**	**652,333**
Segment expenses	(347,792)	(102,979)	(33,952)	(484,723)
Segment result	**182,120**	**(33,885)**	**19,375**	**167,610**
Unallocated corporate expenses				(75,194)
Operating profit				**92,416**
Other income/(expenses), net				3,811
Interest expense, net				(2,638)
Foreign exchange gain, net				113
Income tax				(16,899)
Net profit				**76,803**

	Cargo	Passenger	Other	Total
Segment assets	729,976	201,984	76,234	1,008,194
Unallocated corporate assets				55,239
Consolidated total assets				**1,063,433**
Segment liabilities	124,455	22,768	4,607	151,830
Unallocated corporate liabilities				133,416
Consolidated total liabilities				**285,246**
Capital expenditure	106,962	30,954	11,289	149,205
Fixed assets	656,859	190,092	69,321	916,272
Provision for impairment	(18,251)	(4,920)	–	(23,171)
Depreciation of fixed assets	(45,866)	(12,364)	(3,521)	(61,751)

3. Property, Plant and Equipment, Net

Property, plant and equipment as of 31 December 2005 and 2004 comprised the following:

Carrying Value

	Balance as of 31 December 2004	Additions	Disposals	Transfers	Balance as of 31 December 2005
Land	4,305	–	–	–	**4,305**
Buildings	102,647	327	(353)	16,314	**118,935**
Construction	228,694	5,459	(3,850)	32,279	**262,582**
Subgrade	135,386	–	–	6,161	**141,547**
Superstructure	146,468	28,832	(16,438)	6,926	**165,788**
Operating equipment	207,449	1,090	(5,641)	53,927	**256,825**
Locomotives	88,747	5,386	(5,577)	11,726	**100,282**
Transport, cargo	87,377	10,544	(3,889)	6,397	**100,429**
Transport, passenger	70,647	5,673	(5,896)	13,698	**84,122**
Non-production assets	18,213	–	–	–	**18,213**
Other fixed assets	48,116	57	(843)	6,904	**54,234**
Construction in progress	109,810	158,050	(223)	(154,332)	**113,305**
Less: provision for impairment	(23,171)	(4,967)	–	–	**(28,138)**
Total	**1,224,688**	**210,451**	**(42,710)**	**–**	**1,392,429**

(All amounts are in millions of Russian Rubles, unless stated otherwise)

3. Property, Plant and Equipment, Net (continued)

Carrying Value (continued)

	Balance as of 31 December 2003	**Additions**	**Disposals**	**Transfers**	**Balance as of 31 December 2004**
Land	4,305	–	–	–	**4,305**
Buildings	80,498	4	(96)	22,241	**102,647**
Construction	206,061	–	(94)	22,727	**228,694**
Subgrade	131,249	–	(117)	4,254	**135,386**
Superstructure	120,258	22,446	(3,627	7,391	**146,468**
Operating equipment	165,392	1,822	(2,138	42,373	**207,449**
Locomotives	78,313	796	(80)	9,718	**88,747**
Transport, cargo	79,572	5,835	(1,339	3,309	**87,377**
Transport, passenger	60,075	4,780	(180)	5,972	**70,647**
Non-production assets	18,213	–	–	–	**18,213**
Other fixed assets	38,256	27	(3,746	13,579	**48,116**
Construction in progress	115,852	125,522		(131,564	**109,810**
Less: provision for impairment	(9,598)	(13,573)			**(23,171)**
Total	**1,088,446**	**147,659**	**(11,417**	**–**	**1,224,688**

Property, plant and equipment as of 31 December 2005 and 2004 include borrowing costs incurred in connection with the construction of certain property, plant and equipment. Actual borrowing costs capitalized as property, plant and equipment during 2005 using a capitalization rate of 2.6% equated to Rbls 1,363. Borrowing costs capitalized as property, plant and equipment during 2004 were not material.

Accumulated depreciation

	Balance as of 31 December 2004	**Depreciation charge for the year**	**Accumulated depreciation on disposals**	**Balance as of 31 December 2005**
Land	–	–	–	–
Buildings	(6,176	(1,688	51	**(7,813**
Construction	(32,359	(6,917	1,948	**(37,328**
Subgrade	(12,459	(2,182	–	**(14,641**
Superstructure	(61,609	(8,857	8,172	**(62,294**
Operating equipment	(60,068	(15,418	5,342	**(70,144**
Locomotives	(57,269	(10,050	5,566	**(61,753**
Transport, cargo	(59,773	(9,979	3,874	**(65,878**
Transport, passenger	(26,831	(4,045	4,847	**(26,029**
Non-production assets	(3,788	(821)	–	**(4,609**
Other fixed assets	(11,255	(3,403	746	**(13,912**
Construction in progress	–	–	–	**–**
Total	**(331,587**	**(63,360**	**30,546**	**(364,401**

(All amounts are in millions of Russian Rubles, unless stated otherwise)

3. Property, Plant and Equipment, Net (continued)

Accumulated depreciation (continued)

	Balance as of 31 December 2003	**Depreciation charge for the year**	**Accumulated depreciation on disposals**	**Balance as of 31 December 2004**
Land	–	–	–	**–**
Buildings	(4,710	(1,472	6	**(6,176**
Construction	(26,059	(6,312	12	**(32,359**
Subgrade	(10,337	(2,131	9	**(12,459**
Superstructure	(53,482	(8,160	33	**(61,609**
Operating equipment	(46,338	(14,235	505	**(60,068**
Locomotives	(47,121	(10,196	48	**(57,269**
Transport, cargo	(50,126	(10,490	843	**(59,773**
Transport, passenger	(21,916	(4,981	66	**(26,831**
Non-production assets	(2,967	(821)	–	**(3,788**
Other fixed assets	(9,210	(2,953	908	**(11,255**
Construction in progress	–	–	–	**–**
Total	**(272,266**	**(61,751**	**2,430**	**(331,587**

Net book value

	Balance as of 31 December 2005	**Balance as of 31 December 2004**	**Balance as of 31 December 2003**
Land	**4,305**	**4,305**	4,305
Buildings	**111,122**	**96,471**	75,788
Construction	**225,254**	**196,335**	180,002
Subgrade	**126,906**	**122,927**	120,912
Superstructure	**103,494**	**84,859**	66,776
Operating equipment	**186,681**	**147,381**	119,054
Locomotives	**38,529**	**31,478**	31,192
Transport, cargo	**34,551**	**27,604**	29,446
Transport, passenger	**58,093**	**43,816**	38,159
Non-production assets	**13,604**	**14,425**	15,246
Other fixed assets	**40,322**	**36,861**	29,046
Construction in progress	**113,305**	**109,810**	115,852
Less: provision for impairment	**(28,138)**	**(23,171)**	(9,598)
Total	**1,028,028**	**893,101**	816,180

Included in property, plant and equipment are non-production assets in the net amount of Rbls 13,604 (2004: 14,425). Such assets primarily comprise social infrastructure assets and apartment buildings.

Management is of the opinion that expenditures incurred in respect of such objects qualify for capitalization on the basis of the fact that such expenditures are contributing indirectly to cash inflows to the Company through a reduction of cash outflows related to wages and salaries (refer to Note 2). Further, ongoing annual costs related to maintenance and operations of such assets are incurred by the Company.

(All amounts are in millions of Russian Rubles, unless stated otherwise)

3. Property, Plant and Equipment, Net (continued)

Net book value (continued)

Further, included in construction in process are certain projects with the aggregate cost of Rbls 24,988 (2004: 23,171), which the Company abandoned. Further included in Property, plant and equipment as of 31 December 2005 are items with the aggregate net carrying value of Rbls 3,150, which the Company concluded to be impaired. A 100% provision for impairment was recognised by the Company with regard to such assets as of 31 December 2005 and 2004. The corresponding expense of Rbls 4,967 was reported in 2005 (2004: 13,573) and included in other operating expenses.

During the year ended 31 December 2005, the Company received grants in the amount of Rbls 875 (2004: 705) related to the acquisition of property, plant and equipment. These grants were recognised in the accompanying consolidated financial statements by deducting the grants in arriving at the carrying amounts of the assets.

Leased assets as of 31 December 2005 and 2004, included above where the Company is a lessee under a finance lease, comprised the following:

	2005	2004
Cost capitalized finance leases	**38,669**	17,881
Accumulated depreciation	**(1,570)**	(573)
Net book value	**37,099**	17,308

Refer to Note 16 for further details regarding finance leases.

4. Investments, Net

Investments as of 31 December 2005 and 2004 comprised the following (refer to Notes 1 and 2 for explanations regarding basis of reporting of the investments):

	2005	2004
Investments in unconsolidated subsidiaries (1)	**1,908**	2,314
Investments in associated undertakings (2)	**2,692**	2,692
Impairment reserve	**(3,402)**	(4,909)
Total investments, net	**1,198**	97

(1) Investments in unconsolidated subsidiaries, net as of 31 December 2005 comprised:

	Nature of Business	% Equity Interest	Historical Cost	Related Reserve	Carrying Value
Lazur	Manufacturing	71%	1,010	(1,010)	–
Transkat	Manufacturing	57%	377	(377)	–
Russkaya Troika	Transportation services	50%	236	–	236
Other			285	(268)	17
Total			**1,908**	**(1,655)**	**253**

(All amounts are in millions of Russian Rubles, unless stated otherwise)

4. Investments, Net (continued)

Such investments as of 31 December 2004 comprised the following:

	Nature of Business	% Equity Interest	Historical Cost	Related Reserve	Carrying Value
Lazur	Manufacturing	71%	1,010	(1,010)	–
Transkat	Manufacturing	57%	377	(377)	–
Other			927	(892)	35
Total			**2,314**	**(2,279)**	**35**

(2) Investments in associated undertakings as of 31 December 2005 comprised the following:

	Nature of Business	% Equity Interest	Historical Cost	Related Reserve	Carrying Value
Raskom	Fiber-optic cables construction	46%	916	(916)	–
Ekza (A)	Manufacturing	25%	888	–	888
Other			888	(831)	57
Total			**2,692**	**(1,747)**	**945**

(A) Investment in Ekza represents an investment in a jointly controlled entity. Prior to 2005 uncertainty existed with respect of the Company's rights regarding its share in this joint venture. On this basis a 100% provision for diminution in value of this investment was recognised. In 2005 the parties to the joint venture completed determination of their shares in this entity. On this basis, the Company revised its assessment of the recoverability of its investment and reversed the provision for impairment previously recognised. Ekza commenced its operations in late 2005.

Such investments as of 31 December 2004 comprised the following:

	Nature of Business	% Equity Interest	Historical Cost	Related Reserve	Carrying Value
Raskom	Fiber-optic cables construction	46%	916	(916)	–
Ekza	Manufacturing	25%	888	(888)	–
Other			888	(826)	62
Total			**2,692**	**(2,630)**	**62**

Reversal of provision for diminution in value of investments in the amount of Rbls 883 and Rbls 88 was reported in the consolidated statements of income for the years ended 31 December 2005 and 2004, respectively.

During 2005, the Company continued disposing of a number of its investments in subsidiaries and associated undertakings. The proceeds from the disposal of these investments equated to nil in both 2005 and 2004.

(All amounts are in millions of Russian Rubles, unless stated otherwise)

5. Other Investments, Net

Other investments, net as of 31 December 2005 and 2004 comprised the following:

	2005	**2004**
Other equity investments (1)	**316**	327
Other investments (2)	**1,450**	2,349
Impairment reserve	**(472)**	(511)
Total other investments, net	**1,294**	2,165

(1) Other equity investments as of 31 December 2005 comprised the following:

	Nature of Business	**% Equity Interest**	**Cost**	**Related Reserve**	**Carrying Value**
Muromsky Strelochniy Zavod	Manufacturing	13%	112	(112)	–
Other			204	(195)	9
Total			**316**	**(307)**	**9**

Such investments, net as of 31 December 2004 comprised the following:

	Nature of Business	**% Equity Interest**	**Cost**	**Related Reserve**	**Carrying Value**
Muromsky Strelochniy Zavod	Manufacturing	13%	112	(112)	–
Other			215	(207)	8
Total			**327**	**(319)**	**8**

(2) Other investments as of 31 December 2005 and 2004 comprised the following:

	2005			**2004**		
	Cost	**Related Reserve**	**Carrying Value**	**Cost**	**Related Reserve**	**Carrying Value**
Promissory notes FK “Locomotive”	**580**	**–**	**580**	–	–	–
Promissory notes ZAO “Baltiyskiy bank”	**371**	**–**	**371**	–	–	–
Other	**499**	**(165)**	**334**	2,349	(192)	2,157
Total	**1,450**	**(165)**	**1,285**	2,349	(192)	2,157

Reversal of provision for diminution in value of investments in the amount of Rbls 39 (2004: 47) was reported in the consolidated statements of income for the years ended 31 December 2005 and 2004, respectively.

(All amounts are in millions of Russian Rubles, unless stated otherwise)

6. Inventories, Net

Inventories as of 31 December 2005 and 2004 comprised the following:

	2005	2004
Raw materials	**28,527**	26,672
Fuel and lubricants	**4,407**	3,791
Spare parts and construction materials	**10,569**	8,011
Merchandise inventories	**1,318**	1,645
Other	**4,988**	1,282
Total	**49,809**	41,401
Less: provision for obsolete and damaged inventory	**(4,339)**	(3,266)
Total inventories, net	**45,470**	38,135

7. Prepayments and Other Current Assets, net

Prepayments and other current assets as of 31 December 2005 and 2004 comprised the following:

	2005	2004
Input VAT	**61,293**	43,703
Less: Long-term portion (A)	**–**	(1,163)
Less: Valuation allowance (B)	**(2,680)**	–
	58,613	42,540
Prepaid taxes	**2,916**	11,039
Less: Long-term portion (A)	**–**	(5,686)
	2,916	5,353
Advances paid to suppliers	**4,463**	3,443
Other current assets	**2,859**	1,510
Total prepayments and other current assets	**68,851**	52,846

(A) Long-term portion of input VAT of Rbls 1,163 and prepaid VAT of Rbls 5,686 as of 31 December 2004 related to export sales with 0% VAT rate. During 2004 the Company was involved in a series of litigations with tax authorities with respect to the right to offset the above VAT balances. Taking into account that such court cases' resolution usually extends beyond the twelve months period, the Company classified the above amounts as long-term in the accompanying consolidated balance sheet as of 31 December 2004. During 2005 the Company successfully defended its right to offset VAT.

(B) A 100% provision was recognised by the Company as of 31 December 2005 with respect of input VAT related to construction in process projects abandoned (refer to Note 3).

(All amounts are in millions of Russian Rubles, unless stated otherwise)

8. Receivables, Net

Receivables as of 31 December 2005 and 2004 comprised the following:

	2005	2004
Trade receivables, net (1)	**4,063**	4,513
Other accounts receivable, net (2)	**11,519**	7,163
Total receivables, net	**15,582**	11,676

(1) Trade receivables as of 31 December 2005 and 2004 comprised the following:

	2005	2004
Trade receivables	**6,469**	19,458
Less: provision for doubtful accounts	**(2,406)**	(14,945)
Total trade receivables, net	**4,063**	4,513

Approximately 35% of the provision balance recognised as of 31 December 2004 was recorded in connection with a related party receivable. During 2005 the Company wrote-off receivables from this related party against the related reserve. The Company has discontinued business with this related party.

(2) Other accounts receivable as of 31 December 2005 and 2004 comprised the following:

	2005	2004
Other accounts receivable	**15,469**	12,250
Less: provision for doubtful accounts	**(3,950**	(5,087
Total other accounts receivable, net	**11,519**	7,163

Bad debt expense of Rbls 285 was recognised during the year ended 31 December 2005 (2004: 2,571).

9. Cash and Cash Equivalents

Cash and cash equivalents as of 31 December 2005 and 2004 comprised the following:

	2005	2004
Cash in local currency	**11,765**	9,911
Cash in foreign currencies	**435**	734
Total cash and cash equivalents	**12,200**	10,645

(All amounts are in millions of Russian Rubles, unless stated otherwise)

10. Payables

Payables as of 31 December 2005 and 2004 comprised the following:

	2005	2004
Trade payables	**30,649**	37,440
Liabilities to customers	**33,288**	27,653
Other accounts payable	**11,067**	12,150
Total payables	**75,004**	77,243

Liabilities to customers as of 31 December 2005 and 2004 comprised the following:

	2005	2004
Advances received from customers	**28,417**	23,248
Services in transit	**4,871**	4,405
Total liabilities to customers	**33,288**	27,653

11. Taxes and Similar Charges Payable

Taxes and similar charges payable as of 31 December 2005 and 2004 comprised the following:

	2005	2004
VAT	**14,464**	7,736
Income tax	**1,545**	2,595
Settlements with social funds	**4,961**	4,279
Property tax	**4,028**	2,848
Personal income tax	**1,744**	1,961
Other taxes	**807**	1,237
Total taxes and similar charges payable	**27,549**	20,656

12. Long-Term and Short-Term Borrowings

Short-term Borrowings

Short-term borrowings as of 31 December 2005 and 2004 comprised the following:

	2005	2004
Bank loans (A)	**16,809**	15,433
MPS / EBRD loan (B)	**1,206**	1,415
Bonds (C)	**–**	4,121
Other	**77**	–
Total short-term borrowings	**18,092**	20,969

(All amounts are in millions of Russian Rubles, unless stated otherwise)

12. Long-Term and Short-Term Borrowings (continued)

Short-term Borrowings (continued)

(A) Bank loans as of 31 December 2005 and 2004 comprise short-term loans obtained from various Russian banks, including loans from Gazprombank of Rbls 8,765 (2004: 1,001), Sberbank of Russia of Rbls 3,503 (2004: 8,042), TransCreditBank of Rbls nil (2004: 1,564) and VneshtorgBank of Rbls nil (2004: 4,017). These banks are considered related parties to the Company (refer to Note 22).

Further, included in short term loans as of 31 December 2005 are loans obtained from Dresdner Bank of Rbls 2,511 (2004: nil) and International Moscow Bank of Rbls 1,004 (2004: nil).

For the year ended 31 December 2005 interest rates on such loans varied from 5.5% to 7.5% (2004: 6% to 25%).

(B) Loan from European Bank for Reconstruction and Development (the EBRD) / MPS.

The MPS / EBRD loan as of 31 December 2005 and 2004 represents a US dollar denominated loan obtained by MPS under a credit line agreement signed between the government of the Russian Federation and the EBRD in 1996, which was then assigned to MPS. As a result of reorganization of MPS (refer to Note 1), RZD assumed responsibility previously reported by MPS, including the outstanding balance of the EBRD loan referred to above (on terms and conditions of the original loan agreement between MPS and the EBRD). In 2004 the Company signed additional agreement with MPS, Ministry of Finance and Federal Agency on Railroad Transport, under which MPS obligations and rights under the EBRD loan agreement referred to above were formally re-assigned to RZD.

The total amount of the credit line provided by the EBRD equates to USD 120,130 thousand. In 2004 the credit line was reduced at the request of the Company to USD 110,163 thousand. The outstanding balance of the loan drawn by the Company as of 31 December 2005 including accrued interest equated to USD 41,884 thousand (Rbls 1,206 at the exchange rate as of 31 December 2005) (2004: USD 51,000 (Rbls 1,415 at the exchange rate as of 31 December 2004)). The interest rate equates to LIBOR + 0.75% (LIBOR equated to 4.8% and 3.1% as of 31 December 2005 and 2004, respectively). The loan is not secured.

Repayments of the above debt under the original terms of the credit line agreement were scheduled as of 31 December as follows:

	2005 Principal amount		**2004 Principal amount**	
	in original currency (USD'000)	**(millions of Rubles)**	**in original currency (USD'000)**	**(millions of Rubles)**
2005	–	–	10,200	283
2006	**10,200**	**294**	10,200	283
2007	**10,200**	**294**	10,200	283
2008 and thereafter	**20,400**	**587**	20,400	566
Total	**40,800**	**1,175**	51,000	1,415

(All amounts are in millions of Russian Rubles, unless stated otherwise)

12. Long-Term and Short-Term Borrowings (continued)

Short-term Borrowings (continued)

As of 31 December 2005 and 2004, the Company did not comply with certain covenants stipulated in the loan agreement with the EBRD. Under provisions of the loan agreement referred to above, EBRD had the right to demand on immediate repayment of the full outstanding amount of the loan.

During 2005 and 2004 the Company did not receive any formal notice from the EBRD waiving its right to demand the immediate repayment of the loan. On this basis, the whole amount of the loan above outstanding as of 31 December 2005 and 2004 was classified as short-term (refer to Note 25).

(C) This amount represents bonds issued by the Company in December 2004 with maturity of less than 12 months after 31 December 2004 (refer to Long-Term Borrowing section below for further comments). The bonds were redeemed in full in 2005.

Long-term Borrowings

2005

The outstanding balances of long-term borrowings as of 31 December 2005 comprised the following:

	Original currency	**Amount in original currency**	**Amount in Rbls**
Syndicated bank loans (A)			
Tranche A	USD	300 mln	**8,635**
Tranche B	USD	300 mln	**8,635**
			17,270
Bonds (B)			**33,000**
Other			**469**
Total			**50,739**

(A) In October 2005 the Company obtained a US dollar denominated loan from a consortium of international banks led by Barclyas Capital, Dresdner Kleinwort Wasserstein, HSBC Bank plc, Raiffeisen Zentralbank Osterreich AG. The loan attracts interest calculated as an aggregate of MARGIN (0.75% per annum with respect of Tranche A and 0.90% per annum with respect of Tranche B), LIBOR and mandatory cost (additional interest as calculated by the loan agent in accordance with the provisions of the agreement).

The loan is repayable as follows:

a) Tranche A – in three years from the date of its utilization;

b) Tranche B – in five equal semi-annual installments commencing 36 months after the date of the agreement.

(All amounts are in millions of Russian Rubles, unless stated otherwise)

12. Long-Term and Short-Term Borrowings (continued)

Long-term Borrowings (continued)

The loan agreement provides for certain covenants (including financial ratios), which the Company is obligated to comply with. Non-compliance with these covenants gives the lenders the right to demand on immediate repayment of the loan.

The loan is not secured.

(B) In November and December 2005 the Company issued 3 tranches / series of bonds with the face value of Rbls 1 thousand. The aggregate amount of each series is as follows:

	Amount	**Coupon rate (%)**	**Maturity**
Series 04	10,000	6.59	2007
Series 06	10,000	7.35	2010
Series 07	5,000	7.55	2012
Total	**25,000**		

Coupon interest is paid semi-annually. The repayment of the Company’s bonds is guaranteed by Trans-Invest LLC, a subsidiary of non-state pension Fund “Blagosostoyanie”, which is a related party (refer to Note 22).

The aggregate amount of bonds outstanding as of 31 December 2005 comprised bonds of Series 2 and 3 issued in 2004 (refer below) and Series 4, 6 and 7 issued in 2005 as outlined above.

The amount of accrued interest on these bonds equated to Rbls 215 as of 31 December 2005.

2004

In December 2004 the Company issued 3 tranches / series of bonds with the face value of Rbls 1 thousand. The aggregate amount of each series is Rbls 4,000. These series mature in 1, 3 and 5 years from the date of issuance. Bonds have coupons as follows:

	Series 1 (maturity 1 year)	**Series 2 (maturity 3 years)**	**Series 3 (maturity 5 years)**
Coupon rate	6.59%	7.75%	8.33%

Coupon interest is paid semi-annually. The repayment of the Company’s bonds is guaranteed by the Company’s 100% subsidiary – KRP-Invest. Due to the fact that financial position and results of operations of this subsidiary are immaterial, investment in this subsidiary of Rbls 14 was reported in the financial statements as of 31 December 2004 at cost, net of provision for diminution in value.

Long-term borrowings as of 31 December 2004 comprised Ruble-denominated bonds issued by the Company with maturity of more than 12 months after 31 December 2004.

(All amounts are in millions of Russian Rubles, unless stated otherwise)

13. Other Long-Term Debt

Other long-term debt as of 31 December 2005 and 2004 comprised the following:

	2005	2004
Long-term tax liabilities	**13,067**	20,662
Less: current portion of long-term tax liabilities	**–**	–
Long-term tax liabilities, net	**13,067**	20,662
Other	**244**	–
Total other long-term debt	**13,311**	20,662

In December 2001 the Government of the Russian Federation issued a decree allowing MPS to restructure the repayment schedule of a portion of its tax liabilities upon signing an agreement concerning such restructuring with the tax authorities. These agreements allowed individual departments of MPS and, pursuant to the reorganisation discussed in Note 1, of the Company, as defined in Note 1, to defer the repayment of tax obligations accumulated as of 1 December 2001 under the provision that tax liabilities arising in periods subsequent to the date referred to above and the agreed portion of the restructured tax debts are paid timely as they fall due. On this basis the amount of Rbls 13,067 (2004: 20,662) was reported in the accompanying consolidated balance sheet as other long-term debt.

The restructured tax liability as of 31 December 2005 and 2004 comprised the following:

	2005	2004
VAT	**7,928**	7,958
Income tax	**1,921**	5,025
Other taxes	**3,218**	7,679
Restructured tax liability	**13,067**	20,662

Under the terms of the Government Decree referred to above, the restructured tax liability bears interest of 5.5% per annum payable in quarterly installments.

Repayments of these obligations are scheduled as follows:

	2005	2004
2006	**–**	–
2007	**–**	–
2008 and thereafter	**13,067**	20,662
Total	**13,067**	20,662

The tax restructuring agreements referred to above specify that in the event of the Company's non-compliance with the repayment term referred to above and further, in case of delays of settlement of the current tax liabilities, the tax authorities have the right to call the full amount of the restructured tax liabilities for immediate repayment.

13. Other Long-Term Debt (continued)

During 2004 the Company repaid in full the principal amount of the restructured taxes. Accordingly, the balance outstanding as of 31 December 2004 comprised only restructured tax related fines and penalties. The Government Decree referred to above specifies that in case of repayment of the principal amount of the restructured tax liabilities in compliance with the agreed upon repayment schedule, the restructured tax related fines and penalties are to be forgiven as consented to by the tax authorities. During 2005 approximately Rbls 7,595 of the restructured fines and penalties were forgiven. A corresponding gain is included in the statement of income for the year ended 31 December 2005 and is reported as taxes other than income tax in the amount of Rbls 4,491, and income tax in the amount of Rbls 3,104. Although, there is some uncertainty exists as to whether the gain on such forgiveness recognised in 2005 is subject to income tax, management believes that the probability of these gains being considered taxable is remote. Accordingly, no related provision for income tax was recognised as of 31 December 2005.

With regard to the residual balance of deferred fines and penalties of Rbls 13,067 the Company believes that all conditions set forth by the Government Decree above for deferred fines and penalties forgiveness have been met and expects to receive a confirmation from the tax authorities on such forgiveness. In the absence of such a confirmation as of 31 December 2005, the Company did not recognise any gain resulting from extinguishment of this debt and reported fines and penalties above as other long-term debt.

Subsequent to the change in tax legislation effective from 1 January 2006, the gains on forgiveness of the above amount will be taxed when recognised.

14. Pension Plans and Employee Benefits

The Company provides defined benefit and defined contribution pension plans covering substantially all of its employees, requiring contributions to be made to a separately administered non-state pension fund "Blagosostoyanie" and not-for-profit fund "Pochet". Pension entitlements are accrued using the projected unit credit method.

In order to be entitled to pension through the non-state pension fund "Blagosostoyanie" a person should meet the following criteria:

1) active participants in defined benefit plan[(A)] born before 1967 – 15 years of past service with the Company or 10 years of participation in the defined benefit plan;
2) all other employees who are not active participants in the defined benefit plan[(A)] referred to above or in defined contribution plans:
   i. joined pension plan before 1 January 2005 – 15 years of past service with the Company, including 5 years of continuing service before retirement;
   ii. joined pension plan after 1 January 2005 – 15 – 20 years (15 years for women, 20 years for men) of continuing service before retirement;
3) employees (including active participants in defined benefit plan[(A)]) should retire from the Company.

(A) An active participant in defined benefit plan is a person, making contributions to the pension plan at his/her own expense. Such contributions are matched by the Company.

(All amounts are in millions of Russian Rubles, unless stated otherwise)

14. Pension Plans and Employee Benefits (continued)

Not-for-profit fund "Pochet" provides pensions to employees of the Company retired before the defined benefit plans provided through the non-state pension fund "Blagosostoyanie" referred to above were introduced.

Benefits accrued through pension plan administered by non-state pension fund "Blagosostoyanie" are partially funded, whilst benefits administered by not-for-profit fund "Pochet" are unfunded.

In addition, the Company provides other retirement and post employment benefits to its employees, which comprise a once per year free of charge transportation on long-distance trains and one-time bonus on retirement ranging from 1 to 6 monthly salaries and depending on the duration of the service period and some other. These benefits are unfunded.

Similarly to pension plans above, entitlements to such additional benefits are accrued using the projected unit credit method. During the year ended 31 December 2005 the Company increased some of these benefits. Such benefits which vested immediately were recognised as past service in the statement of income for the year ended 31 December 2005.

There were approximately 1.3 million employees eligible to some part of the post employment and post retirement benefit program of the Company as of both 31 December 2005 and 2004, of which 277,000 and 320,000 employees were considered active participants in the defined benefit pension plan as at 31 December 2005 and 31 December 2004. In addition, there are approximately 608,000 and 591,000 retired employees eligible for the post retirement benefit program of the Company provided through not-for-profit fund "Pochet" as of 31 December 2005 and 2004.

The amounts recognised in the consolidated balance sheet are as follows:

As of 31 December 2005:

	Blago-sostoyanie	**Pochet**	**Other post-employment benefits**	**Total**
Present value of defined benefit obligations	34,853	15,815	20,525	**71,193**
Fair value of plan assets	(2,941)	–	–	**(2,941)**
Present value of unfunded defined benefit obligations	31,912	15,815	20,525	**68,252**
Unrecognised past service cost	(12,213)	–	(2,295)	**(14,508)**
Net pension liability in the balance sheet	19,699	15,815	18,230	**53,744**

(All amounts are in millions of Russian Rubles, unless stated otherwise)

14. Pension Plans and Employee Benefits (continued)

As of 31 December 2004:

	Blago-sostoyanie	**Pochet**	**Other post-employment benefits**	**Total**
Present value of defined benefit obligations	35,650	16,837	17,645	**70,132**
Fair value of plan assets	(1,872)	–	–	**(1,872)**
Present value of unfunded defined benefit obligations	33,778	16,837	17,645	**68,260**
Unrecognised past service cost	(19,425)	–	(1,442)	**(20,867)**
Net pension liability in the balance sheet	14,353	16,837	16,203	**47,393**

The amounts recognised in the consolidated statement of income, which are included in "Wages, salaries and related contributions", are as follows:

For the year ended 31 December 2005:

	Blago-sostoyanie	**Pochet**	**Other post-employment benefits**	**Total**
Current service cost	2,840	–	1,236	**4,076**
Interest on benefit obligations	2,966	1,391	1,626	**5,983**
Expected return on plan assets	(205)	–	–	**(205)**
Actuarial loss	1,771	36	–	**1,807**
Loss on settlement	4,055	–	–	**4,055**
Amortization of past service cost	3,157	–	808	**3,965**
Net expense for the year	14,584	1,427	3,670	**19,681**

For the year ended 31 December 2004:

	Blago-sostoyanie	**Pochet**	**Other post-employment benefits**	**Total**
Current service cost	2,487	–	850	**3,337**
Interest on benefit obligations	2,604	1,441	1,327	**5,372**
Expected return on plan assets	(178)	–	–	**(178)**
Actuarial loss	–	266	13	**279**
Amortization of past service cost	3,010	–	147	**3,157**
Net expense for the year	7,923	1,707	2,337	**11,967**

(All amounts are in millions of Russian Rubles, unless stated otherwise)

14. Pension Plans and Employee Benefits (continued)

Movements in the net liability recognised in the consolidated balance sheets are as follows:

	2005	2004
Net liability at the 1 January	**47,393**	43,677
Net expense recognised in the statement of income	**19,681**	11,967
Contributions	**(13,330)**	(8,251)
Net liability at 31 December	**53,744**	47,393

Movements in the net assets of defined benefit pension plans during 2005 and 2004 were as follows:

	2005	2004
Fair value of plan assets at 1 January	**1,872**	867
Actual return on plan assets	**205**	178
Employer contributions	**13,330**	8,251
Settlement of liability	**(8,375)**	(4,058)
Benefits paid	**(4,091)**	(3,366)
Fair value of plan assets at 31 December	**2,941**	1,872

As of 31 December 2005 and 2004 actuarial assumptions used were as follows:

	2005	2004
Discount rate	**8.52%**	8.52%
Rate used for calculation of annuity value	**4.00%**	4.00%
Average remaining working life	**19 years**	19 years
Expected return on plan assets	**14.00%**	14.00%
Mortality tables	**year 1994**	year 1994

The Company further assumed that salary will increase in future in line with inflation rate.

15. Accrued and Other Current Liabilities

Accrued and other current liabilities as of 31 December 2005 and 2004 comprised the following:

	2005	2004
Provision for tax liabilities (Note 23)	**37,175**	53,510
Settlements with employees	**17,124**	13,184
Provision for legal claims (Note 23)	**3,849**	5,992
Provision for social infrastructure assets transferred to municipalities (Note 1)	**2,515**	4,411
Other liabilities	**1,806**	40
Total accrued and other liabilities	**62,469**	77,137

(All amounts are in millions of Russian Rubles, unless stated otherwise)

16. Finance Lease Liabilities

During 2005 and 2004, the Company entered into several finance lease agreements for cargo and passenger transport, locomotives and other operating equipment. The lease agreements are for periods from 1.5 to 9 years with the effective interest rate varying from 8.7% to 69.9% p.a. Future minimum lease payments together with the present value of the net minimum lease payments as of 31 December 2005 and 2004 are as follows:

	2005	**2004**
Finance lease liabilities – minimum lease payments		
Not later than 1 year	**10,230**	4,661
Later than 1 year and not later than 5 years	**28,869**	13,189
Later than 5 years	**6,176**	2,573
Total minimum lease payments	**45,275**	20,423
Less: interest	**(15,548)**	(7,301
Present value of minimum lease payments	**29,727**	13,122
Representing lease liabilities		
Current	**5,557**	2,477
Non-current	**24,170**	10,645

Depreciation of property, plant and equipment under these finance lease agreements for 2005 was equal to Rbls 1,025 (2004: 377) (see also Note 3). Finance charges for the year ended 31 December 2005 amounted to Rbls 3,676 (2004: 1,539) and are included in "Interest expense and similar items, net" in the accompanying consolidated statement of income.

17. Taxes Other than Income Tax, Net

Included in the amount of taxes other than income tax expense for the years ended 31 December 2005 and 2004 are the amounts of Rbls 16,335 and Rbls 20,931, which represent a reversal of provision for tax liabilities recognised by the Company (refer to Note 15).

18. Social Expenses

Social expenses for the years ended 31 December 2005 and 2004 comprised the following:

	2005	**2004**
Expenses of healthcare and educational departments	**2,345**	8,170
Expenses related to social infrastructure assets transferred to municipalities (refer to Note 15)	**378**	3,822
Social assets maintenance (refer to Note 1)	**4,004**	5,783
Other miscellaneous social expenses	**1,854**	59
Total social expenses	**8,581**	17,834

(All amounts are in millions of Russian Rubles, unless stated otherwise)

18. Social Expenses (continued)

Further, for the purposes of the presentation in the accompanying consolidated financial statements, certain other social expenses were classified and reported based on their nature under appropriate headings in the accompanying consolidated statements of income.

19. Other Income/(expenses), net

Other income/(expenses), net for the years ended 31 December 2005 and 2004 comprised the following:

	2005	2004
Loss on disposals of property, plant and equipment, net	**(11,592)**	(5,767)
Gain on disposal of inventory, net	**842**	1,290
Other income, net	**14,267**	17,893
Reversal of / (provision for) legal claims (Note 23)	**2,170**	(1,560)
Other expenses, net	**(5,945)**	(8,180)
Total other income/(expenses), net	**(258)**	3,676

Included in other income, net for the year ended 31 December 2005 is the amount of Rbls 8,256 (2004: 8,005), which represents income from rent of cargo cars. Further included in other income, net for the year ended 31 December 2005 is the amount of penalties charged by the Company to its customers of Rbls 5,655 (2004: 5,743).

20. Equity

The share capital of the Company as of 31 December 2005 and 2004 consists of 1,535,700,000 authorized, issued and outstanding common shares with par value of Rbls 1 thousand. The sole shareholder of the Company is the Russian government, which is allowed one vote per share.

The issued shares were paid through a contribution of net assets previously owned by MPS and further a contribution of land of Rbls 4,305 (refer to Note 3).

All common shares are eligible for distribution of earnings available in accordance with the Russian statutory accounting regulations. Dividends may only be declared from accumulated undistributed and unreserved earnings as shown in the Russian statutory financial statements. Dividends are subject to a 9% (2004: 6%) withholding tax. Approximately Rbls 9,751 and Rbls 8,754 were available for dividends as of 31 December 2005 and 2004, respectively, under the Russian statutory accounting regulations. The amount of dividends declared and paid by the Company in 2005 equated to Rbls 875 (2004: 587).

(All amounts are in millions of Russian Rubles, unless stated otherwise)

21. Income Taxes

Total accumulated temporary differences that arise between the Russian statutory tax base of assets and liabilities and their carrying amounts in the accompanying consolidated balance sheets, which relate primarily to revaluation of property, plant and equipment for tax purposes and payables, give rise to the following deferred tax effects:

Deferred Tax Assets

	2005	2004
Valuation of property, plant and equipment	**72,459**	100,124
Employee benefit obligations	**4,728**	7,374
Valuation of inventory and related reserves	**1,562**	1,555
Valuation of accounts receivable	**1,264**	1,413
Payables / Accruals	**12,158**	6,027
Other	**288**	552
Total deferred tax asset	**92,459**	117,045
Unrecognised portion of deferred tax asset	**(49,753)**	(72,252)
Balance as of 31 December	**42,706**	44,793

Tax effects of temporary differences referred to above are measured at the tax rates that are expected to apply to the periods when the asset is realized or the liability is settled, based on tax rates that have been enacted or substantively enacted by the balance sheet date. Commencing from 1 January 2002 the Government of the Russian Federation enacted the national income tax rate of 24%.

Although certain indicators of improvement of the Company’s performance, primarily the existence of taxable profits, which were sufficient to realise a portion of the temporary differences, which gave rise to the deferred tax asset above, in part related to depreciation charge for the period as calculated in respect of tax base of property, plant and equipment, were present as of 31 December 2005 and 2004, however, in management’s opinion the continuation of positive trends noted with regard to 2005 and 2004 performance cannot be currently ascertained due to significant uncertainties in respect of possible changes in the tariff setting policy and further implementation of railroad industry restructuring program as more fully discussed in Note 23. The factors above made the availability in the future of sufficient taxable profit, against which the deductible temporary differences giving rise to the deferred tax asset above can be utilized, uncertain.

On this basis 69% of the amount of the deferred tax asset related to property, plant and equipment was not recognised as of 31 December 2005 and 2004.

Further, due to the reasons above, 19% of the amount of deferred tax asset related to other deductible temporary differences was not recognised as of 31 December 2004.

(All amounts are in millions of Russian Rubles, unless stated otherwise)

21. Income Taxes (continued)

Deferred Tax Assets (continued)

During 2005 the Company re-assessed future deductibility of certain temporary differences and derecognised the related deferred tax assets (refer below). Simultaneously, the Company increased the recognised part of the deferred tax asset related to other temporary differences, previously considered uncertain for deductibility.

The remaining balance of the recognised deferred tax asset of Rbls 42,706 (2004: 44,793) represents deferred tax effects related to the amount of temporary differences which in management's opinion can be utilized based on the assessment of taxable profit, which is expected to be available in the future. This deferred tax asset will be realized through the recognition of a higher depreciation expense for tax purposes in comparison with depreciation expense for accounting purposes in the future periods.

Provision for current income taxes is calculated on the basis of income, which is determined in accordance with the Russian statutory tax regulations.

Income taxes for the years ended 31 December 2005 and 2004 comprised the following:

	2005	**2004**
Current tax charge per Russian accounting regulations	**24,717**	19,561
Deferred tax charge / (credit), net	**2,087**	(1,593)
	26,804	17,968
(Forgiveness of) penalties related to income tax	**(3,104)**	(1,069)
Total income taxes	**23,700**	16,899

A reconciliation of theoretical income tax to the actual income tax expense recorded in the consolidated statements of income for the years ended 31 December 2005 and 2004 is as follows:

	2005	**2004**
Income before taxation	**138,110**	93,702
Statutory income tax rate	**24%**	24%
Theoretical tax expense at statutory rate	**33,146**	22,488
Add (deduct) tax effect of:		
Non-deductible / (taxable) differences:		
(reversal of) provision for tax liabilities and legal claims (refer to Note 15)	**(4,880)**	(4,069)
(reversal of) provision for diminution in value of investments	**(212)**	–
non-deductible social and other expenses, net	**15,125**	8,439
bad debt expense	**932**	617
loss on disposals of property, plant and equipment and impairment	**1,192**	3,262
	45,303	30,737
Derecognised deferred tax asset	**4,000**	–
Change in unrecognised portion of deferred tax asset	**(22,499)**	(12,769)
Total income taxes	**26,804**	17,968

22. Related Party Transactions

As defined by IAS 24 "Related Party Disclosures" the counter parties, which meet the following criteria, are treated as related parties of the reporting company:

a. enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise. (This includes holding companies, subsidiaries and fellow subsidiaries);

b. associates - enterprises in which the company has significant influence and which is neither a subsidiary nor a joint venture of the investor;

c. individuals owning, directly or indirectly, an interest in the voting power of the company that gives them significant influence over the company, and anyone expected to influence, or be influenced by, that person in their dealings with the company;

d. key management personnel, that is, those persons having authority and responsibility for planning, directing and controlling the activities of the company, including directors and officers of the company and close members of the families of such individuals;

e. enterprises in which a substantial interest in the voting power is owned, directly or indirectly, by any person described in (c) or (d) or over which such a person is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the company and enterprises that have a member of key management in common with the company;

f. the party is a post-employment benefit plan for the benefit of employees of the entity.

In considering each possible related party relationship, attention is directed to the substance of the relationship, and not merely the legal form.

(All amounts are in millions of Russian Rubles, unless stated otherwise)

22. Related Party Transactions (continued)

The Company entered into a variety of transactions with related parties during the years ended 31 December 2005 and 2004. The most significant of these transactions are as follows (for description of the nature of relationships between the Company and its related parties refer to definitions in a.-f. above):

2005:

Related party	Nature of relations	Type of service / product	Sales / Income	(Purchases) / (Expenses)	Accounts receivable at 31 December	(Accounts payable) at 31 December
State-controlled companies:						
1. Services rendered						
Rosneft and subsidiaries	(a)	Cargo transportation	13,636	–	–	(567)
Ministries of the Russian Federation	(a)	Cargo transportation, telecommunication services	15,106	–	364	–
Financing received from Regional and Federal budgets	(a)	Compensations for passenger transportation	1,628	–	237	–
Other	(a)		2,173	–	369	–
2. Purchases						
RAO "EES"	(a)	Electricity	–	(50,520)	76	–
FGUP "VO ZD transporta Rossii"	(a)	Security services	–	(8,117)	–	(607)
FGUP "VNIIAS"	(a)	Research and development works	–	(2,128)	–	(548)
FGUP "VNIIZT"	(a)	Research and development works	–	(1,846)	–	(692)
Other	(a)		222	(2,240)	1,000	(1,053)
3. Financial services						
Gazprombank	(a)	Loans payable	–	–	–	(8,765)
Sberbank	(a)	Loans payable	–	–	–	(3,503)
Other companies:						
OAO "ZHASO"	(e)	Insurance expense	–	(5,152)	–	(5)
		Premiums received by medical organizations	4,176	–	–	–
Blagosostoyanie	(f)	Non-state pension fund	–	(9,895)	–	(369)
Pochet	(f)	Not–for–profit fund	–	(2,448)	–	–
Other	(a), (b)		–	(3,235)	–	(322)

(All amounts are in millions of Russian Rubles, unless stated otherwise)

22. Related Party Transactions (continued)

During 2005, the Company maintained several bank accounts in state-controlled credit institutions. The amount of cash held in these institutions as of 31 December 2005 equated to Rbls 9,322.

Further, during 2005 the Company received tariff compensation of Rbls 7,068 for transportation of certain categories of passengers from Health Care and Social Development Agency of Russia.

2004:

Related party	Nature of relations	Type of service / product	Sales / Income	(Purchases) / (Expenses)	Accounts receivable at 31 December	(Accounts payable) at 31 December
State-controlled companies:						
1. Services rendered						
Rosneft and subsidiaries	(a)	Cargo transportation	7,670	–	–	(232)
Ministries of Russian Federation	(a)	Cargo transportation	11,615	–	1,371	–
Financing received from Regional and Federal budgets	(a)	Compensations of losses from passenger transportation	2,656	–	322	–
Other	(a)		1,471	–	105	–
2. Purchases						
RAO “EES”	(a)	Electricity	–	(46,160)	111	–
FGUP “VO ZD transporta Rossii”	(a)	Security services	–	(7,397)	–	(723)
FGUP "VNIIAS"	(a)	Research and development works	–	(832)	–	(951)
FGUP "VNIIZT"	(a)	Research and development works	–	(956)	–	(723)
Other	(a)		235	(1,408)	7	(871)
3. Financial services						
Gazprombank	(a)	Loans payable	–	–	–	(1,001)
Sberbank	(a)	Loans payable	–	–	–	(8,042)
Vneshtorgbank	(a)	Loans payable	–	–	–	(4,017)
TransCreditBank	(a), (e)	Loans payable	–	–	–	(1,564)
Other companies:						
OAO “Zhaso”	(e)	Insurance expense	–	(3,647)	12	–
Blagosostoyanie	(f)	Non-state pension Fund	–	(5,489)	–	(204)
Pochet	(f)	Not–for–profit fund	–	(1,953)	–	–
Other	(a), (b)		–	(5,319)	–	(780)

22. Related Party Transactions (continued)

During 2004, the Company maintained several bank accounts in state-controlled credit institutions. The amount of cash held in these institutions as of 31 December 2004 equated to Rbls 7,138.

Key management personnel comprise members of the Management Board and the Board of Directors of the Company. Total remuneration to the members of Management Board included in "Wages, salaries and related contribution" in the statement of income amounted to Rbls 288 for the year ended 31 December 2005 (2004: 121) and consists of short-term benefits.

Management believes that transactions with other related party entities are insignificant.

23. Commitments and Contingencies

Environment

The operations and earnings of the Company are affected by political, legislative, fiscal and regulatory developments. The nature and frequency of these developments and events associated with these risks, which generally are not covered by insurance, as well as their effect on future operations and earnings are not predictable.

In particular, the implementation of the Program of railway transportation restructuring during the period 2001-2010 developed by the Company, the Ministry of Economic Development and Trade of the Russian Federation, Antimonopoly Ministry, Ministry of State Property of the Russian Federation and certain other ministries and approved by the Government of the Russian Federation, is likely to have a significant effect on the operations of the Company.

As referred to in Note 1, under the Program a state-owned open joint stock company RZD was established. It is planned that the Company's activities will be focused solely on provision of transportation services and maintenance of railroads infrastructure, whilst auxiliary business activities and the related facilities will be transferred to independent newly established entities. Further, a part of the Company's employees will also be transferred to such entities. During 2005 the Company established two of such entities engaged in provision of repair services and production of electrical engineering equipment (refer to Note 1). However, in respect to other activities their definition, identification of their related assets and corresponding liabilities and further the definition of ownership and business relations between the Company and such new entities have not been finalized as of 31 December 2005 (refer to Note 25 for further comments).

23. Commitments and Contingencies (continued)

Tariff Regulation Policy

Potential reforms in tariff-setting policy including abandonment of cross subsidy practices may have a significant effect on the Company. The company is continuously discussing the tariff setting policy, including both unification of such tariffs between domestic and foreign transportation, and increases in the tariffs with the Government of the Russian Federation. However, such attempts to increase transportation tariffs are opposed by the Company’s customers. At present, the Government of the Russian Federation plans to limit the growth of the Company’s tariffs to inflation growth. It is currently uncertain whether any further changes will be introduced in the tariff setting policy. The accompanying consolidated financial statements do not include any adjustments that might result from these uncertain effects. Such adjustments, if any, will be reported in the Company's consolidated financial statements in the period when they become known and estimable.

Taxation

Russia currently has a number of taxes imposed by both federal and regional governmental authorities. Applicable taxes include value added tax, corporate income tax (profit tax), property tax and payroll (social) taxes, together with others.

In recent years, the Russian government has initiated revisions of the Russian tax system. Effective 1 January 1999, the first part of the Tax Code was enacted. Effective 1 January 2001, the second part of the Tax Code (with the exception for profit tax and property tax rules) was enacted. Effective 1 January 2002 and 1 January 2004 new principles for income tax and property tax calculation, respectively, were further enacted. The new tax system is generally intended to reduce the number of taxes and, thus, the overall tax burden on businesses, and to simplify the tax laws.

However, 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 Company may be challenged by the relevant regional and federal authorities. Recent events within the Russian Federation suggest that the tax authorities are taking a more assertive position in its interpretation of the legislation and assessments and as a result, it is possible that transactions and activities that have not been challenged in the past may be challenged. As such, significant additional taxes, penalties and interest may be assessed. In addition, the complexities of the Company’s organizational and business flows structure negatively affect the Company’s ability to ensure proper application of certain provisions of tax laws, thus creating additional risks, and, as a consequence, tax-related contingent liabilities.

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.

23. Commitments and Contingencies (continued)

Taxation (continued)

Management believes that it has adequately provided for tax liabilities in the accompanying consolidated balance sheet as of 31 December 2005 (refer also to Note 15). However, the general risk remains that relevant authorities could take different positions with regard to interpretative issues and the effect could be significant.

Claims and Potential Claims against the Company

The Company is subject to a number of proceedings arising out of the normal circumstances of its business. These proceedings revolve primarily around application of transportation tariffs. As of 31 December 2005 a provision regarding such proceedings of Rbls 3,849 (2004: Rbls 5,992) was recognised by the Company.

Social Assets Maintenance

As discussed in Note 1, as part of transfer of social assets to the local municipalities, the Company committed to continue financing maintenance costs regarding such social assets during 2006. Management estimated the total amount of such expenses equate approximately to Rbls 730.

Insurance

The Russian insurance industry is in a developing stage and many forms of insurance protection common in other parts of the world are not yet available. Although during 2005 the Company extended insurance coverage regarding certain categories of its property (primarily buildings and constructions), the Company did not maintain insurance coverage on significant other part of its property, plant and equipment, business interruption or third party liability in respect of property or environmental damage arising from accidents to the Company’s property or relating to the Company’s operations. Until the Company obtains adequate insurance coverage, there is a risk that the loss of destruction of certain assets could have a material adverse effect on the Company’s operations and financial position.

Purchase Commitments

1. The Company has a long-term contract with Siemens AG regarding the purchase of high-speed trains for Moscow - St. Petersburg and Moscow – Nizhny Novgorod lines for the aggregate amount of EUR 316 million (Rbls 10,802 at the exchange rate as of 31 December 2005).

2. The Company has a long-term contract signed with Unified Metallurgical Company for purchase of rail wheels. The original value of the contract equated to approximately USD 1,250 million (Rbls 34,687 at the exchange rate as of 31 December 2004). Under the contract the approximate amount of deliveries expected after 31 December 2005 amounts to Rbls 44,400.

24. Financial Instruments and Risk Management Objectives and Policies

The Company’s principal financial instruments comprise bank loans, finance leases and cash. The main purpose of these instruments is to raise finance for the Company’s operations. The Company has other financial assets and liabilities such as trade receivables and trade payables, which arise directly from its operations.

Credit Risk

Credit risk is the risk that a counter party will fail to discharge an obligation and cause the Company to incur a financial loss.

Financial assets, which potentially subject the Company entitles to credit risk, consist principally of trade receivables. The carrying amount of accounts receivable, net of provision for impairment of receivables, represents the maximum amount exposed to credit risk. The Company has no significant concentrations of credit risk. Although collection of receivables could be influenced by economic factors, management believes that there is no significant risk of loss to the Company beyond the provision already recorded.

Cash is placed in financial institutions, which are considered at time of deposit to have minimal risk of default.

Foreign Exchange Risk

A part of Company’s receivables and payables balances, related primarily to settlements with customers is denominated in currencies other than Ruble. This exposes the Company to foreign exchange risk.

Further, the loan obtained by the Company from consortium of banks (refer to Note 12) is denominated in US Dollars. For the period from 31 December 2004 to 31 December 2005 the exchange rate of the Russian Ruble to the US Dollar decreased by approximately 3.7%.

The Company does not have formal arrangements to mitigate foreign exchange risks of the Company’s operations.

Interest Rate Risk

Interest rate risk is the risk that changes in market interest rates may negatively impact the Company’s financial results. The Company is exposed to interest rate risk through market value fluctuations of interest-bearing long-term borrowings. The majority of interest rates on the borrowings are fixed, these are disclosed in Note 12.

The Company has no significant interest-bearing assets.

24. Financial Instruments and Risk Management Objectives and Policies (continued)

Fair Value

Fair value of a financial instrument is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction (except for forced sale or liquidation). Market prices are considered to be the best evidence of fair value.

Management believes that the carrying values of financial assets and liabilities approximate their fair values.

In case management becomes aware that carrying value materially exceeds the fair value of certain financial assets, specific valuation allowances will be recorded to provide for the specific assets.

25. Subsequent Events

Borrowings

Bonds

Subsequent to 31 December 2005, the Company registered the issue of bonds of Series 5 in the amount of Rbls 10,000.

EBRD loan

Subsequent to 31 December 2005 the Company received a formal notice from the EBRD waiving the applicability to the Company of certain covenants stipulated in the loan agreements and confirming, as a result, the absence of breaches of these covenants (refer to Note 12).

Investments

Transcreditbank

Currently, management of the Company is considering the possibility of acquiring an equity interest in TransCreditBank that was previously expropriated.

Elgaugol

In 2006, the Company together with the Ministry of Economic Development and Trade of the Russian Federation, the Federal Agency of State Property of the Russian Federation and the regional government of Yakutia initiated certain steps to commence implementation of the plan of disposal of the Company's 29.5% ownership interest in Elgaugol and the related construction in process project through their sale to third parties. The investment in Elgaugol as of 31 December 2005 equated to Rbls 44 before 100% provision for diminution in value. The value of construction in progress project referred to above equated to Rbls 9,554 as of 31 December 2005. A 100% provision for impairment was recognised with regard to this project as of the above date (refer to Note 3).

25. Subsequent Events (continued)

Dividends

In 2006 the Company declared dividends related to 2005 of Rbls 975.

Joint Ventures, Subsidiaries and Associates

Subsequent to 31 December 2005, the Board of Directors of the Company approved signing a number of agreements on establishing various joint ventures. One of the most significant of such joint ventures was OJSC “Skorostnyje magistrali” planned to be incorporated by the Company and CJSC “Transmashholding” for implementation of investment project regarding construction of a high-speed Moscow-St. Petersburg line.

Establishment of Cargo Transportation Company

In 2006 the Company’s Board of Directors approved the concept and general principles of creation of Cargo Transportation Company (“CTC”), a new 100% subsidiary. Under the proposed plan, it is expected that the Company will contribute the majority of its cargo cars to the share capital of CTC and will lease a part of such cars back. The proposed concept is expected to be approved by the Russian government by 31 December 2006.

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Independent Auditors' Report

To the Shareholders of
Open Joint Stock Company "Russian Railroads"

1. We have audited the accompanying consolidated balance sheet of OAO "Russian Railroads" and its subsidiaries (hereinafter referred to as "the Company") as of 31 December 2005, and the related consolidated statements of income, cash flows and changes in equity for the year then ended. These consolidated financial statements are the responsibility of Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

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

3. As discussed in Note 2 to the consolidated financial statements, in accordance with the Company's accounting policy, subsequent to initial recognition, property, plant and equipment are carried at revalued amounts being their fair values at the date of the revaluation less any subsequent accumulated depreciation and impairment loss. In accordance with the requirements of International Accounting Standard 16 "Property, Plant and Equipment" ("IAS 16"), as amended, revaluations should be made with sufficient regularity such that the carrying amount of property, plant and equipment does not differ materially from that which would be determined using fair value at the balance sheet date. The last revaluation of the Company's property, plant and equipment was performed as of 31 December 1998. We were unable to determine whether the carrying value of property, plant and equipment as reported by the Company as of 31 December 2005 and 2004 complies with the requirement referred to above. Furthermore, we could not determine whether the impairment reserves provided by the Company are adequate to reflect the value of the Company's total property, plant and equipment at its recoverable value. The effects of these departures from International Financial Reporting Standards on the consolidated financial statements, including but not limited to the effect on depreciation expense and the related deferred income tax, have not been determined. As discussed in Note 2, the Company engaged an independent appraiser and commenced revaluation of its property, plant and equipment.

4. As of 1 January 2005, the Company commenced the application of a more comprehensive approach to components accounting for property, plant and equipment by re-defining certain significant components and revising its accounting estimates regarding their useful lives. These changes were accounted for by the Company as change in estimates. However, the Company has not consistently applied these new policies for component accounting, including capitalization and determination of useful lives, to certain property, plant and equipment in the year ended 31 December 2005. The effect of this departure from International Financial Reporting Standards on the consolidated financial statements has not been determined.

5. Our auditors' report on the consolidated financial statements as of 31 December 2004 and for the year then ended included scope limitations because we were unable to satisfy ourselves with certain balances as of 31 December 2003 and 2004, and transactions that affected those balances. In 2005, the Company resolved the matters which gave rise to modifications of our auditors' report on balance sheet accounts as of 31 December 2004. However, we are unable to satisfy ourselves as to whether these transactions are properly reflected in the statements of income and cash flows for the year ended 31 December 2004.

6. In our opinion, except for the effects on the consolidated financial statements of the matters referred to in paragraphs 3-4, and except for the effects on the corresponding figures of the adjustments, if any, to the results of operations and cash flows for the year ended 31 December 2004, which we might have determined had we been able to satisfy ourselves at to the matters referred to in paragraph 5, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of 31 December 2005, and the results of its operations and its cash flows for the year then ended in conformity with International Financial Reporting Standards.

7. Further, we draw attention to Note 23 to the consolidated financial statements. OAO "Russian Railroads" together with the Ministry of Economic Development and Trade, the Federal Agency of State Property of the Russian Federation and certain other ministries, continued implementation of the Program of railway transportation restructuring.

Ernst & Young LLC

12 September 2006