

SISTEMA-HALS REAL ESTATE DEVELOPMENT GROUP

Financial Statements

Years Ended December 31, 2005,
2004 and 2003

SISTEMA-HALS REAL ESTATE DEVELOPMENT GROUP

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholders of JSFC Sistema:

We have audited the accompanying statements of assets and liabilities of Sistema-Hals Real Estate Development Group (the "Group"), comprising the real estate business of JSFC Sistema conducted in the Commonwealth of Independent States ("CIS"), as of December 31, 2005, 2004 and 2003, and the related statements of operations, cash flows and changes in net assets/(liabilities) for the years then ended. These financial statements are the responsibility of the Group's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

The accompanying financial statements were prepared to present the assets and liabilities and related results of operations and cash flows of the Group, as described in Note 1 to the financial statements, and may not necessarily be indicative of the conditions that would have existed or the results of operations and cash flows if the Group had been operated as a stand-alone company during the periods presented.

In our opinion, such financial statements present fairly, in all material respects, the assets and liabilities of the Sistema Hals Real Estate Development Group as of December 31, 2005, 2004 and 2003, and the results of its operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche

October 2, 2006
Moscow, Russia

SISTEMA-HALS REAL ESTATE DEVELOPMENT GROUP

STATEMENTS OF ASSETS AND LIABILITIES AS OF DECEMBER 31, 2005, 2004 AND 2003 (Amounts in thousands of U.S. Dollars)

	Notes	2005	2004	2003
ASSETS				
Cash and cash equivalents	3	10,362	6,540	6,148
Accounts receivable, net	4	20,929	3,977	1,681
Taxes receivable	5	25,058	15,953	15,399
Prepaid expenses and other assets, net	6	3,917	3,815	14,177
Loans and notes receivable	7	7,708	11,035	9,095
Costs and estimated earnings in excess of billings on uncompleted contracts	8	38,348	18,141	36,769
REAL ESTATE INVESTMENTS, NET:				
Real estate developed for sale	9	124,312	109,585	39,730
Income producing properties, net	9	47,580	40,734	34,005
Total		171,892	150,319	73,735
Plant and equipment, net	10	3,356	2,507	1,929
Development rights and other intangible assets, net	11	43,178	43,231	43,277
Investments in shares	12	287	259	6,135
TOTAL ASSETS		325,035	255,777	208,345
LIABILITIES				
Payables to suppliers and subcontractors	13	12,148	18,526	12,830
Billings in excess of costs and estimated earnings on uncompleted contracts	14	13,996	15,211	18,792
Accrued expenses and other liabilities	15	5,198	3,896	10,365
Taxes payable		856	1,945	522
Construction obligations	16	21,898	27,186	27,315
Loans and notes payable	17	216,500	157,374	138,386
Deferred tax liabilities	21	10,883	10,344	10,357
TOTAL LIABILITIES		281,479	234,482	218,567
COMMITMENTS AND CONTINGENCIES	24	-	-	-
MINORITY INTERESTS		14,125	5,497	3,392
NET ASSETS/(LIABILITIES)	18	29,431	15,798	(13,614)

See notes to financial statements

SISTEMA-HALS REAL ESTATE DEVELOPMENT GROUP

STATEMENTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003 (Amounts in thousands of U.S. Dollars)

	Notes	2005	2004	2003
REVENUES	25	93,124	108,977	32,535
OPERATING EXPENSES	19	(81,425)	(87,167)	(31,515)
OPERATING INCOME		11,699	21,810	1,020
OTHER INCOME/(EXPENSES):				
Other (expenses)/income, net		(1,201)	(1,275)	2,251
Interest income		682	552	121
Interest expense, net of amounts capitalized		(3,988)	(2,214)	(3,829)
Loss on foreign currency transactions		(193)	(1,872)	(977)
Gain on sale of a controlling interest in a subsidiary	20	2,781	-	-
INCOME/(LOSS) BEFORE INCOME TAX AND MINORITY INTERESTS		9,780	17,001	(1,414)
Income tax expense	21	(4,517)	(2,018)	(154)
INCOME/(LOSS) BEFORE MINORITY INTERESTS		5,263	14,983	(1,568)
Minority interests		(4,556)	(2,105)	(205)
NET INCOME/(LOSS)		707	12,878	(1,773)

See notes to financial statements.

SISTEMA-HALS REAL ESTATE DEVELOPMENT GROUP

STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003 (Amounts in thousands of U.S. Dollars)

	<u>2005</u>	<u>2004</u>	<u>2003</u>
OPERATING ACTIVITIES:			
Net income/(loss)	707	12,878	(1,773)
Adjustments to reconcile net income/(loss) to net cash (used in)/ provided by operations:			
Depreciation and amortization	2,783	1,556	685
Gain on disposal of plant and equipment	(293)	(291)	(161)
Minority interests	4,556	2,105	205
Gain on sale of a controlling interest in a subsidiary	(2,781)	-	-
Gain on sale of real estate investment	(2,195)	-	-
Loss on disposal of a long-term investment	-	87	-
Deferred tax expense/(benefit)	539	(13)	(1)
Change in estimate of construction obligations	(5,288)	-	-
Bad debt expense	2,041	876	109
Changes in operating assets and liabilities:			
(Costs in excess of billings)/billings in excess of costs on uncompleted contracts	(19,804)	13,805	8,695
Accounts receivable	(16,952)	(2,296)	7,686
Prepaid expenses and other assets	(102)	1,701	(2,305)
Taxes receivable	(9,105)	(554)	(8,351)
Payables to suppliers and subcontractors	(8,589)	2,084	(1,944)
Accrued expenses and other current liabilities	1,302	544	(139)
Taxes payable	(1,089)	1,423	214
Net cash (used in)/provided by operating activities	(54,270)	33,905	2,920
INVESTING ACTIVITIES:			
Payments for real estate investments	(22,095)	(80,943)	(26,967)
Proceeds from sale of real estate investments	-	8,661	-
Purchases of plant and equipment and intangible assets	(1,701)	(2,054)	(525)
Proceeds from sale of plant and equipment	340	1,086	315
Increase/(decrease) in short-term loans and notes receivable, net	3,142	(7,132)	10,542
Purchases of long-term investments	(247)	-	-
Repayment/(issuance) of long-term loans and notes receivable	185	5,192	(4,226)
Proceeds from sale of shares	-	5,789	-
Proceeds from sale of a controlling interest in a subsidiary	3,000	-	-
Net cash used in investing activities	(17,376)	(69,401)	(20,861)

SISTEMA-HALS REAL ESTATE DEVELOPMENT GROUP

STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003 (CONTINUED) (Amounts in thousands of U.S. Dollars)

	<u>2005</u>	<u>2004</u>	<u>2003</u>
FINANCING ACTIVITIES:			
Principal payments on long-term borrowings	(60,744)	(39,887)	(55,452)
Proceeds from long-term borrowings	33,424	103,138	50,708
Proceeds from/(principal payments on) short-term borrowings, net	86,440	(44,263)	20,785
Net transfers from Sistema	12,610	16,534	-
Proceeds from capital transaction of a subsidiary	4,052	-	-
Net cash provided by financing activities	<u>75,782</u>	<u>35,522</u>	<u>16,041</u>
Effects of foreign currency translation on cash and cash equivalents	(314)	366	502
INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS	3,822	392	(1,398)
CASH AND CASH EQUIVALENTS, beginning of the year	<u>6,540</u>	<u>6,148</u>	<u>7,546</u>
CASH AND CASH EQUIVALENTS, end of the year	<u><u>10,362</u></u>	<u><u>6,540</u></u>	<u><u>6,148</u></u>
CASH PAID DURING THE YEAR FOR:			
Income taxes	4,807	606	69
Interest, net of amounts capitalized	3,750	2,023	3,025

NON CASH INVESTING AND FINANCING ACTIVITIES:

Non-cash investing and financing activities for the year ended December 31, 2004 included acquisitions by Sistema of Terra, Yalta Fish Processing Plant and Kaskad, and sale of Bolshaya Ordynka, as described in Note 18.

See notes to financial statements.

SISTEMA-HALS REAL ESTATE DEVELOPMENT GROUP

STATEMENTS OF CHANGES IN NET ASSETS/(LIABILITIES) FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003 (Amounts in thousands of U.S. Dollars)

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Beginning balance	15,798	(13,614)	(11,841)
Net income/(loss)	707	12,878	(1,773)
Net transfers from Sistema (Note 18)	12,610	16,534	-
Capital transaction of a subsidiary (Note 18)	316	-	-
Ending balance	<u>29,431</u>	<u>15,798</u>	<u>(13,614)</u>

See notes to financial statements.

SISTEMA-HALS REAL ESTATE DEVELOPMENT GROUP

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003 (Amounts in thousands of U.S. Dollars, unless otherwise stated)

1. BASIS OF PRESENTATION

The financial statements of Sistema-Hals Real Estate Development Group (the “Group”) are presented on a carve-out basis to include the historical operations of the Real Estate business segment of JSFC Sistema (“Sistema”). In 2006, Sistema has completed the corporate reorganization of its Real Estate business segment to consolidate ownership of the segment’s entities under Sistema-Hals JSC.

The Group is engaged in real estate development, project and construction management, asset management and investments and facilities management, primarily focused on the “Class A” and “Class B” segments of the Moscow office market, shopping centers, high-end housing, single family houses, apartment buildings and land development. The Group’s revenues are derived principally from the following activities: (i) sale of completed development projects, both commercial and residential, as well as the sale of rights to land; (ii) project and construction management activities for infrastructure and other construction and development projects; (iii) rental income from completed development projects held as investments; and (iv) facility management services.

Business operations of the Group are conducted in the Russian Federation (hereinafter referred to as the “RF”) and the CIS, primarily in Moscow, the Moscow Region and Saint-Petersburg. All significant operating entities of the Group are incorporated in the RF.

During the years ended December 31, 2005, 2004 and 2003, Sistema did not charge the Group for any management services, including corporate oversight, financial, legal, corporate communications or human resources. Costs incurred by Sistema to provide such services to the Group have not been significant during these periods. However, these financial statements may not necessarily be indicative of the conditions that would have existed or the results of operations and cash flows if the Group had been operated as a stand-alone company during the periods presented.

During the three years in the period ended December 31, 2005, majority of the Group’s borrowings was provided by Sistema. Significant portion of this financing was of a short-term nature. In August and September 2006, the Group obtained loans from international financial institutions for the term of one year (Note 26), that it expects to use, in part, to refinance borrowings from Sistema. Management believes, on the basis of cash flow forecasts, that the total facilities available to the Group will be sufficient to cover all of the Group’s current obligations.

All significant transactions within the Real Estate business segment of Sistema, balances and unrealized gains (losses) on such transactions have been eliminated in these financial statements.

The beneficial ownership and proportion of voting power of Sistema in significant operating entities of the Group as of December 31, 2005, 2004 and 2003 were as follows:

Operating entities	Ownership interest			Voting power		
	2005	2004	2003	2005	2004	2003
Mosdachtrest	56%	44%	44%	60%	51%	51%
Sistema Temp	100%	100%	100%	100%	100%	100%
Kuntsevo-Invest	81%	81%	81%	81%	81%	81%
Landshaft	100%	100%	100%	100%	100%	100%
Landshaft-2	100%	100%	-	100%	100%	-
City-Hals	100%	100%	100%	100%	100%	100%
Hals-Stroy	100%	100%	100%	100%	100%	100%
Beijing-Invest	90%	90%	90%	90%	90%	90%
Sistema-Hals Severo-Zapad	76%	76%	76%	76%	76%	76%
Organizator	51%	51%	51%	51%	51%	51%
PSO Sistema-Hals	51%	51%	51%	51%	51%	51%

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NOTES TO THE FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003 (Amounts in thousands of U.S. Dollars, unless otherwise stated)

Operating entities	Ownership interest			Voting power		
	2005	2004	2003	2005	2004	2003
Bolshaya Ordynka	-	-	70%	-	-	70%
Hotel Korona Intourist	100%	100%	100%	100%	100%	100%
Terra	99%	99%	-	99%	99%	-
Yalta Fish Processing Plant	98%	98%	-	98%	98%	-
Kaskad	100%	100%	-	100%	100%	-

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying combined statements have been prepared in conformity with the accounting principles generally accepted in the United States of America (“U.S. GAAP”). The Group’s entities maintain accounting records and prepare their statutory financial statements in Russian rubles (“RUB”) in accordance with the requirements of accounting and tax legislation in Russia. The accompanying combined financial statements differ from the financial statements prepared for statutory purposes in Russia in that they reflect certain adjustments, not recorded in the Russian statutory accounting books of the Group’s entities, which are appropriate to present the financial position, results of operations and cash flows in accordance with U.S. GAAP.

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

Concentration of business risk – The Group’s principal business activities are within the RF. Laws and regulations affecting businesses operating in the RF are subject to rapid changes. Russian land and property legislation is complicated, often ambiguous and contradictory at the federal and regional levels. In particular, it is not always clear which state bodies are authorized to enter into land leases with respect to particular land plots, construction approval procedures are complicated and prone to challenge or reversal, and construction and environmental rules often contain requirements that are impossible to comply with in practice. As a result, the risk exists that the Group’s ownership of and/or lease rights to land and buildings might be challenged by government authorities or third parties.

The construction industry in general is subject to unique risks in respect to the means of financing, the legal and political risks and the financial risks associated with construction projects which transpire over a prolonged period of time. The Group is also reliant on a limited number of general contractors and subcontractors to undertake its commitments for construction in the timeframe required to avoid penalties and other associated costs.

Foreign currency translation – The Group follows a translation policy in accordance with Statement on Financial Accounting Standards (“SFAS”) 52, “Foreign Currency Translation”.

Management believes that the USD is the functional currency of the Group, as the majority of its revenues, costs and capital expenditures are either priced, incurred, payable or otherwise measured in USD. As such, during the years ended December 31, 2005, 2004 and 2003, the Group remeasured its assets, liabilities, income and expense items in USD. Monetary assets and liabilities were translated into USD at the rate in effect as of the balance sheet date; non-monetary assets and liabilities and income and expense items were translated at the rate prevailing on the date of the transaction. Exchange gains and losses arising from the remeasurement of monetary assets and liabilities not denominated in USD were included in gains/(losses) on foreign currency transactions in the statements of operations. The official exchange rates quoted by the Central Bank of Russia as of December 31, 2005, 2004 and 2003 were 28.78, 27.75 and 29.45 rubles per 1 USD, respectively.

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NOTES TO THE FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003 (Amounts in thousands of U.S. Dollars, unless otherwise stated)

During the years ended December 31, 2005, 2004 and 2003, the Russian ruble was not a fully convertible currency outside of the territory of the RF. The translation of ruble denominated assets and liabilities into USD for the purpose of these financial statements does not indicate that the Group could realize or settle in USD the reported values of the assets and liabilities.

Revenue recognition – The Group’s revenues are principally derived from i) real estate development, ii) project and construction management, iii) asset management and investments, iv) facilities management. The Group records revenues as follows:

(i) Revenues from real estate development activities are recognized in accordance with the provisions of SFAS 66 “Accounting for Sales of Real Estate” or AICPA Statement of Position 81-1, “Accounting for Performance of Construction-Type and Certain Production-Type Contracts” (“SOP 81-1”).

When the Group undertakes real estate development projects at its own risk, it recognizes revenues from sales of real estate when a) a sale is consummated; b) the buyer's initial and continuing investments are adequate to demonstrate a commitment to pay; c) the Group's receivable is not subject to future subordination; d) the Group has transferred to the buyer the usual risks and rewards of ownership and does not have a substantial continuing involvement with the project. A sale is not considered consummated until (a) the parties are bound by the terms of a contract; (b) all consideration has been exchanged; (c) any permanent financing for which we are responsible has been arranged; and (d) all conditions precedent to closing have been performed. Revenues from development of office buildings, apartments, condominiums, shopping centers and similar structures are recognized prior to consummation of sale by the percentage-of-completion method if (a) construction is beyond a preliminary stage; (b) the buyer is committed to the extent of being unable to require a refund except for nondelivery of the property; (c) sales prices are collectible; (d) aggregate sales proceeds and costs can be reasonably estimated.

Investments in real estate developed for sale where the sale is not consummated are accounted for under the deposit method in accordance with SFAS 66, except for those investments in development of office buildings, apartments, condominiums, shopping centers and similar structures, where criteria for revenue recognition have been met as of the balance sheet date. Such investments are accounted for by the percentage-of-completion method.

In those instances, when the Group acts as a contractor under construction contracts with third parties, it applies the percentage of completion method to the respective contracts where and as soon as it is able to reliably estimate the stage of progress to completion of the project, costs to complete the project and contractual revenues. Progress towards completion is measured by the percentage of costs incurred to date to the estimated total costs at completion for each contract (the “cost-to-cost” method). On most of its contracts, the Group is not able to reliably estimate costs to complete the project and contractual revenues until the project is at least 30% complete. Until the 30% completion point, the Group carries the projects at cost. The Group does not recognize revenue on contracts until reasonably dependable estimates of costs to complete the project and contractual revenues can be made.

(ii) The Group provides project and construction management services to municipal governments on certain socially important infrastructure projects. The Group’s remuneration for such services was determined as a percentage of project costs incurred by third parties and approved by the municipal government. Based upon the guidance in Emerging Issues Task Force Consensus 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent (“EITF 99-19”), management has concluded that the Group’s services under such contracts do not transfer to the Group full risks and rewards associated with the projects. Therefore, the Group recognizes as revenues only its fees from project management services. Fees are recognized as the project costs are incurred and approved by the municipal government.

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NOTES TO THE FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003 (Amounts in thousands of U.S. Dollars, unless otherwise stated)

(iii) Revenues from asset management and investments include rental revenues, revenues from sale or assignment of rights to land plots and residential units. Rental revenues are recognized over the lease term on a straight-line basis. Revenues from sale or assignment of rights over real estate are recognized when substantially all the risks and rewards of ownership have been passed to the buyer.

(iv) Revenues from service contracts for facilities management are recognized on the accrual basis over the periods when services are provided.

Change orders and claims – Once contract performance is underway, the Group may experience changes in the conditions, client requirements, specifications, designs, materials and or work schedule (“change orders”). Generally a change order will be negotiated with the customer to modify the original contract to approve both the scope and the pricing of the change. When a change order becomes a point of dispute between the Group and its customer, the Group then considers it as a claim. Costs related to change orders and claims are recognized when they are incurred. Change orders are included in total estimated contract revenues when it is probable that the change order will result in a bona fide addition to the relevant contract value and can be reliably estimated. Claims are included in total estimated contract revenue only to the extent that contract costs related to the claim have been incurred and when it is probable that the claim will result in a bona fide addition to contract value and can be reliably estimated.

Estimated losses on uncompleted contracts and changes in contract estimates – The Group provides for estimated losses on uncompleted contracts in the periods in which such losses are identified. The cumulative effects of revisions to contract revenue and estimated completion costs are recorded in the accounting period in which the amounts become evident and can be reasonably estimated. These revisions may include such items as the effects of change orders and claims, warranty claims, other contractual penalties and contract closeout settlements.

Costs and billings on uncompleted contracts – Costs related to the Group’s performance under construction contracts (including estimated earnings from uncompleted contracts) is recorded net of billings on those contracts. Billings when in excess of costs and estimated earnings on uncompleted contracts are recorded as liabilities.

Income producing properties – The Group has a number of developments where it generated or expects to generate economic benefits through retaining title to or lease rights for the property and receiving rental revenues. Such properties primarily consist of residential and commercial buildings and land which is, or will be, leased on either a short-term or long-term basis.

Income producing properties are depreciated on a straight-line basis over estimated useful lives of the assets (buildings and land improvements – 20 to 40 years; leasehold improvements – the lesser of the remaining life of the asset or term of the lease).

Financial instruments – The Group’s financial instruments primarily comprise cash and cash equivalents, short-term and long-term investments, receivables, payables and debt. The estimated fair value of short-term financial instruments as of December 31, 2005 approximated their carrying value as reflected in the balance sheet. The fair value of long-term loans and notes payable which have variable interest rates based on market rates approximate the carrying amount of those financial instruments. The fair value of the Group’s long-term loans and notes payable to Sistema and its subsidiaries is not practicable to estimate based on the related party nature of the underlying transactions. The fair value of long-term investments was not determined due to quoted market prices not being readily available and valuations not being obtained due to the excessive costs involved.

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NOTES TO THE FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003 (Amounts in thousands of U.S. Dollars, unless otherwise stated)

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

Loans and notes receivable – Loans and notes receivable with original maturities in excess of three months are being accounted for at amortized cost. Management annually assesses the realizability of the carrying values of loans and notes receivable and, if necessary, records impairment losses to write the investments down to fair value.

Investments in shares – The Group's share in net assets and net income of Amiral B.V., Regiony, TRK Kazan and Kamenny Ostrov, in which the Group holds 50% of voting shares and has the ability to exercise significant influence over their operating and financial policies ("affiliates") is accounted for using the equity method of accounting. During the years ended December 31, 2005, 2004 and 2003, the Group's share in the net income (loss) of these entities was insignificant.

Investments in corporate shares where the Group owns less than 20% voting interest are accounted for at cost of acquisition.

During the year ended December 31, 2005, the Group acquired 25% of voting shares of CJSC Sixteenth Trust for USD 142 thousand and 26% of voting shares of CJSC Institute Promos for USD 1 thousand.

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

Prepaid expenses – Prepaid expenses are primarily comprised of advance payments for services to vendors.

Value-added taxes – Value-added taxes ("VAT") related to sales are payable to the tax authorities either on an accrual or a cash basis (members of the Group are applying different methodologies, as allowed by Russian tax law) based upon invoices issued to the customer. VAT incurred for purchases may be reclaimed, subject to certain restrictions, against VAT related to sales. VAT related to purchase transactions that are reclaimable after the balance sheet dates is recorded in taxes receivable. Non-reclaimable VAT is included into the cost of construction as it is a cost necessarily incurred in the completion of the relevant object.

Plant and equipment – Plant and equipment with a useful life of more than one year is capitalized at historical cost. Cost includes major expenditures for improvements and replacements which extend useful lives of the assets or increase their revenue generating capacity. Repairs and maintenance are charged to the statements of operations as incurred.

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

Plant and equipment is depreciated on the straight-line basis over 3 to 5 years.

Development rights and other intangible assets – Development rights acquired by the Group are stated at acquisition cost. The costs of development rights will be amortized on a straight-line basis from the date when the project starts generating revenues until the development period expires. Development rights as of December 31, 2005, 2004 and 2003 comprise rights to develop residential property in the Western Kuntsevo district of Moscow. The development period for this project expires in 2012. Amortization of other finite-life intangible assets is computed on a straight-line basis.

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NOTES TO THE FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003 (Amounts in thousands of U.S. Dollars, unless otherwise stated)

Impairment of long-lived assets – The Group periodically evaluates the recoverability of the carrying amount of its long-lived assets in accordance with SFAS 144, “Accounting for the Impairment or Disposal of Long-Lived Assets”. Whenever events or changes in circumstances indicate that the carrying amounts of those assets may not be recoverable, the Group compares undiscounted net cash flows estimated to be generated by those assets to the carrying amount of those assets. When these undiscounted cash flows are less than the carrying amounts of the assets, the Group records impairment losses to write the asset down to fair value, measured by the estimated discounted net future cash flows expected to be generated from the use of the assets. Management does not believe there should be any impairment charge recorded relating to the Group’s investments in long-lived assets during the years ended December 31, 2005, 2004 and 2003.

Construction obligations – Construction obligations represent obligations to construct apartments, title in which is to be transferred to the Moscow City Government. These obligations were assumed as a result of the acquisition of development rights to uncompleted construction contracts.

Income taxes – Income taxes have been computed in accordance with the laws of the RF. The standard income tax rate in the RF for the years ended December 31, 2005, 2004 and 2003 was 24%.

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

Retirement benefit and social security costs – The Group contributes to the RF state pension fund, social insurance fund, medical insurance fund on behalf of all of its current employees. In accordance with the current RF legislation, all social contributions are calculated by the application of a regressive rate from 26% to 2% (from 35.6% to 2% before January 1, 2005) to the annual gross remuneration of each employee. The contributions are expensed in the period in which they are incurred.

Borrowing costs – The Group capitalizes interest on borrowings during the active construction period of its capital projects. Capitalized interest is added to the cost of the underlying assets and is amortized over the useful lives of the assets. For the years ended December 31, 2005, 2004 and 2003, capitalized borrowing costs were USD 10,960 thousand, USD 6,274 thousand and USD 2,167 thousand, respectively. Other borrowing costs were recognized as an expense in the period in which they were incurred.

Advertising costs – The Group expenses the cost of advertising in the period in which they are incurred.

Minority interests – Minority interests represents share in book value of net assets of the Group’s entities proportional to equity interests in those entities owned, directly or indirectly, by shareholders other than Sistema and its subsidiaries.

Dividends and distributions – Dividends and distributions to shareholders are recognized at the date they are declared. Distributable retained earnings of the Group are based on amounts extracted from statutory accounts of individual entities and may differ from amounts calculated on the basis of U.S. GAAP.

Comprehensive income – Comprehensive income consists of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) refers to revenues, expenses, gains and losses that are not included in net income, but rather are recorded directly in net assets (liabilities). For the years ended December 31, 2005, 2004 and 2003, the Group had no items of other comprehensive income (loss), and, accordingly, comprehensive income is the same as net income.

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New accounting pronouncements – In December 2004, the Financial Accounting Standards Board (“FASB”) issued FAS No. 123R, “Share-Based Payment” (“FAS No. 123R”), a revision of FAS No. 123, “Accounting for Stock-Based Compensation”. FAS No. 123R supersedes Accounting Principles Board (“APB”) Opinion No. 25, “Accounting for Stock Issued to Employees” and requires all entities to recognize compensation cost in an amount equal to the fair value of share-based payments grant-date to employees. That cost is recognized over the period during which an employee is required to provide service in exchange for an award of equity instruments. FAS No. 123R must be adopted by most public entities no later than the beginning of the first fiscal year commencing after June 15, 2005. The adoption of FAS No. 123R did not have a material impact on the Group’s financial position or results of operations.

In December 2004, the FASB issued FAS No. 153, “Exchanges of Nonmonetary Assets”, an amendment of APB Opinion No. 29, “Accounting for Nonmonetary Transactions”. FAS No. 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets set in the APB Opinion No. 29 and replaces it with a general exception for exchanges that do not have commercial substance. FAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. FAS No. 153 is effective prospectively for nonmonetary exchanges occurring after June 15, 2005. The adoption of FAS No. 153 did not have a material impact on the Group’s financial position or results of operations.

In March 2005, the FASB issued Interpretation No. 47, “Accounting for Conditional Asset Retirement Obligations – an interpretation of FASB Statement No. 143.” This Interpretation clarifies that the term “conditional asset retirement obligation” as used in FASB Statement No. 143, “Accounting for Asset Retirement Obligations”, refers to a legal obligation to perform an asset retirement activity, in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. Uncertainty about the timing and (or) method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists to make a reasonable estimate of the fair value of the obligation. Interpretation No. 47 is effective for the Group beginning January 1, 2006. The adoption of Interpretation No. 47 did not have a material impact on the Group’s financial position or results of operations.

In March 2005, the SEC released Staff Accounting Bulletin 107, “Share-Based Payments”, or SAB 107. The interpretations in SAB 107 express views of the SEC staff regarding the interaction between FAS No. 123R and certain SEC rules and regulations, and provide the SEC staff’s views regarding the valuation of share-based payment arrangements for public companies. In particular, SAB 107 provides guidance related to share-based payment transactions with nonemployees, the transition from nonpublic to public entity status, valuation methods (including assumptions such as expected volatility and expected term), the accounting for certain redeemable financial instruments issued under share-based payment arrangements, the classification of compensation expense, non-GAAP financial measures, first-time adoption of FAS No. 123R in an interim period, capitalization of compensation cost related to share-based payment arrangements, the accounting for income tax effects of share-based payment arrangements upon adoption of FAS No. 123R, the modification of employee share options prior to adoption of FAS No. 123R.

In May 2005, the FASB issued FAS No. 154, “Accounting Changes and Error Corrections”, which replaces APB Opinion No. 20, “Accounting Changes” and FAS No. 3, “Reporting Accounting Changes in Interim Financial Statements”. FAS No. 154 changes the requirements for the accounting and reporting of a change in accounting principle and is applicable to all voluntary changes and to changes required by an accounting pronouncement if such pronouncement does not specify transition provisions. FAS No. 154 requires retrospective application to the prior periods’ financial statements

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of changes in accounting principle. In cases when it is impracticable to determine the period-specific or cumulative effects of an accounting change, the statement provides that the new accounting principle should be applied as of the earliest period for which retrospective application is practicable or, if impracticable to determine the effect of a change to all prior periods, prospectively from the earliest date practicable. This Statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

In June 2005, the Emerging Issues Task Force (“EITF”) reached a consensus on EITF Issue No. 05-6, “Determining the Amortization Period for Leasehold Improvements.” As part of a business combination, the acquiring entity will often assume existing lease agreements of the acquired entity and acquire the related leasehold improvements. The issues are whether the “lease term” should be reevaluated at consummation of a purchase business combination and whether the amortization period for acquired leasehold improvements should be reevaluated by the acquiring entity in a business combination. The consensus reached by EITF No. 05-6 is effective for leasehold improvements that are purchased or acquired in reporting periods beginning June 29, 2005. The adoption of EITF No. 05-6 did not have a material impact on the Group’s financial position and results of operations.

In February 2006, the FASB issued FAS No. 155, “Accounting for Certain Hybrid Financial Instruments, an amendment to FAS No. 133 “Accounting for Derivative Instruments and Hedging activities” and FAS No. 140 “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities”. FAS No. 155 addresses application of FAS No. 133 to beneficial interests in securitized financial assets and permits to remeasure fair value for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, requires to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, amends FAS No. 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument, and clarifies certain other derivatives classification issues. This Statement is effective for all financial instruments acquired or issued after the beginning of an entity’s first fiscal year that starts after September 15, 2006, and is not expected to have a material impact on the Group’s financial position and results of operations.

In July 2006, the FASB issued Interpretation No. 48, “Accounting for Uncertainty in Income Taxes”, of SFAS No. 109, “Accounting for Income Taxes”. The Interpretation applies to all tax positions that are within the scope of SFAS No. 109 and requires the two-step approach for recognizing and measuring tax benefits. The Interpretation establishes a “more-likely- than-not” recognition threshold that must be met before a tax benefit can be recognized in the financial statements. To meet this threshold, the enterprise must determine that upon examination by the taxing authority, the tax position is more likely to be sustained than not, based on the technical merits of the position. Once the recognition threshold has been met, enterprises are required to recognize the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with the taxing authority. In both steps, enterprises must presume that the taxing authority has full knowledge of all relevant information. The Interpretation also requires enterprises to make explicit disclosures at the end of each reporting period about uncertainties in their income tax positions, including a detailed rollforward of tax benefits taken that do not qualify for financial statement recognition. The Interpretation is effective for fiscal years beginning after December 15, 2006, and should be applied to all tax positions upon initial adoption. The cumulative effect of applying the provisions of the Interpretation should be reported as an adjustment to the opening balance of retained earnings for that fiscal year.

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3. CASH AND CASH EQUIVALENTS

Cash and cash equivalents as of December 31, 2005, 2004 and 2003 consisted of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Cash and cash equivalents on deposit with:			
Third parties	3,732	2,286	1,109
Moscow Bank of Reconstruction and Development (“MBRD”), a subsidiary of Sistema	<u>6,630</u>	<u>4,254</u>	<u>5,039</u>
Total	<u>10,362</u>	<u>6,540</u>	<u>6,148</u>

The Group had USD 500 thousand, USD 468 thousand and nil of time deposits classified as cash equivalents as of December 31, 2005, 2004 and 2003, respectively.

4. ACCOUNTS RECEIVABLE, NET

Accounts receivable, net of provision for doubtful debts, as of December 31, 2005, 2004 and 2003 consisted of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Trade receivables from third parties	6,267	3,966	1,435
Trade receivables from Sistema subsidiaries	14,958	492	355
Less: provision for doubtful debts	<u>(296)</u>	<u>(481)</u>	<u>(109)</u>
Total	<u>20,929</u>	<u>3,977</u>	<u>1,681</u>

As of December 31, 2005, trade receivables from Sistema subsidiaries included USD 14,442 thousand due from MGTS, a subsidiary of Sistema, for reimbursement of construction costs incurred.

5. TAXES RECEIVABLE

Taxes receivable as of December 31, 2005, 2004 and 2003 consisted of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
VAT receivable	22,608	14,611	12,234
Other taxes receivable	<u>2,450</u>	<u>1,342</u>	<u>3,165</u>
Total	<u>25,058</u>	<u>15,953</u>	<u>15,399</u>

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6. PREPAID EXPENSES AND OTHER ASSETS, NET

Prepaid expenses and other assets, net of provision for doubtful debts, as of December 31, 2005, 2004 and 2003 consisted of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Advance payments to third parties	3,233	1,681	1,814
Other receivables from Sistema subsidiaries	276	588	2,902
Prepaid expenses	1,111	1,223	173
Other assets	1,597	525	9,288
Less: provision for doubtful debts	<u>(2,300)</u>	<u>(202)</u>	<u>-</u>
Total	<u>3,917</u>	<u>3,815</u>	<u>14,177</u>

Management assesses the likelihood of the performance of services in respect of advances paid on an annual basis. This assessment identified advances paid for construction of residential property for which the receipt of services is unlikely and, accordingly, has provided for those advances paid.

Other assets as of December 31, 2003 included USD 8,661 thousand in respect of amounts due from Sistema for the restoration of the Davydov Estate ("Usadba Davydova"). This amount was settled during the year ended December 31, 2004.

7. LOANS AND NOTES RECEIVABLE

Loans and notes receivable as of December 31, 2005, 2004 and 2003 consisted of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Loans receivable from Sistema and its subsidiaries	7,258	2,704	9,095
Loans receivable from third parties	<u>450</u>	<u>8,331</u>	<u>-</u>
Total	<u>7,708</u>	<u>11,035</u>	<u>9,095</u>

The weighted average interest rate for loans unpaid as of December 31, 2005, 2004 and 2003 was 5.54%, 2.73% and nil, respectively.

The schedule of repayment of loans and notes receivable is as follows:

Year ended December 31,	
2006	5,509
2007	<u>2,199</u>
Total	<u>7,708</u>

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8. COSTS AND ESTIMATED EARNINGS IN EXCESS OF BILLINGS ON UNCOMPLETED CONTRACTS

Costs and estimated earnings in excess of billings on uncompleted contracts as of December 31, 2005, 2004 and 2003 consisted of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Accumulated costs and earnings	102,345	60,360	53,380
Less: amounts billed	<u>(63,997)</u>	<u>(42,219)</u>	<u>(16,611)</u>
Total	<u>38,348</u>	<u>18,141</u>	<u>36,769</u>

9. REAL ESTATE INVESTMENTS, NET

Real estate investments, net of accumulated depreciation, as of December 31, 2005, 2004 and 2003 consisted of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Real estate developed for sale	124,312	109,585	39,730
Income producing properties:			
Buildings and constructions	51,290	26,171	21,566
Construction in progress	<u>130</u>	<u>16,508</u>	<u>14,240</u>
	51,420	42,679	35,806
Less: accumulated depreciation	(3,840)	(1,945)	(1,801)
Total	<u>47,580</u>	<u>40,734</u>	<u>34,005</u>
Total	<u>171,892</u>	<u>150,319</u>	<u>73,735</u>

Depreciation charges on income producing properties for the years ended December 31, 2005, 2004 and 2003 amounted to USD 1,925 thousand, USD 829 thousand and USD 470 thousand, respectively.

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NOTES TO THE FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003 (Amounts in thousands of U.S. Dollars, unless otherwise stated)

10. PLANT AND EQUIPMENT, NET

Plant and equipment, net of accumulated depreciation, as of December 31, 2005, 2004 and 2003 consisted of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Plant and equipment	3,114	2,289	1,664
Other assets	2,136	1,725	1,127
	<u>5,250</u>	<u>4,014</u>	<u>2,791</u>
Less: accumulated depreciation	(1,894)	(1,507)	(862)
Total	<u><u>3,356</u></u>	<u><u>2,507</u></u>	<u><u>1,929</u></u>

Depreciation charges for the years ended December 31, 2005, 2004 and 2003 amounted to USD 799 thousand, USD 681 thousand and USD 207 thousand, respectively.

11. DEVELOPMENT RIGHTS AND OTHER INTANGIBLE ASSETS, NET

Development rights and other intangible assets, net of accumulated amortization, as of December 31, 2005, 2004 and 2003 consisted of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Development rights – Kuntsevo properties	43,156	43,156	43,156
Other intangible assets	137	131	131
	<u>43,293</u>	<u>43,287</u>	<u>43,287</u>
Less: accumulated amortization	(115)	(56)	(10)
Total	<u><u>43,178</u></u>	<u><u>43,231</u></u>	<u><u>43,277</u></u>

Amortization charges for the years ended December 31, 2005, 2004 and 2003 amounted to USD 59 thousand, USD 46 thousand and USD 8 thousand, respectively.

In 2002, the Group obtained control over Kuntsevo-Invest, which, as of the date of acquisition, was holding developer's rights and obligations under the program for reconstruction of residential property in the Western Kuntsevo district of Moscow in accordance with the Decree of the Moscow City Government # 158 of March 4, 1997 ("the Kuntsevo properties"). Under the program, the developer is committed to complete construction of 379.0 thousand square meters of residential living space to be sold in the market ("commercial buildings") and of additional 172.1 square meters of residential living space to be transferred to the Moscow City Government ("municipal buildings").

The purchase price allocation for acquisition of Kuntsevo-Invest was as follows:

Development rights	43,156
Construction obligations	(27,316)
Other liabilities	(5,481)
Deferred taxes	<u>(10,358)</u>
Purchase price	<u><u>1</u></u>

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Management estimates that on the basis of the amortization policy referred to in Note 2, the estimated amortization expense is as follows:

Year ended December 31,	
2006	3,321
2007	6,643
2008	6,643
2009	6,643
2010	6,643
Thereafter	<u>13,285</u>
Total	<u><u>43,178</u></u>

Actual amortization expense to be reported in future periods could differ from these estimates as a result of new intangible assets acquisitions, changes in useful lives and other relevant factors.

12. INVESTMENTS IN SHARES

Investments in shares as of December 31, 2005, 2004 and 2003 consisted of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
MBRD common shares	-	-	5,539
Other	<u>287</u>	<u>259</u>	<u>596</u>
Total	<u><u>287</u></u>	<u><u>259</u></u>	<u><u>6,135</u></u>

The Group's investment in common shares of MBRD as of December 31, 2003 was transferred to Sistema in 2004.

13. PAYABLES TO SUPPLIERS AND SUBCONTRACTORS

Payables to suppliers and subcontractors as of December 31, 2005, 2004 and 2003 consisted of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Payables to third parties	10,568	17,398	10,506
Payables to Sistema subsidiaries	<u>1,580</u>	<u>1,128</u>	<u>2,324</u>
Total	<u><u>12,148</u></u>	<u><u>18,526</u></u>	<u><u>12,830</u></u>

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14. BILLINGS IN EXCESS OF COSTS AND ESTIMATED EARNINGS ON UNCOMPLETED CONTRACTS

Billings in excess of costs and estimated earnings on uncompleted contracts as of December 31, 2005, 2004 and 2003 consisted of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Amounts billed	44,820	37,876	27,906
Less: accumulated costs and earnings	(30,824)	(22,665)	(9,114)
Total	<u>13,996</u>	<u>15,211</u>	<u>18,792</u>

15. ACCRUED EXPENSES AND OTHER LIABILITIES

Accrued expenses and other liabilities as of December 31, 2005, 2004 and 2003 consisted of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Accrued expenses and other liabilities to third parties	3,725	3,876	7,527
Other liabilities to Sistema subsidiaries	1,473	20	2,838
Total	<u>5,198</u>	<u>3,896</u>	<u>10,365</u>

16. CONSTRUCTION OBLIGATIONS

The Group is required, as referred to in Note 11, to construct buildings to be transferred to the Moscow City Government. During the year ended December 31, 2005, the Group has completed and delivered to the Moscow City Government 980 square meters of municipal residential space and revised the estimate of construction obligations outstanding as of December 31, 2005. Gain resulting from the change in estimate of the construction obligations in amount of USD 5,288 thousand was recorded in the Group's operating expenses for the year ended December 31, 2005.

17. LOANS AND NOTES PAYABLE

The Group's loans and notes payable as of December 31, 2005, 2004 and 2003 consisted of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Loans and promissory notes payable to Sistema and its subsidiaries:			
MBRD	129,572	64,583	59,924
Sistema	45,259	62,358	-
Other Sistema subsidiaries	7,609	3,749	78,087
	<u>182,440</u>	<u>130,690</u>	<u>138,011</u>

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	2005	2004	2003
Loans and promissory notes payable to third parties:			
Commerzbank	20,000	20,000	-
West LB Vostok	10,400	5,000	-
Other	3,660	1,684	375
	<u>34,060</u>	<u>26,684</u>	<u>375</u>
Total loans and notes payable	<u>216,500</u>	<u>157,374</u>	<u>138,386</u>
Current portion of loans and notes payable	152,857	45,142	82,054
Non-current portion of loans and notes payable	63,643	112,232	56,332

The Group's activities have historically primarily been financed through the provision of loans and notes by the controlling shareholder and its subsidiaries. The interest rates on loans and notes obtained by the Group from Sistema and its subsidiaries are fixed and range from 0% to 17%.

The interest rate on the CommerzBank loan was LIBOR+5% (9.84% and 7.4% as of December, 31 2005 and 2004 respectively). The loan was guaranteed by Sistema and has been settled in March 2006.

The interest rate on the West LB Vostok loan was LIBOR+6.8% (11.64% and 9.4% as of December 31, 2005 and 2004 respectively). The loan was guaranteed by MGTS, a subsidiary of Sistema, and has been settled in March 2006.

The weighted average interest rate for loans unpaid as of December 31, 2005, 2004 and 2003 was 9.01%, 7.47% and 5.30%, respectively.

The schedule of repayments of loans and notes payable over the five-year period beginning on December 31, 2005 is as follows:

Year ended December 31,	
2006	152,857
2007	50,516
2008	10,231
2009	1,931
2010	<u>965</u>
Total	<u>216,500</u>

18. TRANSFERS FROM/(TO) SISTEMA AND OTHER CAPITAL TRANSACTIONS

During the year ended December 31, 2004, the Group has completed the Bolshaya Ordynka development project and disposed of it for an amount of USD 52,932 thousand. The net gain from sale of USD 12,933 thousand was retained by Sistema.

During the year ended December 31, 2004, Sistema acquired a 99% stake in Terra, a 100% stake in Kaskad and a 98% stake in Yalta Fish Processing Plant for an aggregate consideration of USD 29,467 thousand. These entities hold rights to land plots, that the Group plans to develop. The cost of the acquisitions were paid for by Sistema (see also Note 26).

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In June 2005, Sistema-Hals issued 125 common shares to Sistema with par value of RUB 50 at RUB 3,480 thousand per share. The proceeds from the issuance amounted to USD 15,113 thousand.

During the year ended December 31, 2005, Sistema-Hals acquired from Sistema's subsidiaries, outside of the Group, 50% of the ordinary shares in Sistema Temp for USD 2,091 thousand, 81% of the ordinary shares in Kuntsevo-Invest for USD 2 thousand and 30% of the ordinary shares in City-Hals for USD 10 thousand.

During the year ended December 31, 2005, Mosdachtrest issued 19,894 common shares with a par value of RUB 16,361. The Moscow Government acquired 7,162 common shares for USD 4,046 thousand. Other shareholders acquired 10 common shares for USD 6 thousand. The remaining shares were acquired by Sistema-Hals. These transactions increased Sistema-Hals' ownership interest in Mosdachtrest to 56%. The excess of the Moscow Government contribution over the book value of the respective share of Mosdachtrest's net assets of USD 316 thousand has been recorded as a capital transaction.

The share capital of Sistema-Hals as of December 31, 2005, 2004 and 2003, comprises 1,175, 1,050 and 1,050 authorized, issued and outstanding common shares, respectively, with par value of 50 RUB.

19. OPERATING EXPENSES

Operating expenses for the years ended December 31, 2005, 2004 and 2003 comprised the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Cost of sales of development projects	51,969	62,596	14,355
Payroll and employee related costs	15,318	10,763	7,722
Consulting services	4,584	4,062	4,220
Depreciation and amortization	2,783	1,556	685
Rent of premises and land	2,512	1,754	570
Security expenses	1,884	1,107	367
Taxes other than income taxes	1,451	702	62
Repairs and maintenance	1,021	963	113
Utilities and energy costs	1,021	157	342
Insurance	608	58	31
Advertising and marketing	489	624	213
Change in the estimate of construction obligations (Note 16)	(5,288)	-	-
Bad debt expense	2,041	876	109
Other	1,032	1,949	2,726
Total	<u>81,425</u>	<u>87,167</u>	<u>31,515</u>

20. SALE OF A CONTROLLING INTEREST IN A SUBSIDIARY

The Group disposed of 50% of its interest in the previously wholly owned subsidiary Kamenny Ostrov to a third party for USD 3,000 thousand. As a result of this disposal, the Group recognized a gain on disposal of USD 2,781 thousand and retained a 50% interest in Kamenny Ostrov. Subsequent to the disposal, the Group accounted for its remaining 50% interest under the equity method.

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21. INCOME TAXES

The Group's provision for income taxes for the years ended December 31, 2005, 2004 and 2003 was as follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Current expense	3,978	2,031	155
Deferred tax expense/(benefit)	<u>539</u>	<u>(13)</u>	<u>(1)</u>
Total	<u>4,517</u>	<u>2,018</u>	<u>154</u>

The provision for income taxes is different from that which would be obtained by applying the statutory income tax rate of 24% to income/(loss) before income tax and minority interests. The items causing this difference are as follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Income tax provision computed on income before taxes at statutory rate	2,347	4,080	(339)
Adjustments due to:			
Non-deductible items	745	474	234
Non-taxable items	(137)	(616)	(176)
Profit on sale of a project, retained by the controlling shareholder	-	(3,104)	-
Taxable losses not carried forward	1,103	1,587	541
Currency exchange and translation differences	<u>459</u>	<u>(403)</u>	<u>(106)</u>
Total	<u>4,517</u>	<u>2,018</u>	<u>154</u>

Temporary differences between the Russian statutory tax accounts and these financial statements give rise to the following deferred tax assets and liabilities as of December 31, 2005, 2004 and 2003:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Deferred tax assets:			
Construction obligations	5,062	6,123	6,153
Other	914	455	317
Less: valuation allowance	<u>(5,976)</u>	<u>(6,578)</u>	<u>(6,470)</u>
Total deferred tax assets	<u>-</u>	<u>-</u>	<u>-</u>
Deferred tax liabilities:			
Development rights	(10,330)	(10,330)	(10,330)
Other	<u>(553)</u>	<u>(14)</u>	<u>(27)</u>
Total deferred tax liabilities	<u>(10,883)</u>	<u>(10,344)</u>	<u>(10,357)</u>

Valuation allowance is primarily attributable to the deferred tax asset relating to construction obligations, as deductibility of future costs to settle these obligations is uncertain under current Russian tax legislation.

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22. RELATED PARTY TRANSACTIONS

During the years ended December 31, 2005, 2004 and 2003, the Group entered into the following transactions with Sistema and its subsidiaries:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Revenues from development projects	17,333	1,383	15,490
Interest costs	(12,399)	(7,316)	(5,996)
Services provided	1,269	1,112	625
Services purchased	(374)	(590)	(4,567)
Interest income	96	-	121

Development projects:

MGTS

In the year ended December 31, 2005, the Group derived revenues of USD 14,442 thousand from the reconstruction of MGTS' building at Nastasyinsky lane.

MTS

In the year ended December 31, 2003, the Group derived revenues from MTS, a subsidiary of Sistema, of USD 8,753 thousand from the reconstruction of 3 of its buildings in Saint Petersburg.

MANEZH 13/1

In the year ended December 31, 2005, the Group entered into an investment agreement for USD 40,000 thousand with Manezh 13/1, a wholly owned subsidiary of Sistema, for the redevelopment of the building on Mokhovaya 13/1, owned by Sistema.

Agreements to act as a developer:

In the year ended December 31, 2004, the Group entered into an agreement with Detsky Mir, a subsidiary of Sistema, to act as a developer for a project to redevelop Detsky Mir's flagship store.

In the year ended December 31, 2005, the Group entered into an agreement with NIIDAR, a subsidiary of Sistema, to act as a developer for a project to develop a land plot, on which NIIDAR facilities are located, into a multipurpose residential, office and retail complex.

In the year ended December 31, 2005, the Group entered in a series of agreements with MGTS to act on its behalf as a developer for the first stage of the project to redevelop MGTS' telephone exchanges.

Interest costs:

In the years ended December 31, 2005, 2004 and 2003, interest costs on the Group's borrowings from MBRD amounted to USD 12,399 thousand, USD 7,316 thousand and USD 5,996 thousand, respectively.

Rental revenues:

In the years ended December 31, 2005, 2004 and 2003, the Group received rental revenues from Radio Centre, then a subsidiary of Sistema, of USD 519 thousand, USD 630 thousand and USD 396 thousand respectively.

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Services provided:

In the years ended December 31, 2005, 2004 and 2003, the Group provided site management services of USD 640 thousand, USD 508 thousand and USD 174 thousand, respectively, to Sistema subsidiaries.

Related party balances and guarantees as of December 31, 2005, 2004 and 2003 are disclosed in the corresponding notes to the financial statements.

23. GUARANTEES AND PLEDGES

Warranties and guarantees of work performed – The Group is contractually responsible for the quality of construction works performed subsequent to the date at which the relevant object was handed over, generally for a period up to 2 years subsequent to handover. Based upon prior experience with warranty claims, which have not been significant, no contingent liabilities have been recorded in the Group's financial statements in relation to warranties and guarantees for work performed.

Pledges – As at December 31 2005, common shares of the Group's entities have been pledged under borrowings from MBRD as follows:

	<u>Number of shares</u>	<u>Ownership interest</u>
Mosdachtrest	5,788	32%
Rosturstroy	36	8%
Landshaft	65	65%

As of December 31, 2005, the Group has also pledged land lease rights with the fair value of USD 11,093 thousand and title to apartments with the fair value of USD 1,243 thousand.

As of December 31, 2005, Sistema has guaranteed MBRD's borrowings to the Group in the amount of USD 39,288 thousand.

24. COMMITMENTS AND CONTINGENCIES

a) Licenses

The Group's revenues are derived from operations conducted pursuant to licenses issued by state authorities. These licenses expire in years 2007-2011. Suspension or termination of the Group's licenses or any failure to renew them could have a material adverse effect on the financial position and operations of the Group. However, the Group has no reason to believe that the licenses will not be renewed or suspended or terminated, and the management estimates the possibility of such events as remote.

b) Taxation environment

Russia currently has a number of laws related to various taxes imposed by both federal and regional governmental authorities. Applicable taxes include VAT, income tax, unified social tax, together with others. The government's policy on implementation of these regulations is often inconsistent or nonexistent. Accordingly, few precedents with regard to tax rulings have been established. Tax declarations, together with other legal compliance areas (for example, customs and currency

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control matters), are subject to review and investigation by a number of authorities, which are enabled by law to impose severe fines, penalties and interest charges. These facts create tax risks in Russia that are more significant than typically found in countries with more developed tax systems. Generally, tax declarations remain open and subject to inspection for a period of three years following the tax year. Management believes that it has adequately provided for tax liabilities; however, the risk remains that relevant authorities could take a different position with regard to interpretive issues.

c) Russian environment and current economic situation

Over the past decade Russia has undergone substantial political and social changes. As an emerging market, Russia does not possess a fully developed business and regulatory infrastructure that would generally exist in a more mature market economy. The Russian government is attempting to address these issues; however it has not yet fully implemented the reforms necessary to create banking and judicial systems that usually exist in more developed markets. As a result, operations in Russia involve risks that typically do not exist in more developed markets.

d) Industry regulation

Construction and development of real estate in Russia is primarily governed by the Civil Code, the Federal Land Code, the Federal Law on the State Registration of Rights to Immovable Property and Transactions Therewith, construction norms and regulations approved by the Ministry of Industry and Energy, and others. In addition, a new City Construction Code and the Federal Law on Entry into Effect of the City Construction Code came into force on December 30, 2004. Construction and development involves compliance with burdensome regulatory requirements, and authorizations from a large number of authorities at the federal, regional and local levels. In particular, the Federal Agency on Construction, Housing and the Communal Sector, or Rosstroi, the Federal Service for Supervision in the Sphere of Use of Natural Resources, the Federal Service on Ecological, Technologic and Nuclear Supervision and regional bodies of the state architectural and construction supervision are involved in the process of authorizing and supervising real estate development.

In addition, construction is subject to all applicable environmental, fire safety and sanitary norms and regulations.

The Group has started construction of a number of cottages without obtaining necessary construction permits. However, management is in the process of addressing this issue and does not foresee that this will adversely affect the Group's financial position or results of operations.

e) Legal proceedings

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

During 2005, no expenses or allowances for legal proceedings were recognized as the management estimates the probability of a negative outcome as low.

f) Commitments under construction contracts

The Group has entered into agreements with third parties for construction of objects which will require capital outlays subsequent to December 31, 2005. A summary of significant commitments under construction contracts as of December 31, 2005 is provided below:

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Leningradsky 39 – The Group has contracted for construction works, including foundations, shell and core, utilities and other general construction expenditures for the total amount of USD 114,663 thousand.

Mokhovaya 13/1 – The Group has hired a contractor, owned by a director of Sistema-Hals, to perform construction and finishing works for USD 31,855 thousand, the anticipated completion date being 2008.

MGTS properties – The Group entered contractual agreements for reconstruction of the abovementioned buildings for the total amount of USD 12,216 thousand.

Mosdachtrest properties – The Group has contracted for construction works related to Mosdachtrest properties for the total amount of USD 32,429 thousand.

Western Kuntsevo properties – The Group has hired a contractor to perform general construction works for USD 13,231 thousand.

Moscow City Government – The Group has obligations to manage a number of construction projects which will be completed subsequent to the balance sheet date. The Moscow City Government has the obligation to finance these construction projects, the Group generating commissions based on the agreed upon budget cost of the project.

g) Operating leases

Future minimum rental payments under land lease agreements in effect as of December 31, 2005 approximate USD 70 thousand per annum in the period from 2006 to 2015.

Mosdachtrest leases numerous cottages to individuals at a discount to market rates as a result of the Moscow Government requirement to make available certain properties to pensioners and other individuals entitled to social benefits.

h) Commitment to maintain production at Yalta Fish Processing Plant

In acquisition of Yalta Fish Processing Plant, the Group assumed obligations to maintain activities and workforce of the plant up to 2008. Management does not expect this commitment to result in significant cash outflows for the Group.

25. SEGMENT INFORMATION

SFAS No. 131, “Disclosures about Segments of an Enterprise and Related Information”, established standards for reporting information about operating segments in financial statements. Operating segments are defined as components of an enterprise engaging in business activities about which separate financial information is available that is evaluated regularly by the chief operating decision maker or group in deciding how to allocate resources and in assessing performance.

The Group’s operating segments are: Real estate development, Project and construction management, Real estate asset management and Facility management. Activities of the Group’s Real estate development segment include identification of investment opportunities, performance of feasibility studies, obtaining necessary construction permits, project financing and marketing activities. The Project and construction management segment is currently primarily acting as a construction manager to oversee compliance by contractors with design specifications and the terms of a particular contract. The Real estate asset management segment is involved in renting of residential and commercial properties that we have developed or acquired. The Facility management segment provides site management services, including security, cleaning, staffing, technical support,

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repair and renovation, as well as general building maintenance. The Group's management evaluates performance of the segments based on both operating income and income before income taxes and minority interests.

Intersegment eliminations presented below consist primarily of intersegment sales transactions, elimination of capitalized interest on intersegment borrowings and other intersegment transactions conducted under the normal course of operations.

As of and for the year ended December 31, 2005	Real estate development	Project and construction management	Real estate asset management	Facility management	Total
Net sales to external customers	48,497	22,729	14,878	7,020	93,124
Intersegment sales	463	14	421	247	1,145
Interest income	638	136	-	-	774
Interest expense, net of amounts capitalized	(1,956)	(1,948)	(541)	-	(4,445)
Depreciation and amortization	(261)	(274)	(2,223)	(25)	(2,783)
Operating income/(loss)	(6,642)	11,553	6,740	370	12,021
Income tax expense	(644)	(2,836)	(987)	(50)	(4,517)
Income/(loss) before income tax and minority interests	(1,948)	9,119	2,533	76	9,780
Segment assets	253,560	28,643	85,862	4,113	372,178
Capital expenditures	15,282	439	8,043	32	23,796

As of and for the year ended December 31, 2004	Real estate development	Project and construction management	Real estate asset management	Facility management	Total
Net sales to external customers	87,786	8,646	10,063	2,482	108,977
Intersegment sales	365	180	234	76	855
Interest income	552	-	-	-	552
Interest expense, net of amounts capitalized	(2,106)	-	(108)	-	(2,214)
Depreciation and amortization	(157)	(151)	(1,248)	-	(1,556)
Operating income	12,619	4,703	4,646	118	22,086
Income tax expense	(222)	(1,145)	(649)	(2)	(2,018)
Income/(loss) before income tax and minority interests	8,266	5,608	2,930	197	17,001
Segment assets	175,788	23,665	74,329	4,404	278,186
Capital expenditures	33,058	68	18,546	1,858	53,530

As of and for the year ended December 31, 2003	Real estate development	Project and construction management	Real estate asset management	Facility management	Total
Net sales to external customers	18,296	3,040	6,224	4,975	32,535
Intersegment sales	613	461	-	-	1,074
Interest income	121	-	-	-	121
Interest expense, net of amounts capitalized	(3,555)	-	(274)	-	(3,829)
Depreciation and amortization	(63)	(100)	(470)	(52)	(685)
Operating income/(loss)	(365)	4	1,879	(192)	1,326
Income tax expense	-	(83)	(69)	(2)	(154)
Income/(loss) before income tax and minority interests	(2,474)	(984)	2,281	(237)	(1,414)
Segment assets	158,584	5,602	53,770	1,746	219,702
Capital expenditures	14,826	110	12,506	-	27,442

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The reconciliation of segment operating income to the income/(loss) before income tax and minority interests and reconciliation of segment assets to total assets of the Group are as follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Total segment operating income	12,021	22,086	1,326
Intersegment eliminations	(322)	(276)	(306)
Other (expenses)/income, net	(1,201)	(1,275)	2,251
Interest income	682	552	121
Interest expense, net of amounts capitalized	(3,988)	(2,214)	(3,829)
Loss on foreign currency transactions	(193)	(1,872)	(977)
Gain on sale of a controlling interest in a subsidiary	2,781	-	-
Income/(loss) before income tax and minority interests	<u>9,780</u>	<u>17,001</u>	<u>(1,414)</u>
Total segment assets	372,178	278,186	219,702
Intersegment eliminations	(47,143)	(22,409)	(11,357)
Total assets	<u>325,035</u>	<u>255,777</u>	<u>208,345</u>

26. SUBSEQUENT EVENTS

Acquisitions – In January 2006, PSO Sistema-Hals acquired 25% plus one share of OJSC Sibmost for USD 2,400 thousand. Sibmost is a leading infrastructure project manager and developer in the Siberian Federal Region.

In March 2006, Sistema-Hals acquired 50% of the share capital of TRK Kazan, which it did not already own, for USD 11 thousand from another shareholder, after which TRK Kazan became a wholly owned subsidiary.

In May 2006, the Group acquired a 51% stake in NPTC Transtekhproekt for consideration of USD 36 thousand. NPTC Transtekhproekt is engaged in the construction, modernization and electrification of railways, motor roads, aerodromes and air terminals, sea and river ports, bridges, tunnels and subways, as well as industrial, housing and other facilities unrelated to transportation. The accounts of NPTC Transtekhproekt are included in the Group's financial statements starting from June 1, 2006.

In August 2006, to complete the corporate reorganization of Sistema's Real Estate segment, Sistema-Hals acquired from Sistema's subsidiaries outside of the Group a 99% stake in LLC Terra, a 100% stake in CJSC Capital-Invest, and 100% stake in LLC Kaskad and a 100% stake in Hotel-Korona Intourist for an aggregate consideration of USD 30,300 thousand.

In August 2006, the Group acquired from related parties a 100% stake in LLC Nostro for consideration of USD 26,600 thousand and committed to additionally invest USD 7,200 thousand to settle the debts of that entity. LLC Nostro owns a building located at Sadovnicheskaya st., 75. The difference between the purchase price for the Group and the price paid by the related parties was recorded by the Group as a distribution to the related parties.

Financing – In August 2006, Sistema-Hals entered into a loan facility with Deutsche Bank AG in the amount of USD 140,000 thousand for the term of one year. The loan facility was extended for the Group's general operational needs and bears interest rate of 8.65%. The debt is guaranteed by Sistema. The guarantee fee payable by the Group is 3% per annum.

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In September 2006, Sistema-Hals entered into a loan facility with NOMURA International Plc in the amount of USD 100,000 thousand for the term of one year. The loan facility was extended for the Group's general operational needs and bears interest rate of 8.45%. The debt is guaranteed by Sistema. The guarantee fee payable by the Group is 3% per annum.

In September 2006, the Group paid USD 100 thousand to acquire 19% of common shares of Kuntsevo-Invest from a minority shareholder. The transaction will be closed upon approval by regulatory bodies. As a result of this transaction, the Group's ownership interest in Kuntsevo-Invest will increase to 100%.

In September 2006, the directors approved general parameters of share-based payment awards to key employees of the Group. Conditions of the awards for individual employees will be finalized at a later date.