

GOLDEN TELECOM INC  
Form 10-K  
March 16, 2007

**Table of Contents**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549  
Form 10-K**

**Ⓟ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the Fiscal Year Ended December 31, 2006**

**○ TRANSITION REPORT PURSUANT TO SECTIONS 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number: 0-27423  
Golden Telecom, Inc.  
(Exact name of registrant as specified in its charter)**

**Delaware** 51-0391303  
(State of incorporation) (I.R.S. Employer Identification No.)  
**REPRESENTATION OFFICE OF GOLDEN TELESERVICES, INC.**  
**1 Kozhevnicshy Proezd**  
**Moscow, Russia 115114**  
(Address of principal executive offices)  
**(011-7-495) 797-9300**  
(Registrant's telephone number)

Title of each class: **Common Stock, \$0.01 par value per share**  
Name of each exchange on which registered: **NASDAQ Global Select Market**  
**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined by Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value of the Registrant's voting and non-voting common equity held by non-affiliates of the Registrant as of June 30, 2006 (the last business day of the Registrant's most recently completed second fiscal quarter) was \$212,790,060 based upon the closing price reported for such date on the NASDAQ Global Select Market.

The number of outstanding shares of the Registrant's common stock, par value \$0.01 per share, was, 36,673,015 as of March 13, 2007.

**Item of Form 10-K**  
Part III, Items 10-14

**Documents Incorporated By Reference**

Portions of the Registrant's proxy statement for the 2007 annual meeting of shareholders to be held in May 2007.

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**GOLDEN TELECOM, INC.**  
**FORM 10-K**  
**Year Ended December 31, 2006**  
**TABLE OF CONTENTS**

	<b>Page</b>
<b><u>PART I</u></b>	
<u>ITEM 1. Business</u>	3
<u>ITEM 1A. Risk Factors</u>	31
<u>ITEM 1B. Unresolved Staff Comments</u>	41
<u>ITEM 2. Properties</u>	42
<u>ITEM 3. Legal Proceedings</u>	42
<u>ITEM 4. Submission of Matters to a Vote of Security Holders</u>	42
<b><u>PART II</u></b>	
<u>ITEM 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	43
<u>ITEM 6. Selected Financial Data</u>	44
<u>ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	46
<u>ITEM 7A. Qualitative and Quantitative Disclosures About Market Risk</u>	72
<u>ITEM 8. Financial Statements and Supplementary Data</u>	74
<u>ITEM 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure</u>	106
<u>ITEM 9A. Control and Procedures</u>	106
<u>ITEM 9B. Other Information</u>	108
<b><u>PART III</u></b>	
<u>ITEM 10. Directors and Executive Officers of the Registrant</u>	109
<u>ITEM 11. Executive Compensation</u>	109
<u>ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	109
<u>ITEM 13. Certain Relationships and Related Transactions</u>	109
<u>ITEM 14. Principal Accountant Fees and Services</u>	109
<b><u>PART IV</u></b>	
<u>ITEM 15. Exhibits and Financial Statement Schedules</u>	110
<b><u>SIGNATURES</u></b>	<b>113</b>
<u>Employment Agreement</u>	
<u>Schedule of Compensation Arrangements with Directors</u>	
<u>Subsidiaries</u>	
<u>Consent of Ernst &amp; Young LLC</u>	
<u>Certification of CEO Pursuant to Section 302</u>	
<u>Certification of CFO Pursuant to Section 302</u>	
<u>Certification of CEO Pursuant to Section 906</u>	
<u>Certification of CFO Pursuant to Section 906</u>	

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**Table of Contents**

**PART I**

**ITEM 1. Business**

**Introduction**

We are a leading facilities-based provider of integrated telecommunication and Internet services in major population centers throughout Russia and other countries of the Commonwealth of Independent States ( CIS ). We offer voice, data and Internet services to corporations, operators and consumers using our metropolitan overlay network in major cities throughout Russia, Ukraine, Kazakhstan and Uzbekistan, and via intercity fiber optic and satellite-based networks, including approximately 289 combined access points in Russia and other countries of the CIS. In addition, we offer mobile services in the Ukrainian cities of Kiev and Odessa.

We organize our operations into four business segments, as follows:

***Business and Corporate Services.*** Using our fiber optic and satellite-based networks in and between major metropolitan areas of Russia, Ukraine and other countries of the CIS, we provide business and corporate services including voice and data services to corporate clients across all geographical markets and all industry segments, other than telecommunications operators;

***Carrier and Operator Services.*** Using our fiber optic and satellite-based networks in and between major metropolitan areas of Russia, Ukraine and other countries of the CIS, we provide a range of carrier and operator services including voice and data services to foreign and Russian telecommunications and mobile operators;

***Consumer Internet Services.*** Using our fiber optic and satellite-based networks, we provide Internet access to the consumer market and web content offered through a family of Internet portals throughout Russia, Ukraine, Kazakhstan, and Uzbekistan; and

***Mobile Services.*** Using our mobile networks in Kiev and Odessa, Ukraine, we provide mobile services with value-added features, such as voicemail, roaming and messaging services on a subscription and prepaid basis.

We intend, wherever possible, to offer all of our integrated telecommunication services under the Golden Telecom brand, although, some services still carry local brands because of recent acquisitions. Our dial-up Internet services are distributed under the ROL brand in Russia, Kazakhstan and Uzbekistan and under the Svit-On-Line brand in Ukraine.

**Business Section Overview**

The following subsections within the Business section describe our business strategy, our current position in the markets in which we operate, our corporate history and development, our customer base, and a detailed review of our service groups by operating segments. Additionally, we describe our licenses and our network facilities. Finally, we provide a summary of the principal environments in which we operate, the telecommunications markets, the political and economic environments, and the legal, tax and regulatory regimes in Russia and Ukraine.

**Business Strategy**

Our objective is to be the leading facilities-based alternative voice, data and Internet services company in Russia and key markets in the CIS. To achieve this objective, we intend to:

***Increase Market Share by Offering Bundled Data and Voice Services Over an Integrated Network***

Corporate customers increasingly demand integrated telecommunications solutions from one-stop providers that are able to deliver a full service offering in the geographical areas in which these corporate customers operate. As a result, we plan to continue to develop and combine our businesses to create a unified service platform for local access, local exchange, domestic long distance/international long distance ( DLD/ILD ), data, Internet access and services via turn-key solutions.

***Extend Our Leading Position in High Growth Data and Internet Markets***

We plan to build on our position as a leading provider of data and Internet communication services in Russia and other countries of the CIS by increasing the number of network access points in our network to facilitate the growing volume demand for data and Internet communications. In addition, we plan to pursue an expansion of our broadband access strategy.



## **Table of Contents**

### *Reduce Operating Costs and Satisfy Capacity Needs through Network Planning and Optimization*

Our network strategy includes building and owning our local exchange and customer access networks. We have entered into long-term lease agreements for long-distance and international fiber optic cable systems to provide our regional and global connectivity, supplementing these leased land-based channels with satellite circuits for redundancy and remote connectivity. We intend to selectively invest in and to incrementally expand the fiber optic capacity along our heavy traffic and high cost intercity routes to reduce our unit transmission costs and ensure sufficient capacity to meet the growing volume demand for data and Internet services. Wherever possible, we target customers and sell products which enable us to fully utilize existing fixed cost network infrastructure.

### *Focus Operating Activities and Capital Investments in Major Metropolitan Areas*

We plan to make capital investments primarily in major population centers in Russia and Ukraine, where demand for our services is most heavily concentrated. We also intend to expand our operations in regional cities with sufficiently strong local economies in which we believe the potential exists to grow businesses that complement our current operations.

### *Pursue Consolidation Opportunities*

We intend to pursue consolidation opportunities through selective acquisitions that will allow us to expand our geographical reach, add to our service offerings and improve our market share while maintaining operational control. We will target complementary opportunities that will enable us to achieve synergies and economies of scale and seek regional opportunities in major cities where we do not have our own local network infrastructure.

## **Our Position in the Russian and CIS Markets**

We believe that we are well positioned to maintain and consolidate our strong presence in the Russian and CIS telecommunications markets for the following reasons:

our early market entry and local market experience;

our focus on service, quality and reliability;

our strong infrastructure position in major cities throughout Russia, Ukraine, Kazakhstan and Uzbekistan;

our extensive customer base;

our extensive range of integrated voice, data and Internet telecommunications services;

our diverse and influential shareholder base; and

our strong balance sheet position.

## **Corporate History and Development**

*Golden Telecom, Inc.*, initially a majority owned subsidiary of Global TeleSystems, Inc. ( GTS ), was incorporated in Delaware in June 1999 in preparation for our initial public offering ( IPO ) which took place in September 1999. GTS was founded in 1983 as a not-for-profit company under the name San Francisco/Moscow Teleport, Inc. and was among the first foreign telecommunications operators in the former Soviet Union, where it began offering data links to the United States ( US ) in 1986, ILD services in 1992, local access to its networks in 1994 and cellular services in 1995. At the time of our IPO, GTS contributed substantially all of the assets that constituted Golden Telecom, Inc.

In September 2002, we purchased the 50% of EDN Sovintel LLC ( Sovintel ) that we did not own from OAO Rostelecom ( Rostelecom ), the Russian national long distance carrier. As a result of this purchase, we own 100% of Sovintel. In April 2003, we merged the operations of TeleRoss, our wholly-owned subsidiary, into Sovintel.

In August 2003, we acquired 100% of Sibchallenge Telecom LLC ( Sibchallenge ), the leading alternative wireline operator in Krasnoyarsk, Russia. Sibchallenge owns 100% of ZAO Tel ( Tel ), an Internet service provider, also based in Krasnoyarsk. In August 2005, we merged the operations of Sibchallenge, including Tel, into Sovintel.

In December 2003, we acquired 100% of OAO Comincom ( Comincom ), and its wholly-owned subsidiary, OAO Combella ( Combella ), from Nye Telenor East Invest AS ( Telenor ). As part of this transaction, we issued shares to Telenor representing





**Table of Contents**

19.5% of our shares outstanding after the acquisition. In December 2004, we merged the operations of Comincom, including Combellga, into Sovintel.

In February 2004, we acquired 100% of ST-HOLDING s.r.o., a Czech company that owns 50% plus one share of ZAO Samara Telecom ( Samara Telecom ), a telecommunications service provider in Samara, Russia, from ZAO SMARTS and individual owners. In April 2004, we acquired 100% of OAO Balticom Mobile that owns 62% of ZAO WestBalt Telecom ( WestBalt ), an alternative telecommunications operator in Kaliningrad, Russia. In April 2004, we also acquired the remaining 49% ownership interest that we did not own, in Uralrelcom LLC, which was merged into Sovintel in August 2005. In May 2004, we acquired 54% of SP Buzton ( Buzton ), an alternative telecommunications operator in Uzbekistan.

In March 2005, we acquired 75% of Dicom LLC, an early stage wireless broadband enterprise. In September 2005, we acquired 60% of Joint Venture Sakhalin Telecom Limited LLC ( Sakhalin Telecom ), a fixed line alternative operator in the Far East region of Russia from OAO Vimpel Communications ( Vimpelcom ). As a result of this acquisition and combined with our previous ownership in Sakhalin Telecom, we now own 83% of Sakhalin Telecom. In October 2005, we acquired 100% of ZAO Sochitelecom ( Sochitelecom ), a fixed line alternative operator in the Krasnodar region of Russia. In October 2005, we acquired 100% of Antel Rascom, Ltd., a British Virgin Islands company that owns 49% of ZAO Rascom ( Rascom ), an infrastructure and facilities company in the northwest region of Russia. In December 2005, we acquired an additional 5% of Rascom.

In March 2006, we acquired 70% of ZAO Tatar Intellectual Communications ( Tatintelcom ), an Internet service provider ( ISP ) in the Russian Republic of Tatarstan. In April 2006, we acquired 100% of TTK LLC ( TTK ), a fixed line alternative operator in the Ivano-Frankovsk region of Ukraine. In June 2006, we acquired 74% of Kubtelecom LLC ( Kubtelecom ), a fixed line alternative operator in the Krasnodar region of Russia. In August 2006, we acquired 100% of Telcom LLC ( Telcom ), a fixed line alternative operator in Nizhny Novgorod, Russia. In October 2006, we acquired 75% of S-Line LLC ( S-Line ), an early-stage wireless broadband enterprise in Kiev, Ukraine. In October 2006, we acquired 100% of ZAO Corus ISP ( Corus ), an ISP in Ekaterinburg, Russia.

In February 2007, we acquired 65% of Fortland Limited ( Fortland ), which owns Kolangon-Optim LLC ( Kolangon ), an early-stage digital video broadcast enterprise in Russia.

**Regulatory Environment****Russia**

On January 1, 2004, a new Law on Communications (the Telecommunications Law ) came into effect in Russia. While some of the supporting regulations to implement the Telecommunications Law have not been enacted, the Russian government approved in March 2005 new rules for interconnection (the Interconnection Rules ) that became effective on January 1, 2006. These Interconnection Rules contemplate a new three-layer interconnection system consisting of DLD/ILD, zonal, and local operators. Under this new structure, end-users will have the right to choose a long distance operator, and DLD/ILD operators will be required to have interconnection points in each of the 88 constituent territories of the Russian Federation. In addition, the Telecommunications Law created a universal service fund ( USF ) charge, which became effective on May 3, 2005, calculated as 1.2% of revenue from services provided to customers, excluding interconnection and other operators' traffic routing revenue. We have incurred approximately \$4.6 million in USF charges for year ended December 31, 2006, which is recorded as part of cost of revenue. However, on February 28, 2006, the Constitutional Court of the Russian Federation ruled that the provisions of the Telecommunications Law relating to the USF charge do not comply with the Constitution of the Russian Federation and shall become null and void as of January 1, 2007, unless the Telecommunications Law is amended prior to that date. The Constitutional Court established that essential criteria of the charge, including the maximum rate and basis of calculation, must be established by legislative action and not by the administration. On December 29, 2006, the Russian President approved amendments to the Telecommunications Law setting forth essential criteria of the USF charge. These amendments became effective on January 1, 2007.

On May 31, 2005, we received a DLD/ILD license in Russia which is valid until May 31, 2012. We are required under the license to begin providing services and fulfil the network requirements specified in the Interconnection Rules not later than May 31, 2007. On January 16, 2006, we announced that the construction of our Federal Transit Network ( FTN ) was complete in compliance with the Telecommunications Law and our DLD/ILD license. The FTN

consists of four international communications transit nodes, seven intercity communications transit nodes deployed in each federal district of Russia, and 88 connection points or FTN access nodes located in each constituent territory of Russia. We have obtained the required governmental permissions for operation of all the international and intercity communications transit nodes that are part of the FTN. On April 28, 2006, all of the 88 connection points were formally commissioned by Rossvyaznadzor, a governmental body that reports to the Ministry of Information Technologies and Communications of the Russian Federation (the Russian Ministry of Telecommunications ) that is responsible for the control and the supervision of information technology and communications as well as for commissioning the long distance networks. On March 12, 2007, Russian President Putin signed an order, to take immediate effect, to merge Rossvyaznadzor with Rosokhrankultura, a body which protects culture and supervises media issues. On June 29, 2006, we announced that we have entered into interconnection agreements with all Russian zonal incumbent fixed line telecommunications operators. On December 15, 2006, the Russian Ministry of Telecommunications granted us access codes to

**Table of Contents**

operate our FTN. On January 29, 2007, we launched DLD/ILD services using our FTN. We believe that provision of DLD/ILD services will allow us to gain additional revenues from our international and domestic long distance operations.

We believe that our DLD/ILD license will enable us to protect our relationship with our corporate clients and, in the long term, expand our business into the residential long distance market. Under the previous regulation, the local operators collected full tariffs for DLD/ILD calls and passed only a portion of the revenue to the DLD/ILD operator. However, in the near term, we do not expect significant growth in our DLD/ILD gross margins since we will incur additional costs payable to the incumbent OAO Svyazinvest ( Svyazinvest ) companies in the form of compensatory fees and other surcharges. DLD/ILD carriers will continue to pay this compensatory fee until local tariffs are raised to an economically viable level. This increase in local tariffs is expected to be completed by the end of 2007. Under the new system, the local operators may also act as agents for DLD/ILD carriers, billing clients for long distance calls and collecting payments on behalf of the DLD/ILD operators. We incur additional costs payable to the local operators acting as our agents in the form of commission fees. We currently anticipate that our new license will result in an increase of DLD/ILD revenues since we will begin to earn long distance revenue directly from end-users. However, the impact on our DLD/ILD revenues is dependent on the contractual arrangements with the end-users. Historically, local operators established the end-user tariffs for our DLD/ILD services within the limits we set for local operators. However, in the future we may change this tariff setting policy and fix end-user tariffs. We are still analyzing these future DLD/ILD revenues to determine the impact on our business and how these will be classified for segment reporting purposes. At present we continue to report DLD/ILD revenues from local operators net of payments to these operators for interconnection and agency fees, since the economic substance of our settlements with local operators has not changed following the introduction of the new Interconnection Rules, and other conditions that might otherwise require us to present those same revenues and costs on a gross basis have not yet been fulfilled.

On October 19, 2005, the Russian government enacted the Rules on Price Establishment for Interconnection and Traffic Routing. These rules list interconnection services and traffic routing services provided by the incumbent operators that are subject to pricing regulation by the government. The effective utilization and implementation of the Russian long distance license is subject to the establishment of tariffs for interconnection and traffic routing services to be provided by incumbent Svyazinvest state-owned companies and other incumbent operators. The tariffs are paid by long distance operators to the incumbent local and zonal operators for each minute of long distance traffic that is carried such that all long distance operators are cross-subsidizing the local and zonal network of the incumbent operators. Such cross-subsidization will continue until January 1, 2008. By that date, the new pricing setting mechanisms and tariff re-balancing should be fully implemented. During the first half of 2006, in the absence of the regulated tariffs most of the incumbent operators, including all of Svyazinvest companies, imposed their own independently established tariffs on alternative long distance, zonal and local operators. However, on June 19, 2006, Rossvyaznadzor established the maximum limits for such tariffs. As a result, the incumbent operators are permitted to impose tariffs on alternative long distance, zonal and local operators within these limits. Thus, effective July 1, 2006, tariffs for interconnection with the incumbent zonal operators decreased. To minimize the impact of payments to the incumbent operators, we have received licenses to provide zonal services in all the regions of the Russian Federation. During 2006, we started construction of zonal networks in 12 regions of the Russian Federation. To date, we have completed construction of zonal networks in Moscow, St. Petersburg, Kaliningrad, Pskov, Samara and Sakhalin regions of Russia. In total, we are planning to construct zonal networks in 28 to 30 regions by the end of 2008. However, in those regions where we have not completed construction of zonal networks, we will be required to act as an agent for zonal carriers, billing clients for intra-zonal calls and collecting payments on behalf of the zonal operators. We are still analyzing these changes in settlements with zonal operators to determine the impact on our business.

In the third quarter of 2006, incumbent Svyazinvest operators started introducing new settlement rules for local traffic. Prior to July 1, 2006, we paid fixed monthly fees for interconnection lines with these operators. Under the new rules, the settlements will be based on the actual volume of traffic. The switch to the new rules was not completed in 2006. As a result of these changes, we expect an increase in cost of revenue which could be partially offset by additional revenue for the traffic termination to our network.

In February 2005, we received notice from Vimpelcom, our largest customer, that it was diverting a volume of traffic away from our network due to their preliminary interpretation of traffic routing regulations issued by the Russian Ministry of Telecommunications. However, in the third quarter of 2005, Vimpelcom traffic volumes were restored to their previous 2004 levels as a result of our discussions with Vimpelcom and clarification from the regulatory agencies. In April 2006, Vimpelcom received a DLD/ILD license. Vimpelcom is required under the license to begin providing services and fulfill the network requirements specified in the Interconnection Rules not later than December 12, 2007. However, until Vimpelcom completes all technical requirements and obtains formal commissioning by Rossvyaznadzor, we do not expect this carrier to reduce its traffic volumes with us.

On March 4, 2006, the Russian President approved amendments to the Telecommunications Law that introduced calling party pays rules ( CPP Rules ). Effective July 1, 2006, under the CPP Rules, generally all incoming calls, on fixed and mobile lines, in Russia are free of charge, and only the fixed line or mobile operators originating the call may charge the customer for the call. Subscribers of fixed line telephones did not pay for incoming calls and, therefore, the CPP Rules will not have an impact on fixed-to-fixed line calls, but the CPP Rules impact the fixed-to-mobile calls as mobile companies traditionally charged for incoming calls in Russia. For the year ended December 31, 2006, we have recorded approximately \$29.5 million in additional revenue. However, this increase in

**Table of Contents**

revenue was partially offset by approximately \$20.2 million in additional cost of revenue due to the introduction of termination charges to mobile networks.

**Ukraine**

In March 2006, the Ukrainian government submitted to the Ukrainian Parliament ( Verkhovna Rada ) a draft law introducing a USF charge in Ukraine, calculated as 2% of revenue. In September 2006, this draft law was amended to make a USF charge in Ukraine effective January 1, 2008.

In April 2006, the National Commission of Communication s Regulation ( NCCR ) issued a license for GSM-1800 radio frequency to Golden Telecom (Ukraine) ( GTU ), our subsidiary in Ukraine. Currently, GTU provides services in Kiev and Odessa. The new license will enable GTU to offer mobile services in 22 out of the remaining 25 regions of Ukraine that GTU does not currently cover. Payment of the \$5.5 million license fee was made on May 10, 2006. In May 2006, we began using the frequencies and submitted registration documents to UkrChastotNadzor, a Ukrainian governmental body that is responsible for the control and the supervision of the radio frequencies. To date, we have complied with the license requirements related to the use of allocated radio frequencies by launching operations in 4 out of 22 regions.

Effective July 15, 2006, the NCCR introduced new tariffs for provision of voice services to fixed line subscribers. As a result of the tariff re-balancing policy, the tariffs for local calls and monthly fees increased and tariffs for DLD/ILD calls decreased. Effective November 1, 2006, the NCCR continued the tariff re-balancing process by increasing the tariffs for local calls and monthly fees and by decreasing the tariffs for fixed-to-mobile calls. On October 28, 2006, the Verkhovna Rada approved the amendments to the Ukrainian Law on Telecommunications which changed the list of the telecommunication service tariffs subject to the public regulation. Under new regulation, tariffs for DLD/ILD calls were excluded from the public regulation. The amendments also exclude fixed-to-mobile calls from the public tariff regulation. As a result of these changes, we expect increased competition from the incumbent operators in DLD/ILD services market.

Effective January 1, 2007, the NCCR introduced new interconnection settlement rules. During 2006, we paid fixed monthly fees for interconnection lines with other operators. However, under the new rules the settlements will be based on the actual volume of traffic. As a result of these changes, we expect an increase in cost of revenue which could be partially offset by additional revenue for the traffic termination to our network.

**Customer Base**

We compete primarily for high-volume business customers and carriers who require access to highly reliable and advanced telecommunications facilities to operate their business. Together, our top five customers accounted for approximately 7% of our consolidated revenues for the year ended December 31, 2006. Our largest customer, Vimpelcom, accounted for approximately 3% of our consolidated revenues for the year ended December 31, 2006. No customer accounted for over 5% of our consolidated revenues for the year ended December 31, 2006.

Our principal customer segments are:

*Corporate Network Customers.* Corporate network customers are typically large multinational, Russian or Ukrainian companies which require the full range of voice, data and Internet services in several cities across Russia, Ukraine and other countries of the CIS. While pricing is always a factor, this segment places more value on network coverage, reliability as defined by service level agreements, and the ability to design, install and maintain local area networks ( LAN ) and wide area networks ( WAN ). These customers are willing to make longer-term commitments to integrated one-stop providers in exchange for higher levels of service.

*Corporate End-Users.* Corporate end-users are foreign and Russian enterprises with centralized operations, either in Moscow, Kiev or in the regions. These corporate end-users also require a full range of voice, data and Internet services, but are more likely to purchase distinct services from separate suppliers based on price. We attempt to increase business with corporate end users by providing superior technology and service levels at competitive prices.

*Small and Medium Businesses ( SMB ).* We define small and medium enterprises as those business customers that require a full range of voice, data and Internet services and generally have monthly billings of less than \$2,000.

*Fixed-Line Operators.* Fixed-line operators are other telecommunications providers, including other overlay operators operating in Moscow, alternative regional fixed-line operators and local operators, which we refer to as the local telcos. Price is the primary factor in their purchase decision, and although long-term contracts are rare, traffic

volumes can be large. Voice telephony is a commodity for customers in this segment.

**Table of Contents**

*Cellular Operators.* Russian cellular operators purchase large quantities of local numbering capacity in Moscow that they use in selling cellular services to their customers. Ukrainian cellular operators distribute large volumes of international and intercity traffic through our network in Ukraine. Price, availability and quality of service are primary factors in the purchase decision of these customers.

*Mass Market.* We define the mass market as households or in some cases more narrowly, as those customers who utilize calling cards or dial-up Internet access. This market segment is price-sensitive, but quality of service is also important, particularly in the Internet access market. These customers predominantly prepay for such services. In Kiev and Odessa, Ukraine, we also offer mobile services to the mass market, targeting individuals with above average disposable income, where price and quality are also primary decision factors.

Our recently constructed FTN and receipt of access codes will also present new opportunities for growth. Our FTN provides us with a potential customer base across all geographic zones in the Russian Federation of up to 2.2 million businesses, 143 million people, of which there are 32 million residential customers, in the 88 Russian regions. This is an increase from our previous breadth of coverage which only allowed us to reach 25 regions in Russia with up to 0.3 million businesses and a population of 77.1 million people. With the FTN, we will be able to offer our wide range of telecommunications services, including DLD/ILD telecommunications services, to every person and all businesses across Russia's eleven time zones.

**Pricing**

Historically, our customers made payments to us in the appropriate local currency, however the majority of our tariffs were denominated in United States dollars ( USD ) and were indexed to the USD for settlement purposes. Also, the majority of our operating costs were denominated in USD, but settled in the appropriate local currency. However, in the second and the third quarters of 2006, our main operating subsidiary, Sovintel, introduced semi-fixed USD/RUR exchange rate for settlements with the majority of its customers. This rate is effective only if the official USD exchange rate set by the Central Bank of Russia ( CBR ) is below the fixed level. If the RUR depreciates against USD so that the CBR exchange rate exceeds the fixed level, Sovintel will resume applying the CBR exchange rate, or floating rate, for settlements with its customers.

**Our Service Groups**

This section provides a detailed review of our business on a segment basis and by operating division. We provide additional information on the services and customers, marketing and pricing, and competition within each division.

**Business and Corporate Services ( BCS )*****BCS Services in Russia***

We operate a number of competitive local exchange carriers ( CLECs ) that own and operate fully-digital overlay networks in a number of major Russian cities. The majority of our services are provided through our wholly-owned Moscow-based subsidiary Sovintel. We are an integrated provider of the largest range of telecommunication services available on the Russian market, including network access and hardware and software solutions including installation, configuration and maintenance. Our geographical coverage includes all major population centers including Moscow, St. Petersburg, Nizhny Novgorod, Khabarovsk, Arkhangelsk, Ufa, Vladivostok, Irkutsk, Kaliningrad, Ekaterinburg, Voronezh, Krasnodar, Tyumen, Volgograd, Samara, Tula, and Krasnoyarsk.

***Services and Customers***

*Local Access Services.* Local access services are provided to business customers through the connection of the customers' premises to our fiber network, which interconnects to the local public switched telephone network ( PSTN ) in Moscow, St. Petersburg, Nizhny Novgorod, Khabarovsk, Ufa, Vladivostok, Novosibirsk, Irkutsk, Kaliningrad, Ekaterinburg, Voronezh, Krasnodar and Krasnoyarsk.

*International and Domestic Long Distance Services* We provide ILD services to our customers via our FTN network comprising our own international toll exchanges in European and Asian part of the Russian Federation in full compliance with regulatory requirements towards networks interconnection.

DLD services are primarily provided through our federal intercity transmission network, proprietary and leased capacity between major Russian cities, and through interconnection with zonal networks and networks of Rostelecom in compliance with state regulation on the interconnection of telecommunications networks. We offer very small aperture terminal ( VSAT ) satellite services





**Table of Contents**

to customers located in remote areas that cannot be physically connected through terrestrial cables to our regional long distance switches, as well as to large infrastructure projects in need of sophisticated and reliable communications systems.

*Dedicated Internet and Data Services.* We provide our business customers with dedicated access to the global Internet through our access and backbone networks. We also offer traditional and high-speed data communications services to business customers who require WAN to link computer networks in geographically dispersed offices, using frame relay, X.25, asynchronous transfer mode and Internet protocol technologies. We also provide private line channels to customers who require high-capacity and high-quality domestic and international point-to-point connections. Private lines can be used for both voice and data applications.

*Integrated Voice and Data Services.* The markets where we operate are experiencing a continuing trend toward routing voice traffic over the Internet using Internet Protocol ( IP ) technology, known as Voice over IP or VoIP . We are a leading provider of this service. In addition to using data networking services for typical LAN to LAN interconnections, many customers will also route their voice traffic over our frame relay data network to reduce overall telecommunications expenses. Voice over frame relay involves packetizing voice calls using frame relay, a data transmission protocol, and transporting the voice call over our data network to be de-packetized at the terminating end. The call is finally terminated through normal circuit switching. Packet switching offers greater cost efficiencies over circuit switching, and offers this division an opportunity to leverage its data network investment across a greater number of services and geographic areas. This type of integrated communication solution is also offered by Integrated Services Digital Network ( ISDN ) products where basic services include telephony, fax, data transmission, Internet access, and video conferencing.

*Value-Added Services.* We offer an increasing range of value-added services such as dedicated hosting, co-location and IP, or IP-based Virtual Private Networks ( VPNs ) and we intend to increase our market position in these services. Our Managed Data Center, which consists of a total area of 600 square meters, continues to be the leading hosting center in Russia and provides services to news agencies, financial and entertainment services providers. We enjoy strong sales synergies between our Managed Data Center products and our IP transit sales efforts. We offer a variety of information services addressing the needs of financial markets including access to S.W.I.F.T., Reuters, Bloomberg and MICEX, or the Moscow Inter-bank Currency Exchange. We also have a Moscow-based Call Center that has a leading position in providing telemarketing, actualization and Hot Line services for business clients. We offer fixed-to-mobile convergence services in conjunction with Vimpelcom to corporate clients that wish to use their mobile phone as an extension of their private branch exchange ( PBX ).

*Equipment Sales.* As part of our integrated service offering, we sell equipment manufactured by Nortel Networks, Cisco Systems, Alcatel, Siemens, Avaya, Motorola and Ericsson. As part of our turnkey solutions, we also offer the installation, configuration and maintenance of Nortel Meridian One products, Norstar key systems, Mercator PBXs and the Passport lines of data equipment. This close customer contact assists in the marketing of additional services and enhances customer retention.

Major customers range from large multinational and Russian corporate groups to Russian SMBs and residential users. Our business customers cover all industry segments including business centers, hotels, financial institutions, professional services firms, fast moving consumer goods companies, manufacturers and companies involved in extractive industries. Our customers are located in all major cities throughout Russia.

***Marketing and Pricing***

For Sovintel, sales to customers are made through a direct sales force consisting of approximately 148 account managers in Moscow. Each account manager targets specific customer groups and industry segments and is supported by specialists in technical sales support, marketing, customer service and end-user training.

In addition, a team of regional sales managers is responsible for supporting the regional sales force and maintaining relations with our regional partners. We have a dedicated sales force in each of our regional branch offices and for other regional cities we have sales incentive plans with our regional partners.

We train our employees to provide customer service at a level which is comparable or better to that provided by Western telecommunications companies. As a result, we believe we have earned a reputation for providing high-quality telecommunications services through an experienced and professional customer service staff.

We price our services at a premium compared to those offered by the incumbent local operator and competitively with other alternative service providers within the market. We offer volume discounts to customers for exceeding certain defined revenue thresholds. Although we publish standard tariffs, generally we are not required to obtain regulatory approval to change tariffs. While pricing competition remains a factor, especially for voice services, many corporate data networking customers place more value on network coverage, reliability and our ability to design, install and maintain LANs and WANs. These customers often require integrated solutions, including connections to offices located in different cities. Depending on the cities involved, there are often few operators that can provide these services, and accordingly, there is often less pricing pressure.

## **Table of Contents**

### *Competition*

We compete principally on the basis of installation time, network quality, geographical network reach, customer service, range of services offered and price. While we have a leading position in this market, we face significant competition from other service providers, including:

Comstar-UTS, a subsidiary of Sistema Telecom, including Moscow City Telephone Network ( MGTS ) for all services provided to corporate customers and the SMB market in Moscow;

Equant, trading as Orange Business Services, a subsidiary of France Telecom, for corporate data networking services across Russia;

TransTelecom, currently owned by the Russian Railways, for corporate data networking services across Russia;

Peterstar, an affiliate of Telecominvest, for services provided in St. Petersburg; and

Regional subsidiaries of Svyazinvest, a holding group with a majority government ownership, for services provided in St. Petersburg and within Russian regional cities.

### ***BCS Services in Ukraine***

The BCS division of GTU, our largely Kiev-based CLEC, has constructed and owns a 781 kilometer fiber optic network, including 495 kilometers in Kiev, which is interconnected to the local PSTN in Kiev, to other major metropolitan areas in Ukraine, and to our international gateway. Data and Internet access services are provided in 89 regional access points in 35 metropolitan cities in Ukraine using leased terrestrial capacity from Ukrtelecom, the Ukrainian incumbent operator, and from some alternative providers.

Since the opening of our mobile service operation in Odessa in 2001, we have expanded our local access service offerings into Odessa, targeting business clients. In the third quarter of 2002, GTU started to offer local access and pre-paid VoIP services in Dnepropetrovsk. Further, following our regional development strategy, in the second quarter of 2003 we started to offer local access, VoIP and dial-up Internet services in Lvov, and in the second quarter of 2004 we launched the same service offering in Zaporozhye. The next step of our regional development was the launch of local access, VoIP and broadband and dial-up Internet services offer in Kharkov in June 2005. During 2006 we launched local access and broadband Internet services in Donetsk and Ivano-Frankovsk, through the acquisition of TTK. In 2007, we plan to start deployment and development of the fixed-mobile convergent ( FMC ) services in 22 major metropolitan areas in Ukraine. The FMC network will become the major driver of our regional expansion.

In the second quarter of 2003, GTU constructed a Metropolitan Area Network ( MAN ) in Kiev providing a new range of services, including broadband access to Internet and VPN service. In the fourth quarter of 2004, GTU deployed a MAN in Odessa. In the first quarter of 2004, GTU launched an IP node in Kiev providing interconnection with international operators via the public Internet and the possibility to offer new services such as VoIP, VPN and IP phones. During 2005 and 2006, GTU has completed construction of a fully protected international backbone network from Kiev to its points of presence in Frankfurt, Germany, via three independent border-crossings with Poland and Hungary. During 2006, we upgraded our nationwide backbone network by installing STM-16 capacity from the Western part of Ukraine to Kiev via Lvov, Lutsk, Rovno, Zhitomir, and synchronous digital hierarchy ( SDH ) capacity to the eastern part of Ukraine from Kiev to Kharkov via Chernigov and Sumy. We have also expanded our leased capacity to Dnepropetrovsk, Donetsk, Odessa, and Zaporozhye and upgraded it to STM-1 level.

During 2005, in order to expand market penetration in Ukraine and to increase utilization of technical infrastructure, GTU began to provide wireline local access and broadband Internet services to residential customers in Kiev. Due to the lack of modern, high quality and customer-oriented telecommunications services available on the Ukrainian residential market, we are able to competitively price our services and offer high quality telecommunications services through an experienced and professional customer service staff. GTU plans to significantly increase the number of residential customers during 2007.

As of December 31, 2006, the BCS division of GTU serviced more than 59,500 telephone lines for business and connected almost 9,370 residential telephone lines.

*Services and Customers*

*Local Access Services.* Local access services are provided to business customers through the connection of their premises to GTU's fiber network, which interconnects to the local PSTN in Kiev, Odessa, Dnepropetrovsk, Lvov, Kharkov, Zaporozhye, Donetsk and Ivano-Frankovsk.

## **Table of Contents**

*International and Domestic Long Distance Services.* GTU provides outgoing international voice services to business customers through its international gateway and direct interconnections with major international carriers, transmitting traffic to international operators using least-cost routing. DLD services are primarily provided through our own intercity transmission network, leased capacity between major Ukrainian cities, and through interconnection with Ukrtelecom's network. On September 20, 2005, the NCCR in Ukraine issued an international license (the Ukrainian International License) to GTU. The Ukrainian International License allows GTU to provide international telecommunications services throughout all of Ukraine, allows leasing of transmission channels to third parties, and increases GTU's potential as an international telecommunications carrier.

*Dedicated Internet and Data Services.* GTU provides a private line service, VPN services, an integrated voice and data ISDN connection, frame relay, broadband digital subscriber line (xDSL), and dedicated Internet services. GTU's main focus in 2006 was the development of broadband access to VPN and xDSL services, required by customers with high-volume data traffic needs.

*Voice over Data Services.* GTU is a leading provider of voice over data services in Ukraine. Our pre-paid cards and our VoIP products introduced under the brand Allo! held the leading position in the market with more than a 60% market share in Kiev, providing an alternative international calling solution for corporate and mass market customers. This service is in stagnation stage due to general decrease in ILD tariffs of PSTN and mobile operators.

*Information Services.* GTU provides telecommunications services to financial and banking companies such as S.W.I.F.T. and Western Union, access to processing centers, news services to companies such as Reuters, as well as conduits to airline reservation systems in Ukraine. We have been chosen as one of two exclusive last mile providers for Reuters services in Ukraine. Our data center provides server co-location and hosting services for news agencies, financial and entertainment services providers.

*Call Center Services.* With the launching of Call Center services at the end of 2002, GTU captured the leading position in providing telemarketing, actualization and hot line services for business clients in Kiev.

*Residential Telecommunications Services.* In December 2004, GTU developed unified telephone and Internet broadband access services for residential customers. GTU implemented structural changes that will allow us to serve this market segment in the most effective way.

*FMC Services.* During 2006 we deployed the FMC platform based on Alcatel and Huawei solutions. In 2007, we plan to deploy the FMC network into the regions and launch FMC services.

GTU's BCS division customers primarily consist of corporate network customers, corporate end-users, SMBs and high-end residential customers. Pre-paid VoIP and dial-up Internet services are also provided as a mass market offering.

### *Marketing and Pricing*

While emphasizing the high customer service quality and reliability of its services for corporate customers, GTU focuses on the development of its SMB and mass market offerings. Sales to our corporate customers are made through our direct sales force and through various alternative distribution channels such as sales through agent network. SMB and mass market service offerings are mainly conducted indirectly through alternative distribution channels such as agent networks.

GTU introduced different price policies for each market segments: customized pricing model for corporate customers and standardized pricing for SMB and mass markets.

### *Competition*

In Kiev, in the market for voice services to business end-users, we traditionally compete with Ukrtelecom, multiregional alternative operators Optima and Farlep, and a number of small local CLECs. During 2006, the competitive pressure increased as a result of the Optima-Farlep merger and aggressive marketing policy of Datagroup and Ukrtelecom. However, we believe that because of our early market entry, clear market focus and our ability to provide outstanding customer service combined with individual solutions and integrated voice, data and Internet services, we will keep the leading position on the high-end segments of the corporate market.

The provision of Internet and data services is not licensed in Ukraine. As a result, there is a high level of competition in the market with more than 400 Internet Service Providers (ISPs) in Ukraine, although consolidation through acquisitions has been observed in the market in recent years. The main competitors in the corporate market

for corporate data are Ukrtelecom, Infocom, a majority state-owned operator, and Datagroup, a data and integration services provider. We seek to be competitive in the corporate networks market by providing excellent geographical coverage, wide bandwidth, high quality circuits and professional service. We

**Table of Contents**

maintain our competitiveness in the Internet market by focusing on a strategy to provide the best value and quality Internet services for businesses and developing exclusive consumer Internet content.

In the fast growing residential broadband Internet market, we face competition from Ukrtelecom and Volya-Cable, a cable television provider in Kiev. However, we believe that development of exclusive consumer Internet content for the SMB and residential market segments will enable us to support steady growth of our market share in these market segments.

In addition, we plan to substantially improve accessibility of our services, market coverage and attractiveness of our offerings for the customers by deployment of a fiber-to-the-building ( FTTB ) network in Kiev.

**Carrier and Operator Services*****Carrier and Operator Services in Russia***

The Carrier and Operator Services division in Russia provides a range of carrier and operator services including voice and data transmission services to foreign and Russian telecommunications and mobile operators.

For international telecommunications voice operators, we are an alternative to the incumbent for the completion of calls terminating in Russia and the CIS and extensions of global private networks employing leased circuits in the country. For domestic telecommunications voice operators, we provide termination to Russian and CIS destinations and we also offer international call termination as well as providing telephone numbers, or subscriber ports. In addition, we offer VoIP and data services, including numbering capacity and IP-centric solutions. Due to the geographic reach of our network, high volume of traffic and smart traffic routing, we have a lower cost base than many of our competitors and can therefore resell any excess transit and termination capacity. During 2006, Russia continued to show rapid expansion of the mobile networks into the regions including into lesser developed parts of northern Russia and Siberia. To capitalize on this expansion and facilitate the development of the mobile operators, we have completed several projects with Vimpelcom and Megafon in which we provide satellite based network extension into several locations in Siberia, the Russian Far East and the Northwest of Russia. We expect this expansion to continue throughout 2007 during which time we will deploy a network of satellite stations for Vimpelcom in the remote areas of Russia. Additionally, for the wireless operators and smaller voice providers, we provide telephone numbers which they use for selling their services to their end-users.

Our intra-zonal network is integrated into the Moscow city incumbent telephone network at 78 transit and local exchanges, allowing us to deliver traffic within the local public network. In addition, our network infrastructure is now integrated into the main public city networks in St. Petersburg, Nizhny Novgorod, Samara, Voronezh, Ekaterinburg, Kaliningrad, Krasnoyarsk, and Krasnodar. Our network also interconnects with other fixed-line and cellular operators in Moscow and with other national long distance carriers. We have constructed the infrastructure necessary to support 285,000 ports in Moscow, each corresponding to a unique telephone number.

For international data networking operators, we provide data connectivity across Russia and the CIS. We have constructed a data network covering more than 289 cities across Russia and the CIS, primarily to serve our Russia-based corporate customers. Through network interconnect agreements with international data network operators, we also sell data networking services to customers outside Russia and the CIS. We interconnect with these global providers at our access points in Stockholm, London or Frankfurt.

Our data network infrastructure consists of terrestrial and satellite transmission capacity that we either lease or have purchased via indefeasible rights of use ( IRU ). We currently have IRUs for a STM-16 between Moscow and Stockholm, a STM-4 between Stockholm and London, and a STM-1 between Moscow, Voronezh and Krasnodar. We also lease five STM-16 fiber capacities from Moscow to Stockholm from Rascom, an equity investee. Our remaining domestic terrestrial capacity is leased. For satellite transmission, we have entered into long-term leases primarily with Intelsat, Intersputnik and New Skies Satellite for capacity covering Russia and the CIS. For IP capacity, we have 8 Gbit connectivity from Verizon, Cable&Wireless, Level 3 and Global Crossing. We have changed our interconnect technology from SDH to optical Gbit, which allows us to increase uplink capacity and at the same time have better network utilization. We have our own backbone fiber optic cable links from Moscow to Ufa and Samara via Nizhny Novgorod and Kazan. We have also completed cross-border links between Russia and Ukraine.

The Carrier and Operator Services division also provides domestic and international IP transit services to ISPs in Russia and the CIS. Smaller ISPs can connect to our IP backbone and then use our network to access the global

Internet or Russia-based Internet.

*Services and Customers*

*Voice Services:* The Carrier and Operator Services division offers two types of voice services to its customers: call completion or termination services and the provision of telephone numbers. For international operators, which include traditional incumbents such



**Table of Contents**

as British Telecom and VoIP operators, we provide call completion to the PSTNs located in Russia and the CIS. We typically interconnect with these operators in London, Stockholm, and Frankfurt or through the public Internet and they send us their traffic which is destined for Russia and the CIS. International outbound switched voice traffic is routed by destination, based on either anticipated return traffic from the foreign operator through non-geographical area codes, or through least-cost routing. We attempt to direct international traffic through particular foreign operators so as to balance our settlements paid to and received from foreign operators. Thereafter, we direct all international outbound, switched voice traffic in excess of that required to achieve the balance of the bilateral relationships by the lowest cost route.

Domestic operators in Russia and the CIS, including Russian cellular operators, use us for call completion to the PSTNs located in Russia and the CIS. They also send us international traffic that we then pass onto the PSTN of international operators. Additionally, we provide telephone-numbering capacity to Russian operators who may purchase large blocks of telephone numbers they then provide to their end-users.

We also provide equipment sales, installation and maintenance services to cellular operators. This hardware is usually a PBX with call center capabilities, but also included LAN and WAN equipment. It is our strategic intent to move beyond simply providing call completion into higher value-added solutions such LAN and WAN solutions to cellular operators. We currently provide satellite communication links to Russian cellular operators. This solution is for remote regions in Russia, such as Siberia and the Russian Far East, and allows cellular operators to grow in these markets which still have a low cellular penetration rate. Since 2005, we have been providing cellular operators with access to major mobile content providers and data centers and increased the number of interconnect agreements in these regions.

We have signed new interconnect agreements and launched traffic exchange. The most important agreements are with France Telecom, Telefonica, Telecom New Zealand, Portugal Telecom, Malaysia Telecom, Sprint, Bulgarian Telecom, Slovenia Telecom, Pantel, Exatel, COLT and Ukrainian Mobile Communications ( UMC ).

Our voice services customers include international operators such as Verizon, AT&T, British Telecom, Cable&Wireless, TeleDenmark, TeliaSonera, T-Systems, Telenor, Telecom Italia Sparkle, iBasis, and Teleglobe; domestic cellular operators such as Vimpelcom, MTS, and Megafon; and domestic wireline operators such as Macomnet, Metrocom, WestCall and Peterstar.

*Data Services:* The Carrier and Operator Services division also offers two types of data services to its customers: data networking services such as frame relay, synchronous digital hierarchy capacity and IP VPN, and IP transit ports. In addition to providing the underlying circuit capacity, the provisioning of both types of service also includes the installation and maintenance of customer premises equipment ( CPE ) such as routers, multiplexers and frame relay access devices.

During 2006, we began offering interconnection to our new point of presence in Hong Kong and we experienced rapid demand for this interconnection point. During 2007, we expect further growth of this point of presence.

We have signed new agreements and launched network-to-network interconnections ( NNI ) for provisioning data services with Belgacom, Elisa, GTS Central Europe, Royal Dutch KPN and SAVVIS.

Global data network operators sell worldwide data network services to their multinational clients. Typically, these data network operators have constructed extensive networks in the US, Western Europe and the Asia-Pacific region but have little, if any, infrastructure in Russia and the CIS. In order to sell a turnkey solution to their customers, the global data network operators need partners to reach the areas where they do not have their own infrastructure. Through a network interconnect agreement with us, these global data network operators are able to provide their clients connectivity to over 289 cities in Russia and the CIS where we have infrastructure. These global operators market and re-sell our network as if it were their own network. Such cooperation included a joint project with British Telecom for the construction of Visa International's access network in Russia and CIS, which allows Visa International member banks, over 70 in Russia and 25 in the CIS, to access Visa International's bank processing centers.

Due to our large consumer and corporate customer base for Internet access services, we require very high IP transit capacity from global providers such as Verizon, Cable&Wireless, Level 3 and Global Crossing. This capacity requirement allows us to obtain very favorable pricing from the global providers and, in turn, we can offer Russian and CIS based ISPs an attractive pricing and quality combination for the resale of IP services.

*Marketing and Pricing*

Historically for each telephone number or subscriber port, customers generally pay a one-time port fee, a flat monthly fee and per minute charges based on usage. However, the new Telecommunications Law requires all carriers to implement per-minute charges for access to each other network as well as to implement two types of charges for calls passing through network layers: (1) Initiation and transit charges for long distance calls from local networks to regional and long distance networks, and (2) termination for calls completion from long distance networks to regional and/or local networks.

**Table of Contents**

On March 4, 2006, the Russian President approved amendments to the Telecommunications Law that would introduce the CPP Rules. Effective July 1, 2006, under the CPP Rules all incoming calls, on fixed and mobile lines, in Russia are free of charge, and only the fixed-line or mobile operators originating the call may charge the customer for the call. Under the prior rules, subscribers of fixed-line telephones did not pay for incoming calls and, therefore, the CPP Rules did not have an impact on fixed-to-fixed line calls, but the CPP Rules impact the fixed-to-mobile calls as mobile companies traditionally charged for incoming calls in Russia.

Fixed-networks voice termination services are still priced per minute according to destination. There is an increasing trend towards a single price for all destinations in Russia although the typical pricing has separate rates for Moscow and St. Petersburg and a single rate for all other cities in Russia. Prices for the CIS countries usually follow a similar pattern; the major cities have separate rates and then the rest of the particular country is priced at the same rate. All of these countries have separate rates for traffic termination into cellular networks. We have been actively expanding the geographic reach of our network in order to capture these high revenue and margin destinations and have signed several new interconnect agreements in the CIS countries.

Pricing for data networking services is comprised of a number of elements: a monthly fee for the international bandwidth capacity provided, a monthly fee for the access port, a monthly fee for the last mile connection between our network and the customer location and a monthly maintenance fee for any CPE that we manage for the end-user. Additionally, there are one-time installation fees for all of the elements listed above. Customers have the option to purchase the CPE and provide their own maintenance, however, customers usually prefer a turnkey solution where we manage all elements and are therefore responsible for all service quality issues.

Pricing for IP transit services sold to ISPs is either in the form of a flat monthly fee for an IP port or based on the amount of traffic consumed by the ISP. Typically, the larger ISPs will opt for a flat monthly fee for a large port connection to our network while the smaller ISPs prefer to opt for a fee per megabyte of IP traffic sent to their network from our network.

***Competition***

For voice services, our main competitors are long distance carriers Rostelecom and MTT, an affiliate of Sistema Telecom.

For data networking services, our main competitors are Equant and TransTelecom. Equant's data network in Russia is similar to our network, however, their CIS coverage is not as extensive. Therefore, when a customer needs a route including Russia and the CIS, we have a competitive advantage. Equant's global network gives it access to a wider base of corporate customers, but this advantage is offset, we believe, by the reluctance of Equant's global competitors such as Verizon, British Telecom, Cable&Wireless, Infonet and AT&T to use Equant locally to serve their customers. Thus, to some extent we have access to the corporate clients of Verizon, British Telecom, Cable&Wireless, Infonet and AT&T that require connectivity to Russia and the CIS.

For IP services, our main domestic competitor is TransTelecom. A number of international IP transit providers such as Cable&Wireless and TeliaSonera are also actively selling global IP transit services in Russia. In 2002, we entered into a peering agreement with two other Tier 1 Russian ISPs. According to the terms of this agreement, all Russian ISPs requiring access to these networks pay traffic charges whereas previously all peering was free. As a result, we have been able to earn additional revenue from our infrastructure investments in Russia while improving our competitive position via other IP access providers.

***Carrier and Operator Services in Ukraine***

***Services and Customers.*** The Carrier and Operator Services division in Ukraine operates leased DLD/ILD networks and is a provider of local access, international and intercity long distance services in major Ukrainian cities where our switching equipment is located. The network is comprised of our gateway international switching center ( EWSD ) in Kiev, leased and owned international and intercity fiber optic channels, and regional voice and data switches. For local carriers we provide access to highly reliable and advanced telecommunication services, WAN, and broadband Internet in all existing Kiev and regional access points. We provide Internet access services to more than 30 ISPs in Ukraine.

***International and Domestic Long Distance Services.*** International outgoing traffic terminated via direct interconnections with international carriers such as Deutsche Telekom, Cable&Wireless, Telekom Austria,

TeliaSonera and other. We offer termination services for our international partners for interconnection with Ukrainian PSTN and mobile networks via direct links with the major fixed and mobile carriers such as Ukrtelecom, Kyivstar, UMC, Astelit, URS and other.

We offer DLD services throughout Ukraine via our owned and leased channels between major Ukrainian cities as well as through interconnection with Ukrtelecom. We hold an intercity operator's license allowing us to offer DLD services directly and are interconnected in major Ukrainian metropolitan areas to facilitate this offering. In September 2003, we signed amendments to our settlement agreements with Ukrainian fixed-line and mobile operators introducing the CPP principle imposed by the changes in the Ukrainian telecommunication law. These agreements and the CPP principle remained in force during 2005 and 2006.

## **Table of Contents**

We provide international Internet access via our IP node in Frankfurt and direct IP interconnection with Level3, Global Crossing, and Cable&Wireless.

Fixed-line operators include overlay and wireless local loop operators in Kiev and other major cities of Ukraine, alternative regional fixed-line operators and local operators. Velton, Ucomline, VOLZ and Telesystem are the major fixed-line operators in Ukraine purchasing our international, long distance, and voice services.

A significant portion of our carrier revenue is generated from the Ukrainian cellular operators large volumes of international and long distance traffic. Price and quality of service are the primary factors in their purchase decision. In 2004, several Ukrainian cellular operators, including UMC and Kyivstar, received international communications licenses. As a result, a larger portion of our carrier revenue is now generated by transit fixed-to-mobile traffic via our network.

### *Marketing and Pricing*

As a carrier for other telecommunication operators, we offer a more attractive pricing structure for international calls than incumbent operators like Ukrtelecom. Although price is still the primary factor in the routing decision of the Ukrainian carriers, more of them demand high quality international voice and data wholesale services, making our offerings even more attractive. As a result, our traffic volume continues to increase, especially traffic to international destinations and mobile networks in Ukraine.

In February 2003, the Ukrainian Parliament overrode the President's veto and adopted an amendment to the Ukrainian communication law prohibiting all telecommunications operators from charging their customers for incoming calls, thus introducing the CPP principle, which entered into effect on September 19, 2003. Simultaneously, state regulated tariffs for calls from the PSTN to mobile networks were introduced allowing operators to receive and share revenue from calls to mobile networks. In order to implement CPP settlements, we amended our agreements with Ukrtelecom, other fixed-line carriers and Ukrainian cellular operators establishing agreed access rates for the calls between fixed-line and mobile networks. These changes became effective in October 2003 and enabled us to receive a settlement when a fixed line party calls a mobile telephone as well as to receive a portion of revenue when we route calls from mobile to fixed-line networks.

As a carrier for other ISPs, we offer an attractive pricing structure and we are able to retain our significant market share in this segment. We expect to strengthen our positions in the Ukrainian regions due to close cooperation with Ukrtelecom and Ucomline in these areas. In data services, an increase in market share is expected through the continued sale of international private line connections, international multiprotocol label switching ( MPLS ) connections, and provisioning of last mile services in major Ukrainian cities.

### *Competition*

In Ukraine, the carrier market is dominated by Ukrtelecom, with UMC, Kyivstar, Ucomline, Velton, Datagroup and Optima becoming more competitive. In 2004, several Ukrainian cellular operators received international and intercity communications licenses providing them the possibility to route their traffic through direct interconnection with local and international operators.

## **Consumer Internet Services**

### *Services and Customers*

*Broadband Internet Access.* Currently, we are focused on the local infrastructure development in order to bring broadband Internet access services to the mass market. We use different broadband last mile technologies depending on particular market conditions.

*Asymmetric Digital Subscriber Line ( ADSL ) Services.* ADSL services are offered to customers in selected cities such as St. Petersburg, Nizhny Novgorod, Voronezh, Krasnoyarsk, Tashkent, Krasnodar and Sochi. Customers of our ADSL services are provisioned through long-term agreements with last mile providers. However, with restrictions on our access to unbundled local loop, we are actively exploring alternatives to deliver quality broadband Internet services to consumers at competitive prices in our major markets.

*FTTB Services.* We offer broadband Internet access in selected cities such as St. Petersburg, Nizhny Novgorod, Ekaterinburg, Krasnoyarsk, and Sochi. In 2006, we launched FTTB projects in Kiev and Samara. Our nationwide fiber optic cable network will be used for active rollout of our FTTB network in the regions.

*Wireless Internet Access.* During 2006, we installed more than 6,700 WiFi access nodes in Moscow providing indoor and outdoor Internet access. During the beta-testing period more than 90,000 users registered and tried our WiFi services. On March 1, 2007, we

**Table of Contents**

launched commercial operations of our WiFi network offering prepaid Internet access to the mass market under GoldenWiFi brand. To close the WiFi technology gap and to increase service availability and quality, we plan to sell to our customers equipment called Golden WiFi adapter. The next version of the GoldenWiFi product will include local city map display with Aport search results, based on customer's geographical position (location based service). We also plan to include Voice over IP ( VoIP ) products into our service offerings.

*VoIP.* Currently, we are developing and testing new products based on VoIP technology. We will target VoIP service offerings at the SMB/small office and home office ( SOHO ) and mass markets. VoIP services will be available for computer, mobile devices and VoIP equipment users. We will provide PSTN call terminations under the current telecommunications regulations.

*Dial-up Internet Services.* We offer dial-up Internet services to consumer markets in Russia, Ukraine, Uzbekistan and Kazakhstan. Customers receive local access to our dial-up services throughout the covered areas through capacity acquired by long term local interconnection agreements. Internet backbone and long haul traffic is then provided over our DLD/ILD infrastructure. Currently, ROL has access to multiple gigabit Ethernet fiber optic connections to the domestic networks as well as the equivalent of an STM-4 international connection. As of December 31, 2006, we had a subscriber base of 401,098 active subscribers. We provide these services under multiple brands, the most notable being ROL which is our flagship dial-up service. As early as 1995, ROL, which at that time was known as Russia Online, was the first Russian-English language, online service for accessing the Internet through either dedicated private lines or dial-up servers. Since that time, ROL has evolved as the only nationwide dial-up ISP in Russia. With over 60 locations, including the major markets in Moscow, St. Petersburg, Kiev and Almaty, we are also the largest ISP in the CIS.

The consumer dial-up Internet access service has seen decreased utilization rates over the last year as subscribers have decreased the average number of hours spent online from approximately 23 hours to approximately 17 hours per month. This is due to further penetration of the market by competitors, including those offering broadband services in Moscow and St. Petersburg. We plan to continue to provide dial-up services to keep our existing customer base and to migrate our dial-up customers onto our new Internet access platforms.

*Internet Portals.* In addition, we provide Russian language content based Internet portals covering many topics including Internet search, entertainment, education, computer-gaming and city information specifically for the Russian mass-market. Portals are running under different brands and are being used as a marketing channel for both our existing and future customers. Furthermore, we offer advertising space on our portals along with integrated web services to a variety of customers who require online marketing.

***Marketing and Pricing***

In 2006, we launched a re-branding campaign with the new logo, color scheme and slogan Achieve more! The new brand is primarily targeted at retail customers and maintains various products under one master brand driving up general brand recognition and opportunities for cross-selling. However, we plan to keep ROL-brand for the time being.

Our dial-up services are offered mostly through prepaid tariff plans. Almost all sales of ROL prepaid tariff plans are made possible through the sale of scratch cards which are distributed through an extensive network of retail outlets in our coverage area. As of December 31, 2006, the ROL distribution network consisted of over 30,000 points of sale ( POS ) throughout our covered area. The multi-tiered distribution channels and the number of POSs have grown substantially during 2006. This growth is related to our marketing efforts to further establish the ROL brand awareness in our primary markets. Furthermore, in regional areas a great deal of emphasis was placed on expansion of our distribution channel to increase availability of our services.

Tariff plans are offered as Internet access packages with either hourly-based pricing policies or as bulk hour purchases. For prepaid services, customers can purchase scratch cards from a POS or may pay directly through the banking system. For postpaid schemes, which account for less than three percent of sales, customers are invoiced on a monthly basis for hourly usage. Prepaid tariff schemes provide the customer with lower hourly charges than with postpaid tariffs.

During 2006, the distribution network and POS were extensively used in our marketing plans and we continually improved them as these efforts provide the closest point of connection to our customers. These marketing efforts will

be further enhanced by our existing customer support approach which provides continuous support for end-users and business hour support for distribution customers. Local access support numbers are provided to customers that connect them directly to our coverage area support center located in Moscow. These calls are carried over our voice network.

*Competition*

Our broadband Internet services face local competition from Internet dial-up providers affiliated with incumbent city telephone companies. In the Moscow market we compete with Stream (ADSL-based services) from Comstar, Akado (cable TV and Internet services) from Moscow CableCom; Qwerty from Svyazinvest and local FTTB providers. In St. Petersburg our main competitors are



**Table of Contents**

Web Plus from a subsidiary of Telecominvest and ADSL offerings from Svyazinvest. Nationwide the main competitors are Svyazinvest subsidiaries both in broadband and dial-up services.

**Mobile Services*****Golden Telecom GSM***

We operate a cellular network using GSM-1800 cellular technology in Kiev and Odessa, Ukraine, where our network covers an area with a population of approximately 3.9 million people. Golden Telecom GSM launched cellular operations with a license allowing it to offer services in Kiev and the Kiev region and later obtained a national operating license and commenced operations in Odessa. However, during 2001 our mobile operations in Ukraine were under strong competitive pressure leading to an overall decline in our mobile revenues. In 2002, we evaluated alternative strategies for our mobile operations, and refocused our mobile operations as an additional service offered to high-end mass market and business customers. In 2004, we became more active in the prepaid market. In 2005 and 2006, we faced aggressive competition both from existing carriers and new market entrants.

In 2006, we acquired GSM-1800 radio frequency license for an additional 22 regions of Ukraine. This license provides us with a potential customer base of 38.1 million people, or approximately 81% of the Ukrainian population, compared with our previous coverage of 5.1 million people. In 2006, we entered into an agreement with ZAO Ukrainian Radio Systems ( URS ), a subsidiary of Vimpelcom, for the provision of roaming services. This agreement enables our mobile customers to use the national roaming services of URS nationwide network. In addition, we plan to provide mobile over broadband services in Ukraine. We announced the commencement of construction of our FMC network in Ukraine. The FMC network combines the advantages of fixed-line and mobile communications and will be the first converging communications network in Ukraine. To date, we have deployed the FMC network in Kiev and Odessa based on our existing GSM-1800 networks and wireless segments of the FMC network in Donetsk, Zaporozhye, and Ivano-Frankovsk. In the second quarter of 2007, we plan to complete network testing and launch commercial operations. In 2007, we plan to deploy the FMC network in an additional 19 regions of Ukraine.

***Services and Customers***

*Mobile Services.* We provide two types of mobile services to our clients: a basic service for prepaid calling card clients and an expanded service for subscription clients, including international roaming with 164 operators in 82 countries, and value-added services such as voicemail, call forwarding, conferencing, and a broad range of short message service, or SMS and voice information services.

Our customers cover a broad spectrum of private and corporate users. Our customer base changed in 2004 due to the rapid growth of prepaid service users. As of December 2005, prepaid subscribers constituted more than half of our subscriber base. The remaining subscriber base was represented primarily by the high-end mass market and business customer segments. During 2005, our subscriber base decreased due to competitive pressures. However, due to aggressive pricing and other conditions introduced by GTU in December 2005, the subscriber base remained stable during 2006. Following the launch of the FMC services in 2007, we are expecting to increase our market share of the Ukrainian mobile market.

***Marketing and Pricing***

Our network has the widest frequency bandwidth allocated to any cellular operator in Kiev, allowing us to deploy a high quality network throughout the city and thus market ourselves as a quality service provider. Due to the highly competitive nature of the cellular market in Kiev, we focus on providing a flexible and competitive tariff structure in two target markets. We position our subscription service as an affordable and quality service to private and business users, who have high levels of usage within their home base primary location. In addition, we provide our customers with flexible tariff plans and a variety of basic value-added services. Our international and roaming tariffs are still among the most attractive in the Ukrainian mobile market.

Our marketing strategy for prepaid services is based on providing competitive tariffs for mass-market users with low traffic volumes, which resulted in a retention of our client base during 2006.

Deployment of the FMC services, regional expansion and national roaming will create a unique proposal on the Ukrainian market, which gives us an opportunity to gain additional corporate clients market share in Kiev, Odessa and new regions of presence.

Our sales force in Kiev is represented mainly by direct sales representatives, while in Odessa we utilize both direct sales and an alternative retail dealers network. Our strategy is focused on rapid subscriber growth following the introduction of the FMC services and regional expansion.

**Table of Contents**

*Competition*

The Ukrainian cellular market is highly competitive and dominated by UMC and Kyivstar. Astelit, a new entrant to the Ukrainian mobile market, gained 11% of the market share in 2006. URS gained 4% of the market share in 2006. Apart from UMC and Kyivstar, both which have nationwide coverage, Astelit and URS already covered all cities with population of more than 50 thousand people and are actively investing in further network development. As of December 31, 2006, the Ukrainian cellular market reached approximately 48.9 million subscribers with a sim-card penetration rate of 105%. UMC and Kyivstar together hold approximately 84% market share.

In 2006, Ukrtelecom announced plans to invest approximately \$687.0 million in a 3G mobile network by 2010. Another Ukrainian CDMA operator, Telesystem, plans to launch CDMA-based 3G services in 2007.

As of December 31, 2006 we had a subscriber base of more than 48,448 customers with average revenue per user of approximately \$17 per month, which we believe is the highest average revenue per user level on the Ukrainian mobile market.

This completes our discussion of our operating divisions. Please refer to note 14 Segment Information of the Audited Financial Statements contained within this document, for the quantitative disclosures for revenues by line of business.

**Website Access to Company Filings**

Golden Telecom, Inc. provides public access to its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to these reports filed with the Securities and Exchange Commission ( SEC ) under the Securities Exchange Act of 1934. These documents may be accessed free of charge on Golden Telecom, Inc. s website at the following address: <http://www.goldentelecom.com>. These documents may also be found at the SEC s website at <http://www.sec.gov>. Also, copies of Golden Telecom, Inc. s annual report will be made available, free of charge, upon written request.

**Employees**

As of December 31, 2006, we and our consolidated subsidiaries employed a total of 4,218 full-time employees and our ventures employed 108 full-time employees. As of December 31, 2005, we and our consolidated subsidiaries employed a total of 3,646 full-time employees and our ventures employed 120 full-time employees. Included in the number of full-time employees were 9 and 13 expatriates as of December 31, 2006 and 2005, respectively.

We do not have any collective bargaining agreements with our employees, and we believe that our relations with our employees are good. We believe our future success will depend on our continued ability to attract and retain highly skilled and qualified employees.

**Table of Contents****Our Licenses and Network Facilities****Significant Licenses**

Our subsidiaries hold the following licenses in Russia and Ukraine, which are important to their operations. Renewal applications will be applied for all licenses expiring in 2007 where necessary.

<b>License</b>	<b>License Region (s)</b>	<b>License Number</b>	<b>Expiration Date</b>
<b>Local Communications Services</b>			
Sovintel	Moscow, St. Petersburg	44382	September 21, 2011
GTU	Kiev, Kiev Region, Odessa, Odessa Region	223391	December 31, 2007
GTU	Ukraine (excluding Kiev, Kiev Region, Odessa, Odessa Region)	223392	January 28, 2009
ADS	Nizhny Novgorod Region	35438	October 05, 2010
Buzton	Uzbekistan	0000663	July 4, 2011
Samara Telecom	Samara Region	42681	July 28, 2011
Sakhalin Telecom	Sakhalin Region	35317	October 5, 2010
Kubtelecom	Krasnodar Region	37074	December 12, 2010
<b>Leased Communications Circuits</b>			
Sovintel	Moscow, Moscow Region, St. Petersburg, Leningrad Region	41506	July 5, 2011
Rascom	Moscow, St. Petersburg, Leningrad Region, Moscow Region, N. Novgorod Region, Tver Region	33126	June 8, 2010
Rascom	St. Petersburg, Leningrad Region and outside Russian Federation	43354	July 28, 2011
<b>Voice Communication Services in Data Transmission Networks</b>			
Sovintel	Russian Federation	39543	March 15, 2011
<b>International, National, Intra-Zonal and Local Communications Services</b>			
Sovintel	Moscow, St. Petersburg, Leningrad Region, Moscow Region, Pskov Region, Kaliningrad Region	14479	March 17, 2008
<b>International and National Communications Services</b>			
Sovintel	Russian Federation	32041	May 31, 2012
GTU	Kiev, Odessa, Odessa Region, Donetsk, Donetsk Region, Kharkov, Kharkov Region, Lvov, Lvov Region, Dnepropetrovsk, Dnepropetrovsk Region	223393	December 31, 2013
GTU	Ukraine (excluding Kiev, Odessa, Odessa Region, Donetsk, Donetsk Region, Kharkov, Kharkov Region, Lvov, Lvov Region, Dnepropetrovsk, Dnepropetrovsk Region)	223394	January 28, 2014

**Mobile Communications Services**

GTU	Kiev, Kiev Region	223389	December 31, 2007
GTU	Ukraine (excluding Kiev, Kiev Region)	223390	January 28, 2009

**Telematic Services**

Sovintel	Moscow, Moscow Region, St. Petersburg, Leningrad Region	27309	August 18, 2008
ADS	Nizhny Novgorod Region	37603	December 23, 2010
Dicom	Moscow, Moscow Region	40966	July 5, 2011
Samara Telecom	Samara Region	32138	April 29, 2010

**Table of Contents**

<b>License</b>	<b>License Region (s)</b>	<b>License Number</b>	<b>Expiration Date</b>
<b>Intra-zonal Communications Services</b>			
Sovintel	Moscow, St. Petersburg	45074	October 24, 2011
ADS	Nizhny Novgorod Region	35439	October 5, 2010
Samara Telecom	Samara Region	43357	July 19, 2011
Sakhalin Telecom	Sakhalin Region	32478	June 17, 2010
Kubtelecom	Krasnodar Region	37254	December 12, 2010
<b>Data Transmission Services</b>			
Sovintel	Moscow, Moscow Region, St. Petersburg, Leningrad Region	27310	August 18, 2008
Buzton	Uzbekistan	0000664	August 29, 2011
SA-Telcom	Kazakhstan	0000032	Unlimited
<b>Radio Frequencies</b>			
S-Line	Kiev, Sevastopol, Dnepropetrovsk Region, Donetsk Region, Kharkov Region, Odessa Region, Zaporozhye Region, Kiev Region, Lugansk Region, Lvov Region, Poltava Region, Vinnitsa Region, Zhitomir Region, Suma Region, Kherson Region, Khmel'nitsk Region, Ivano-Frankovsk Region, Volyn Region, Zakarpatye Region, Kirovograd Region, Rovno Region, Ternopol Region, Cherskassk Region, Chernigov Region, Chernovets Region, Crimea	222995	April 20, 2016

**Network Facilities**

Our telecommunications networks reflect the licensing regime adopted by the industry regulators in relevant countries and consist of technologically advanced systems designed for businesses and consumers.

We own the essential elements of the network, including equipment for data and IP services, next generation network technology, switching technology and transmission technology, and either own or lease the network transport elements as well as access to our customers. We also own the necessary support systems to operate our own network, serve our customers and charge for our services.

Our fully integrated network consists of a number of interconnected networks in the Russian Federation, Ukraine, Kazakhstan and Uzbekistan. Sovintel operates the backbone network in Russia and MANs in Moscow, St. Petersburg and other cities of the Russian Federation. Sovintel cooperates with a number of large joint ventures whose networks are integrated into our network in Russia. Networks in Ukraine, Kazakhstan and Uzbekistan are operated and developed by GTU, SA-Telcom and Buzton, respectively.

Our network includes 189 cities across Russia and other countries of the CIS which allows us to connect customer offices in distant locations to their corporate networks. Technological solutions and equipment incorporated into our network are constantly being developed.

We are continuing to review alternative core and access technologies with technology providers, vendors, our partners, and other providers in the Russian Internet market. We selected an ECI platform and are in the process of installing a next generation network ( NGN ). This platform will provide capabilities for innovative data and voice services, smooth migration of existing technologies to IP-based technologies, convergence of voice and data networks,

optimization of capacity usage, and reduction of the time required for new services to be deployed. Our products and services will migrate to a modern high quality network capable of meeting the current and future needs of the market, providing a high level of efficiency and competitiveness.

***Russia***

***Backbone Network***

We use Nortel asynchronous transfer mode Passport technology and IP VPNs based on Cisco and Juniper equipment for our core data network, to provide certain international private line circuits and international data transmission services such as asynchronous transfer mode and frame relay and Cisco routers for Internet access.

**Table of Contents*****International backbone***

Our international backbone network is based on a fiber optic cable line leased from Rascom, an equity investee. This fiber optic cable line extends from Moscow to St. Petersburg and across the Russian border to Finland. Additionally, we lease STM-16 capacity (2.4 Gbps) from Moscow to Stockholm under a ten-year lease agreement signed in February 2000. The lease agreement contains an option to renew the agreement for five years.

In 2006, we constructed our fiber optic cable line ( FOCL ) between Russian and Ukraine which will allow us to connect our Russian and Ukrainian subsidiaries and other leading Ukrainian operators.

***Domestic backbone***

We have developed a land and satellite-based regional network to provide DLD and data services in Russia. Our land-based DLD network consists primarily of fiber optic capacity leased from Rostelecom and TransTelecom. We use this land-based network primarily to serve our regional voice, data and Internet businesses. This network, together with our satellite-based network, connects more than 189 different access points across Russia and several other large cities in the CIS.

In addition the leased circuits, we constructed our own national fiber optic cable lines in the European part of Russia. Our FOCL and fiber optic cables leased from Vimpelcom, allow us to connect several Russian cities, including Nizhny Novgorod, Kazan, Ufa, Samara, Tula, Voronezh, Rostov, Krasnodar and other. We plan to complete connection of this FOCL network in 2007 by extending our FOCL to Saratov, Perm and other major cities.

***Satellite***

In addition to our terrestrial network, we also use satellite transmission to offer the same services between Moscow and other major CIS cities such as Almaty, Tashkent, Tbilisi and Baku.

We also lease capacity on satellite transponders under 5 and 10 year leases. The coverage area of these satellites includes the full territory of Russia and other countries of the CIS. Using these leased satellite transponders, we serve 26 regional earth stations ( RESs ) and more than 130 VSATs stations across Russia and the CIS. These VSATs interconnect with our RESs and central hub in Moscow and with local facilities in the areas where the VSATs are located.

***Voice Services***

We constructed an FTN to provide voice services in accordance with our new long distance license. During deployment of the FTN, we installed 4 international toll switches, 7 domestic switches in 7 federal districts of Russia and points of presence in each of the 88 regions of Russia.

We provide international switched voice, data and IP services in Russia using leased transmission capacity obtained from Rostelecom and TransTelecom within Russia, and international carriers beyond the Russian borders. Similarly, in Ukraine, GTU leases capacity from Ukrtelecom for domestic segments and from international operators for international segments.

We operate 6 international gateway switches, with 5 of these switches located in Russia and one switch located in Stockholm. We are also in the process of installing an ECI soft switch which will be a core of our national VoIP network.

***Metropolitan Area Networks***

In Moscow, Kiev, Odessa, St. Petersburg, Nizhny Novgorod, Krasnoyarsk, Vladivostok, Khabarovsk, Voronezh and Samara we operate MANs. In each of these locations, we own or lease local access lines and PBXs, local exchange switches, local numbering capacity, fiber optic transmission rings and a fiber optic backbone. Our facilities in Moscow are fully integrated with our domestic and international networks, as well as with the networks of Rostelecom and MGTS.

***Moscow***

The Moscow MAN includes the following facilities:  
*Transport.* In Moscow, our MAN has 4,639 kilometers of fiber and 2,158 kilometers of copper cable. In 45 MGTS central offices we have access to copper wire facilities. The copper wire facilities are used when a customer's requirements do not justify an immediate investment into fiber optic facilities.



**Table of Contents**

*Voice.* We have access lines supporting more than 300,000 local access numbers in the 495 area code which is the terrestrial code for the Moscow region. Our network connects approximately 5,000 buildings and approximately 3,596 PBXs. Our PBXs are typically located on customer premises to distribute advanced telephony services in those premises to end-users. Our PBXs function as switches that permit users to receive incoming calls, dial any other telephones on the premises that are connected to the PBX, access a line leading to another PBX or access an outside line to the public switched telephone network.

Our local voice network consists of more than one hundred hub PBXs connected to our fiber optic network, complemented by local and tandem switches. These hub PBXs act as traffic aggregators for our 1,169 PBXs located in customer premises. Our network is connected to major office buildings, hotels, business centers, and factories and is co-located with 82 central offices of MGTS.

To service the needs of SMBs and SOHO customers, we use xDSL solutions in Moscow, symmetrical digital subscriber line ( SDSL ) solutions over the copper wire of the MGTS network, and an ADSL solution. The SDSL technology provides customers with up to 4 telephone lines and a dedicated link to the Internet. We have approximately 3,500 SDSL customers and more than 4,700 ADSL customers in Moscow.

*Wireless Local Loop ( WLL ).* We provide WLL for customers in locations where a fiber optic network is not available. Our WLL access network covers over 80% of our corporate customers' locations in Moscow.

In Moscow, we are constructing one of the largest WiFi networks in Europe for end-users. To date, approximately 6,700 access nodes have been installed in Moscow. We launched commercial operations of our WiFi network on March 1, 2007.

*Data and IP services.* We provide local access for our data services offerings in Moscow generally using the same intracity transport and customer access network as described above. This network is complemented by access lines leased from other Moscow-based operators that possess their own local access networks where our data customers are not otherwise in our network. The steady growth of our MAN has reduced the need for such outsourcing to less than 20%. We have built a Metro Ethernet Network ( MEN ) which provides Internet access and L2 multipoint-to-multipoint VPNs for more than 700 customers and serves as a transport network for many other services.

We are developing VoIP services for broadband users. The broadband VoIP project will provide customers mobility, self-provisioning of services, and on-net and off-net services.

The hub of our IP network is our Internet Data Center in Moscow. This location has redundant power supplies as well as high-level security and fire control systems. The Internet Data Center in Moscow was constructed according to world standards. Both our own equipment and that of our customers to whom we provide collocation services are installed in the Internet Data Center in Moscow.

*St. Petersburg*

Our St. Petersburg network deploys solutions which are similar to those deployed on our Moscow network. We have constructed approximately 2,031 kilometers of fiber optic cable in and around St. Petersburg, which is used to connect office buildings and business centers to our network.

The voice network consists of switches and hub PBXs that are interconnected to the St. Petersburg PSTN through the St. Petersburg City Telephone Network and other PSTN operators. This network has a capacity of 44,000 local numbers and approximately 280 PBXs that are installed on customer premises and within business centers.

Our St. Petersburg MEN provides Internet access and L2 multipoint-to-multipoint VPNs. We have more than 500 SDSL and ADSL customers in St. Petersburg and are expanding our WLL access network in St. Petersburg.

*Nizhny Novgorod*

In Nizhny Novgorod, we have more than 210 kilometers of fiber optic cable. Our voice network in Nizhny Novgorod has a capacity of 32,000 numbers. We also provide Internet and data services. We operate 17 MEN nodes and an ADSL network of 37 nodes.

*Voronezh*

In Voronezh, our voice network has a capacity of over 14,000 numbers. Customer access is provided via leased copper pairs and our own constructed lines which have a current length of approximately 70 kilometers of fiber optic cable and 120 kilometers of copper cable. We are also a leading ISP in Voronezh and operate an ADSL access network with approximately 1,300 customers.



**Table of Contents**

*Ekaterinburg*

We are a leading ISP in Ekaterinburg with more than 1,100 customers connected via dedicated lines deploying ADSL and MEN technologies. Our backbone network consists of 300 kilometers of fiber optic cable. We are also a leading CLEC in Ekaterinburg with capacity of 4,500 numbers being used. Our Ekaterinburg Data Center offers collocation services to content providers, customers in Ekaterinburg, and we have deployed a WLL access network in Ekaterinburg.

*Krasnoyarsk*

We currently have capacity of 200,000 telephone numbers in Krasnoyarsk and we are constructing a customer access network. Our backbone fiber optic network has 230 kilometers of fiber optic cable. We have also deployed a radio access network and we expect to expand our presence to other cities in the Krasnoyarsk region through radio access and VoIP development.

*Samara*

We operate a leading CLEC in Samara which has an extensive access network including 400 kilometers of fiber optic cable and 300 kilometers of copper cable. Our voice network has an installed capacity of 100,000 numbers. We provide Internet services to about approximately 1,000 customers.

*Kaliningrad*

We operate a leading CLEC in Kaliningrad. We have an installed capacity of 100,000 numbers with 30,000 subscribers connected to our copper cable access network. Our fiber optic backbone network consists of 75 kilometers of fiber optic cable. In addition, we offer Internet access in Kaliningrad.

*Sakhalin*

We have a fiber optic backbone network in Sakhalin with 110 kilometers of fiber optic cable. We have capacity of 20,000 numbers and provide Internet services, including a wireless network. We also operate our own satellite network for connection to distant locations.

*Krasnodar*

We operate a leading CLEC in Krasnodar and several major cities in the Krasnodar region. We have several AXE 10 switches, fiber optic and copper networks. We provide voice services, ADSL-based Internet access and cable TV to approximately 15,000.

*Other Regional Local Networks*

We offer combined voice and data services with access to the local PSTN in 15 different major metropolitan areas in Russia. Depending on the region, we have 400 to 3,000 local lines in service. Last mile access to the customers is normally provided through leased copper or fiber optic cable.

*Dial-up Internet Local Access Network.* Sovintel also employs dial-up Internet access servers using more than 17,000 dial-up modem lines in 60 cities in Russia and the CIS, allowing our customers Internet access through a local call. Through these dial-up access servers, we offer local roaming for Internet access, whereby an Internet customer normally residing in Moscow may travel to other regions in Russia and outside Russia, call a local access number and gain access to the Internet.

***Commonwealth of Independent States***

*Ukraine*

GTU has its own network in Ukraine and owns fiber optic cable between Kiev and the western Ukrainian border. GTU is interconnected to international operators' networks via a point of presence in Frankfurt, operated through a leased STM-4 channel. GTU also leases an STM-4 for transmission between Kiev, Lvov, Dnepropetrovsk, Kharkov, and Odessa to the Russian border.

*Kiev*

GTU provides CLEC services through a MAN in Kiev. In Kiev, we have constructed a 480 kilometer fiber optic ring. GTU's voice network is based on four large switches acting as hubs in Kiev and more than 80 PBXs that are installed within business centers. GTU also provides both copper and fiber optic last mile connections.

**Table of Contents**

*Other Regional Local Networks*

We possess other local networks in Kharkov, Dnepropetrovsk, Lvov, Odessa, and Zaporozhye. In these cities, GTU operates a small local SDH network based with the capacity of several thousand local numbers. GTU also operates data, IP and ADSL networks. GTU is also expanding its networks through large-scale construction of copper cable.

*Kazakhstan*

In Kazakhstan, our operations are based on a satellite network. We have earth station HUBs installed in 8 major cities which are connected to our Moscow HUB. We also operate 60 VSATs.

*Uzbekistan*

We operate a leading CLEC in Uzbekistan. Our core business in Uzbekistan is voice services, however, we offer customers ADSL and dialup Internet access services. We operate a fiber optic backbone network connecting 12 nodes in Tashkent and we lease copper pairs from the local PSTN. We have installed switches in 11 cities to further our regional presence throughout Uzbekistan. We have also deployed radio access networks and we also operate satellite earth stations.

## **Table of Contents**

### **The Environment in Which We Operate**

This section provides an overview of some of the key features of the markets where we operate and derive substantially all of our revenue. These overviews focus on our two largest markets, Russia and Ukraine and include:

An overview of the telecommunications markets;

An overview of the political and economic environment; and

An overview of the legal, tax and regulatory regimes.

### ***Overview of Telecommunications Markets in Russia and Ukraine***

*The Telecommunications Market in Russia.* Prior to the early 1990s, the public telecommunications network in the former Soviet Union was inefficient, unreliable and underdeveloped relative to the networks in more-developed countries. In the early 1990s, the Russian Ministry of Telecommunications, which had formerly controlled the Soviet telecommunications infrastructure, ceded operational control to a single long distance and international carrier, Rostelecom, and 80 incumbent regional operators, including four independent city networks in Moscow, St. Petersburg and two other cities. The local telcos provide local exchange services for customers within their regions, but since February 2003 they are obligated to provide access to DLD/ILD services. In the incumbent network DLD calls to and from areas outside the local telcos' service area, as well as ILD calls, are switched through Rostelecom, which interconnects with the local telcos to complete DLD calls and with foreign carriers to complete ILD calls.

The dissolution of the Soviet Union and the collapse of the centrally planned economy reduced the funding available to the local telcos at a time when demand for telecommunications was increasing. The growth in the Russian telecommunications industry since the early 1990s has been principally driven by businesses in Moscow requiring DLD/ILD voice and data services and by mobile telephony users. The growth in Moscow accelerated as multinational corporations established a presence in the capital and Russian businesses expanded. The formerly state-owned local telcos, however, which generally employed an outdated, dilapidated analog infrastructure, could not support the requirements of high-volume consumers of sophisticated telecommunications services. As a result, the inadequacies of the existing legacy networks constructed during the Soviet era became more apparent. Further, the proceeds received by the Russian government from the privatization of state telecommunications assets were not used for the infrastructure improvements required to meet increased demand. As a result, the Russian Ministry of Telecommunications issued licenses to domestic and foreign funded companies to encourage investment in the telecommunications infrastructure. The licensing structure adopted by the Russian Ministry of Telecommunications directly reflected the areas of the legacy networks in most urgent need of investment. Generally, voice and telephony licenses were issued to provide local access, local exchange, and DLD/ILD services.

Although it remains subject to certain restrictions, significant progress in privatization of the telecommunications industry in Russia has occurred. At present, virtually all the former state telecommunications enterprises have been privatized and, subject to restrictions, shares of the newly formed joint stock companies have been sold to the public. Also, a significant number of private operators provide a wide variety of telecommunications services pursuant to licenses issued by the Russian Ministry of Telecommunications.

In September 1995, the Russian government established Svyazinvest as a holding company for the state's telecommunications assets. Svyazinvest now holds the Russian government's equity interests in almost all the incumbent local telcos, as well as Rostelecom. In July 1997, a 25% plus one share interest in Svyazinvest was sold to a private consortium, Mustcom Limited, for approximately \$1.9 billion. In 2000, the government announced a plan to restructure and consolidate Svyazinvest's holdings and in 2002 the reorganization was completed by merging almost all regional incumbent operators into 7 large interregional companies. Svyazinvest currently owns controlling voting interests in all 7 interregional companies and Rostelecom and owns substantial equity interests in other local telcos, including MGTS.

On June 7, 2003, the Russian President signed the Telecommunications Law which came into effect on January 1, 2004. The Telecommunications Law clarifies areas, which were poorly defined, such as interconnect and licensing arrangements, however, certain supporting regulations for the Telecommunications Law have not been passed. See Corporate History and Development in this section and Management's Discussion and Analysis of Financial Condition

and Results of Operations for a discussion of the effect of the Telecommunications Law on our business, a discussion of our new DLD/ILD license and the creation of our own FTN designed to satisfy the requirements of our new license and new numbering capacity and interconnect rules.

The Telecommunications Law introduced the concept of the USF. All telecommunications companies are expected to contribute to the USF which is designed to support the development of telecommunications infrastructure which is deemed to be economically unviable but socially necessary. We are currently paying to the USF 1.2% of the difference between our total revenue from

**Table of Contents**

telecommunication services and revenue from interconnection and traffic transmission services. See Management's Discussion and Analysis of Financial Condition and Results of Operations for a discussion of legislation related to USF charges.

Under the Telecommunications Law, interconnect regulation becomes, in theory, more transparent. The Telecommunications Law states that any telecommunications operator which has a significant presence in a given market must provide interconnect arrangements to all operators. This section of the Telecommunications Law is designed to eliminate the discrimination which is experienced by telecommunications operators when attempting to interconnect with regional incumbents.

On October 19, 2005, the Russian government enacted the Rules on Price Establishment for Interconnection and Traffic Routing. These rules list interconnection services and traffic routing services provided by the incumbent operators that are subject to pricing regulation by the government. The effective utilization and implementation of the Russian long distance license is subject to the establishment of tariffs for interconnection and traffic routing services to be provided by incumbent Svyazinvest state-owned companies and other incumbent operators. The tariffs are paid by long distance operators to the incumbent local and zonal operators for each minute of long distance traffic that is carried such that all long distance operators are cross-subsidizing the local and zonal network of the incumbent operators. Such cross-subsidy will continue until January 1, 2008. By that date, the new pricing setting mechanisms and tariff re-balancing should be fully implemented. During the first half of 2006, in the absence of the regulated tariffs most of the incumbent operators, including all of Svyazinvest companies, imposed their own independently established tariffs on alternative long distance, zonal and local operators. However, on June 19, 2006, Rossvyaznadzor established the maximum limits for such tariffs. As a result, the incumbent operators are permitted to impose tariffs on alternative long distance, zonal and local operators within these established limits. Thus, effective July 1, 2006, tariffs for interconnection with the incumbent zonal operators decreased.

Additionally, on March 4, 2006, the Russian President approved amendments to the Telecommunications Law that introduced CPP Rules. Effective July 1, 2006, under the CPP Rules, generally all incoming calls, on fixed and mobile lines, in Russia are free of charge, and only the fixed line or mobile operators originating the call may charge the customer for the call. Previously, subscribers of fixed line telephones did not pay for incoming calls and, therefore, the CPP Rules did not have an impact on fixed-to-fixed line calls, but the CPP Rules impacted the fixed-to-mobile calls as mobile companies traditionally charged for incoming calls in Russia.

*The Telecommunications Market in Ukraine.* The evolution of the telecommunications sector in Ukraine is similar to that in Russia. Over the last number of years, both incumbent and alternative CLEC operators in Ukraine completed modernization of their networks in Kiev and in some other large Ukrainian cities and became more active in service development. Outside Kiev and other large cities, the infrastructure is still outdated and the industry is generally inefficient and provides low-quality services. Many tariffs are still set by the state as a result of political considerations although the levels of such tariffs are now approximating those expected by the telecommunications market.

In contrast to Russia, there has been no privatization of the state-owned telecommunications sector in Ukraine. Whereas privatization of Ukrtelecom, the Ukrainian incumbent public operator, was considered crucial for raising funds for the state in 2004 and 2005, several changes in priorities and political positioning have resulted in delays. The new Ukrainian government, appointed in 2006, did not sell any part of Ukrtelecom in 2006, and are considering plans for privatization in 2007. To date, only about 7% of Ukrtelecom has been privatized to employees and managers.

Since August 2004, the Ministry of Transport and Telecommunications was the regulatory body that oversaw the Ukrainian telecommunications industry. The Ministry of Transport and Telecommunications was responsible for licensing, and setting tariff regulations. As of January 2005, National Commission of Telecommunications Regulation received the abovementioned functions. Tariffs for local calls and calls between and within regions are set at levels below those which would prevail in a deregulated market. Inter-operator tariffs, however, are often set at levels which challenge the ability of competing operators to effectively position themselves against the monopoly operator.

Ukrtelecom is the main provider of fixed voice telecommunications and Internet services in Ukraine. Ukrtelecom is a joint stock company owned 93% by the State Property Fund with 31 branches, 27 of which represent the company in each region of Ukraine. Ukrtelecom holds national transmission networks, along with broadcasting, research and

satellite assets. Ukrtelecom also holds a third generation ( 3G ) mobile services license. Ukrtelecom also owns shares in five other Ukrainian telecommunication companies.

Public switched voice telephony in Kiev is delivered through a layered hierarchy similar to that used in Moscow. We connect our customers using our local access network with fiber optic and copper-based facilities, which provide direct interconnection with the Kiev city telephone network.

The Ukrainian mobile telecoms market is currently served by five operating companies. GTU commenced operations in accordance with its GSM-1800 license in late 1996.



**Table of Contents*****Overview of the Political and Economic Environments in Russia and Ukraine***

*Russia's Political Environment.* Since the dissolution of the Soviet Union in December 1991, Russia has been in the process of a substantial political transformation. The Russian Constitution, ratified in 1993, establishes a three-branch governing system that replaced the Communist Party dominated Soviet system. The three-branch system consists of a powerful executive branch led by the President, a bicameral legislative branch with an upper assembly, the Federation Council, and a lower assembly, the State Duma, and a judicial branch, which is still underdeveloped. Boris Yeltsin was elected to a second term as President in July 1996 but shortly thereafter lost popular support on account of political and economic dislocations, disaffection with economic reform, institutionalized corruption and his erratic stewardship of the country. On December 31, 1999 Boris Yeltsin resigned the presidency, thereby enabling the Prime Minister, Vladimir Putin, to be elevated to the role of acting president and to emerge as the winning candidate in the presidential election which was held on an accelerated basis on March 26, 2000. On March 14, 2004, Vladimir Putin was elected to a second presidential term. Under the Russian Constitution, no person may serve more than two terms as President. The next federal Duma election will be held at the end of 2007 and the next presidential election will be held in 2008.

As a result of the frequent changes of government in Russia and the other countries of the CIS, government policies are subject to rapid and potentially radical change. Corruption exists in some areas of government and commercial enterprises in which the state has an ownership interest. In an attempt to increase the influence of federal authorities in the regions, President Putin organized the Russian regions into seven administrative regions and appointed special presidential representatives to coordinate and enforce federal policies in each of these regions. Effective January 1, 2005, gubernatorial elections were abolished in favor of a system under which regional governors will be nominated by the President and then approved by local legislatures. The regional governors' authority has also been increased with a reassertion of federal power in the regions.

*Russia's Economic Environment.* In the immediate aftermath of the 1998 financial crisis, the ruble's value declined substantially below the 9.50 rubles per USD floor set on that date, but in the last year has settled in the range of 26.31 to 28.12 rubles per USD, with the rate being 26.33 rubles per USD on December 31, 2006. World oil and gas prices have contributed to the recent strength of the ruble. The gross domestic product (GDP) increased by 6.7% in 2006. According to government figures, inflation has come under relative control since the 1998 crisis with annual inflation numbers of 12% for the year 2004, 11% for the year 2005 and 9% for the year 2006. The Central Bank of Russia increased the amount of its net gold and hard currency reserves from \$182.2 billion at the end of December 2005 to \$303.0 billion at the end of December 2006. The Stabilization Fund of Russia was \$18.8 billion as of December 31, 2004, \$43 billion as of December 31, 2005 and \$89.1 billion as of December 31, 2006. These positive economic indicators must be considered in the context of Russia's status as a major exporter of oil and other natural resources. Any decline in world oil prices could negatively impact the value of the ruble and the continued development of Russia's economy.

*Ukraine's Political Environment.* Ukraine declared independence from the Soviet Union in 1991. Since that time, Ukraine has established a three-branch system of government similar to that in Russia. Following a period of significant political debate, the new Ukrainian Constitution was ratified in June 1996. Independent Ukraine's first President, Leonid Kravchuk, led the country through a period of significant economic and social decline. Following the 1995 presidential elections, Leonid Kuchma succeeded him. Ukraine is one of the few former Soviet republics to smoothly and peaceably transfer executive power. President Kuchma was re-elected for another five-year term in November 1999. On January 10, 2005 Victor Yushenko was declared the President after a divisive presidential election against Victor Yanukovich. In the end of 2004, constitutional reform significantly reduced the powers of the Ukrainian President in favor of the Ukrainian Prime Minister.

Until 2006, half of the members of the Verkhovna Rada (Ukrainian parliament) were elected by proportional representation and the other half by single-seat constituencies. Starting with the 2006 parliamentary election, all 450 members of the Verkhovna Rada were elected by party-list proportional representation. In March 2006, elections to Verkhovna Rada took place. Three months later the official coalitional government was formed among the Party of Regions, Communist Party, and Socialist Party of Ukraine, and Victor Yanukovich was elected to the post of Prime Minister, while the leader of Socialist Party, Alexander Moroz managed to secure the Speaker of the Parliament

position.

Ukraine experienced political instability in 2006 due to tensions between the President and the Prime Minister following the overturning of a presidential veto on a law giving the Cabinet of Ministers more power. Ukraine may experience continued political instability in 2007 as this political and constitutional crisis is resolved.

*Ukraine's Economic Environment.* In September 1996, a new currency, the hryvna, was introduced, replacing the temporary Karbovanets, or coupons, that were in circulation following the country's independence from the Soviet Union. The National Bank of Ukraine, the nation's central bank, has steadfastly refused to permit wholesale printing of the currency despite much pressure from the Parliament. The hryvna is now subject to a floating exchange rate whereas it was previously kept within a fixed range. In 2005, the hryvna strengthened, moving from 5.30 per USD at December 31, 2004 to 5.05 at December 31, 2005. During 2006, exchange rate remained stable at 5.05 hryvnas per USD. Despite large fluctuations in international steel prices and soaring energy import prices, the Ukrainian GDP increased by approximately 7% in 2006. The inflation rate was 12% for the year 2004 and 10% for the year 2005 and 11.6% for 2006.

**Table of Contents*****Overview of the Legal, Tax and Regulatory Regimes in Russia and Ukraine***

*Russia's Legal, Tax and Regulatory Regime.* After the dissolution of the Soviet Union in December 1991, former President Yeltsin and the Duma enacted piecemeal legislation in an attempt to develop a legal framework to guide the transition from a centralized command economy to a more market-oriented economy. While the rudimentary legal framework continues to develop, legislation is often inconsistent, contradictory and unclear. This general characterization is particularly applicable to corporate governance regulations and tax legislation. During 2000, at the urging of President Putin's government, the State Duma approved the first two parts of the revised and reportedly simplified Russian Tax Code. The second part entered into effect as of January 1, 2001 and additional provisions came into effect as of January 1, 2002. Similarly, under pressure from the executive branch, the Duma finally enacted a new Labor Code, which entered into effect in February 2002 and replaced the antiquated Labor Code left over from the Soviet era. In 2006, there were significant changes to the Labor Code, particularly on those areas dealing with senior management of companies. Still, ambiguities in the law are exploited by bureaucrats struggling to increase state budgetary resources. Administrative regulations and decrees are frequently not published and are not available for review. The judiciary in Russia is regarded as not sufficiently independent from political influence and judges are frequently underpaid, inexperienced and commercially unsophisticated. In addition, judges are subject to intimidation, and corruption in the judiciary can occur.

The State Duma has enacted legislation to protect foreign investment and other property against expropriation and nationalization. In the event that such property is expropriated or nationalized, legislation provides for reimbursement of the value of the property and damages. However, due to the lack of state budgetary resources, experience and political will to enforce these provisions, and due to potential political changes, it is uncertain whether such protections could be enforced.

In addition to telecommunications legislation, the Russian telecommunications industry has also been shaped by privatization legislation and the privatization of state-owned telecommunications enterprises.

Historically, taxes payable by Russian companies have been numerous and substantial. These include taxes on profits, assets and payroll, and value-added tax ( VAT ). The recently enacted Tax Code represents an attempt to rationalize the federal tax system. For example, from January 1, 2003, under the new Tax Code, taxes calculated on the basis of gross revenue have been abolished. The maximum unified payroll tax rate decreased from 38.5% to 35.6% in 2001, and to 26% in 2005. From January 1, 2002, the rate of corporate profit tax decreased from 35% to 24%. From January 1, 2004, the VAT rate decreased from 20% to 18%.

Russian companies within the same ownership group cannot be consolidated, and therefore, each company must pay its own Russian taxes. Because there is no consolidation provision, dividends are subject to Russian taxes at each level that they are paid. Currently, dividends are taxed at 15% and the payor is required to withhold such tax when paying dividends, except with respect to dividends paid to foreign entities that qualify for an exemption under treaties on the avoidance of double taxation.

In various jurisdictions, we are obligated to pay VAT on the purchase or importation of assets, and for certain other transactions. In many instances, VAT paid on purchases can be offset against VAT which we collect and otherwise would remit to the tax authorities, or may be refundable. Because the law in some jurisdictions is unclear, the local tax authorities could assert that we are obligated to pay additional amounts of VAT. In our opinion, any additional VAT which we may be obligated to pay would be immaterial.

In addition, the new Tax Code authorizes Russia's regional legislative authorities to impose a local tax on the sale of goods and services on their territories. A number of such subdivisions have exercised this authority, including Moscow and St. Petersburg which have each established a local sales tax rate of 5 percent. This local tax on the sale of goods was abolished from January 1, 2004.

Pursuant to the Telecommunications Law and subsequent governmental decrees, the Russian Ministry of Telecommunications is assigned the authority to regulate and control the development of the communications industry in Russia. Additional legislation defines the roles of other communications regulatory bodies, with the Russian Ministry of Telecommunications exercising responsibility over supervising them. Rossvyaznadzor, which is now a department of the Russian Ministry of Telecommunications, is empowered to issue licenses and certain permits required for network operation and for the importation and use of telecommunications equipment. Rossvyaznadzor

conducts periodic inspections to determine an operator's compliance with the terms and conditions of its licenses and is authorized to issue orders and instructions requiring operators to bring their network into compliance with their licenses or to face fines and/or to suspend a license, or in the case of continued non-compliance, to initiate court proceedings for the revocation of a license. In addition, entities such as Svyazinvest at the federal level, as well as other entities in Moscow and St. Petersburg and other administrative regions within Russia exercise significant control over their respective local telephone networks and may therefore affect the licensing process.

The State Commission for Radio Frequencies, or GKRCh, is responsible for administering the utilization of the radio spectrum. This government agency assigns and oversees the operation of radio frequencies.

**Table of Contents**

Legislation and normative acts specific to the telecommunications industry provide the regulatory framework that guides our operations. The new Telecommunications Law came into effect in Russia on January 1, 2004, however, some of the supporting regulations have not been enacted. See *Corporate History and Development* in this section and *Management's Discussion and Analysis of Financial Condition and Results of Operations* for a discussion of the effect of the Telecommunications Law on our business, a discussion of our new DLD/ILD license and the creation of our own FTN designed to satisfy the requirements of our new license and new numbering capacity and interconnect rules.

The Telecommunications Law also sets forth general principles for the right to carry on telecommunications activities, describes government involvement in telecommunications regulation and operation, establishes the institutional framework involved in regulation and administration of telecommunications, and deals with various operational matters, such as ownership of networks, protection of fair competition, interconnection, privacy and liability. Separate legislation and administrative regulations implement this institutional framework.

The Telecommunications Law also introduces the *significant operator* concept. Significant operators are defined as those companies which generate either more than 25% of traffic or possess more than 25% of the local numbering capacity. Significant operators may not refuse to provide interconnect services, and interconnect rates should be public and equal for all operators. This change should make it more difficult for regional operators to discriminate against competitors in order to protect their own operations.

It can be difficult and expensive to comply with applicable Russian telecommunications regulations. Telecommunications in Russia is confidential and may only be intercepted pursuant to court order. Nevertheless, we are subject to SORM, the Russian acronym for the surveillance system operated partly by the Federal Security Service, a government agency that is responsible for electronic surveillance. SORM requires telecommunications networks to facilitate monitoring of electronic traffic. Many operators and commentators consider that SORM, as applied, is inconsistent with the privacy provisions of the Russian constitution. Full compliance with SORM may be expensive, burdensome and unconstitutional, yet noncompliance with SORM may lead to the administration of fines, penalties or the revocation of our operating licenses.

*Ukraine's Legal, Tax, and Regulatory Regime.* A primary contributor to the relatively slow pace of reform in Ukraine has been the absence of a coherent and enforceable legal framework to facilitate widespread privatization of government assets. As an example, the privatization of Ukrtelecom has been repeatedly delayed because of the absence of key laws required to enable such privatization.

As with other former Soviet Republics corruption still exists in Ukraine, however, organized criminal groups that were very active throughout Ukraine during the 1990s have been almost completely disbanded. Because of corruption among government officials and among commercial enterprises in which the state has an ownership interest, the President and the Government perceive tackling corruption as one of their primary tasks.

The Ukrainian tax regime includes taxes on profits, on payroll, VAT, and special fees and taxes levied against telecommunications operators. In order to stimulate economic growth and broaden the tax base, in 1999 the Government introduced a significant reduction in payroll taxes followed by a subsequent abolition of revenue-based taxes in 2001. At the beginning of 2003, the Ukrainian Parliament adopted amendments to the Profit Tax Law that, among other changes, reduce the profits tax rate from 30% to 25%. The major components of these amendments came into effect in 2004.

The regulatory framework governing the telecommunications industry in Ukraine has improved significantly after the new law *On Telecommunications* came into force on December 23, 2003. The new law sets forth the general principles for telecommunications activities, networks and services, including the relationships between operators and customers. The new law provides for the creation of two new executive bodies – the Central Executive Authority in the Communication Sector ( CEACS ) and the NCCR to replace the former State Committee for Telecommunications.

CEACS retains mostly administrative functions in the telecommunications industry in Ukraine. CEACS develops draft telecommunications laws and other legal documents, defines and monitors quality standards in telecommunications services. NCCR retains regulatory functions in telecommunications and radio-frequency utilization. It is also the central executive body with special status subordinated to the President of Ukraine. NCCR supervises the observance of telecommunications law and quality control of telecommunication services. NCCR assigns numbering capacity, grant licenses, registers services in the telecommunication sector, provides tariff

regulation, and applies sanctions to those that violate telecommunication laws. On March 29, 2006, documentation governing the Public Council which is affiliated to the NCCR was approved, with the aim of the Public Council to provide a forum for the NCCR to consider public opinion when considering issues and taking decisions.

In February 2003, the Ukrainian Parliament adopted an amendment to the law On Telecommunications prohibiting all telecommunications operators from charging their end-user customers for incoming calls, thus introducing the CPP principle, which entered into effect on September 19, 2003. Additionally, on May 14, 2004 a special Order regulating settlements between fixed, fixed wireless and mobile operators was adopted by the State Committee for Telecommunications of Ukraine.

**Table of Contents**

In addition to the CPP principle, state regulated tariffs for calls from the public switched telephone network to mobile networks were introduced, thus allowing mobile operators to receive a share of revenue from calls made to mobile networks. To effect CPP settlements on our network we entered into an agreement with Ukrtelecom that assigned a national destination code numbering plan to our mobile customers and allowed to reallocate our interconnect numbering capacity in Kiev and Odessa from our mobile to our fixed network. This agreement became effective in November 2003 and enabled us to receive a settlement from revenue generated when a fixed line party calls our mobile customer as well as released direct city numbering capacity for future sale to CLEC customers.

A new law *On Individual Income Taxation* came into force on January 1, 2004. The law sets the unified tax rate for personal income at 13% until December 31, 2006, and 15% from January 1, 2007.

On June 24, 2004 the Verkhovna Rada adopted amendments to the law *On Radio Frequency Resource* determining the procedure of granting frequency licenses and permits for the use of radio-electronic and emissive facilities, and for frequency distribution. On August 19, 2005 NCCR adopted new Licensing Conditions for Radio Frequency Resource use. These conditions came into force on October 30, 2005.

Pursuant to the law *On Telecommunications*, new Licensing Conditions for conducting of activity in fixed line telecommunications area were adopted by the State Committee for Telecommunications on June 17, 2004 and came into force on August 16, 2004. Licensing Conditions regulating provision of mobile services and communication channels were developed and adopted in 2005.

The Ukrainian Cabinet of Ministers also adopted rules, effective January 1, 2005, establishing the mandatory payments for obtaining numbering capacity.

Amendments to the Law *On levy on obligatory state pension insurance*, effective August 1, 2005, increased the pension levy rate on mobile services from 6% to 7.5%.

On August 5, 2005 NCCR adopted new Regulations for the state regulation of numbering capacity. These Regulations determine the process of allocating and revoking numbering capacity and principles of numbering capacity utilization by operators. The Regulations came into effect September 23, 2005.

On August 9, 2005, the Ukrainian Cabinet of Ministers adopted the Rules regulating the provision and receiving of telecommunication services. The Rules determine the main requirements for the provision of all telecommunication services (fixed and mobile telephone services, Internet, data transmission, circuits lease), rights and obligations of operators and subscribers, and the settlements process between operators and subscribers.

On January 19, 2006 the Verkhovna Rada approved amendments to the administrative code of Ukraine according to which administrative liability is used for the breach of conditions and rules concerning radio electronic means and radiating devices exploitation.

On September 6, 2006 the NCCR approved an Order on mutual settlements between telecommunication operators for telecommunication network access services for interconnection which entered into force on January 1, 2007. The Order defines the list of telecommunication network access services and provides tariffs for access to the telecommunication networks of exclusive operators. The procedure for calculating tariffs for access services to the telecommunication networks of other operators is not defined.

On October 28, 2006 the Verkhovna Rada approved amendments to the law *On Telecommunications* according to which the list of public telecommunication services with regulated tariffs was changed. Under the new regulation, calls from fixed networks to intercity and international destinations are not regulated. The law also includes regulations concerning calls from fixed to mobile networks. Such calls do not belong to public services and are not regulated. Consequently, fixed line operators can establish tariffs for such services independently. Influential operators will be able to set tariffs for intercity and international connection services at more competitive rates than small operators.

**Table of Contents**

**ITEM 1A. Risk Factors**

**Factors That May Adversely Affect Future Results  
Risks Associated With Doing Business in Russia, Ukraine and  
Other Countries of the CIS**

We generate substantially all our revenues from operations in Russia, Ukraine and other countries of the CIS. All companies operating in the CIS, including us, face significant political, economic, regulatory, legal and tax risks, some of which are described below.

**Political instability in the countries in which we operate could depress foreign and local investment and spending, which could adversely affect our results of operations**

Since the dissolution of the Soviet Union in December 1991, Russia, Ukraine and other countries in which we operate have, to varying degrees, been undergoing significant political and economic transformation. A generally stable political climate has emerged but economic development remains hampered by the absence of a consistent and comprehensive legislative framework necessary to implement and enforce market oriented reforms and by incidents of corruption among government officials. A re-occurrence of the political instability that characterized the first several years of the transformation could disrupt the direction and the pace of economic development. In addition, there has been terrorist activity in Russia from time to time. Political instability or terrorist activity could discourage foreign and local investment and spending, in which case demand for our services could decrease and results of operations could deteriorate. If this were to occur, then the market price of our stock could decrease.

**There is a volatile political situation in Ukraine which may negatively impact our business**

Historically, political and governmental instability has been a feature in Ukraine. The relationship between various state authorities, Ukrainian government policies and the political leaders who formulate and implement such policies is subject to rapid change. In January 2005, Victor Yushenko became president of Ukraine in a very divisive election. Constitutional reform that became a point of consensus at the height of the Orange Revolution came into force on January 1, 2006 and has transferred a great deal of power from the Presidency to parliament. Major changes in the political climate in Ukraine, in particular any changes affecting the stability of the Ukrainian government, reforms, privatization, industrial restructuring or administrative reform, could materially effect our operations.

**Economic instability in Russia and Ukraine could adversely affect the demand for our services and our ability to collect on our invoices**

Although the Russian and Ukrainian economies have experienced periods of economic downturn and heavy inflation, the political and economic situation in Russia and Ukraine appears to have stabilized. Russia ceased to be highly inflationary in 2003. However, any future instability or lack of economic growth in the countries in which we operate could mean that demand for our services could become depressed.

Recently, the Russian and Ukrainian economies have experienced positive trends, such as increases in the gross domestic product, relatively stable currencies, strong domestic demand, rising real wages and reduced rates of inflation, however, these trends may not continue or may be abruptly reversed. Although the communications industry in the markets in which we operate is relatively underdeveloped compared to other European markets and has grown significantly in recent years, we cannot assure you that it will experience significant growth in the future.

**The currency control system of Russia and Ukraine could adversely affect our ability to convert rubles and hryvnas to hard currency and manage cash flows**

Russian legislation currently permits the conversion of ruble revenues into foreign currency. However, the market in Russia for the conversion of rubles into foreign currencies is limited and may not continue to exist. Further, any delay or other difficulty in converting rubles into a foreign currency to make a payment or delay in our restriction on the transfer of foreign currency could limit our ability to meet our payment and debt obligations, which could result in the loss of suppliers, acceleration of debt obligations and, consequently, have a material adverse affect on our business, financial condition and results of operations.

The hryvna is generally non-convertible outside Ukraine so our ability to protect ourselves against devaluation by converting to other currencies is significantly limited. In Ukraine, our ability to convert hryvna into other currencies is subject to rules that restrict the purposes for which conversion and payment in foreign currencies are allowed. In Ukraine, companies are allowed to keep balances in foreign currencies earned from export activities. Therefore, the



liquidity can be supported through synchronization of in-

## **Table of Contents**

and outflows denominated in the same currency. We manage intercompany liquidity through intercompany loans to our subsidiaries. Under the Russian restated currency law, loans to residents may be subject to reserve requirements. Likewise, such reserve requirements may be introduced for the purchase of currency by Russian residents. Such reserve requirements, if they become applicable to us, may adversely affect our operations. If there are changes to the currency control systems in Russia and Ukraine, our ability to manage our liquidity position and our currency risk may be adversely affected.

### **The Russian banking and financial system remains underdeveloped, and another banking crisis could place liquidity constraints on our business and adversely affect our financial condition**

Russia's banking and other financial systems are not well developed or regulated, and Russian legislation relating to banks and bank accounts is subject to varying interpretations and inconsistent applications. Most Russian banks do not meet international banking standards, and the transparency of the Russian banking sector still lags far behind internationally accepted norms.

As a result, the banking sector remains subject to periodic instability. Following a destabilization of the Russian interbank loan market in June 2004, the Central Bank of Russia undertook a number of steps towards stabilizing the banking sector, such as reducing the reserve requirements and expanding governmental deposit guarantees, and the Russian banking sector has since stabilized. However, another banking crisis, or the bankruptcy or insolvency of banks through which we receive or with which we hold funds, could result in the loss of our deposits or adversely affect our ability to complete banking transactions in Russia, which could have an adverse effect on our business and operations.

### **Russian and Ukrainian telecommunications policies could affect our competitive position**

Russian and Ukrainian telecommunications regulations govern the procurement and continuing validity of our licenses and the terms and conditions under which we provide services. Adverse changes to these regulations may make it prohibitively expensive for us to provide services or otherwise frustrate the implementation of our business plans causing a material adverse effect on our results of operations.

As a result of changes in existing regulations, changes in interpretations of existing regulations or arbitrary regulatory decisions affecting various aspects of our business, we could experience:

- Restrictions on how and where we can provide our services;

- Restrictions or delays in receiving approvals on our applications and communications for necessary regulatory approvals for rolling out our network in the regions for which we have licenses;

- Significant additional costs;

- Suspension or revocation of licenses necessary to operate;

- Delays in implementing our operating or business plans; or

- Increased competition.

A significant number of new regulations promulgating the Telecommunications Law came into effect in Russia in 2005 and 2006. We received our access codes to offer DLD/ILD services only in December 2006 despite fulfilling all necessary requirements earlier. It is possible that Russian regulatory agencies will make claims that we were not in compliance with the new regulations from January 1, 2006.

Recently, the Russian government has issued implementing acts under the Telecommunications Law, excluding telematics services altogether from the list of permitted services, however, the previous telematics licenses were not repealed. Thus, it is not yet clear how these regulations would be implemented. Thus, uncertainty related to the Telecommunications Law continues. See Management's Discussion and Analysis of Financial Condition and Results of Operations for a discussion of the effect of the Telecommunications Law on our business and new numbering capacity and interconnect rules.

### **The Telecommunications Law and regulations provide scope for the incumbent operators to raise access costs**

The Telecommunications Law and regulations do not contain provisions for state regulation of access to communication facilities and the lease of long distance channels. Some of our suppliers of telecommunications services have raised their charges to us and we may experience more such cost increases in the future. In the event that we decide to challenge such actions of our suppliers through the appropriate Russian government ministries or courts, we cannot predict whether we will be successful in such a challenge. In addition, the Interconnection Rules do not contain provisions for state regulations of interconnect costs charged by non-dominant operators. In the third quarter of 2006, incumbent Svyazinvest operators started introducing new settlement rules for local traffic. Prior to July 1, 2006, we paid fixed monthly fees for interconnection lines with these operators. Under the new rules, the settlements

## **Table of Contents**

will be based on the actual volume of traffic. The switch to the new rules was not completed in 2006. Introduction of these charges could lead to an increase in cost of revenue which may only be partially offset by additional revenue for the traffic termination to our network.

### **Our operating licenses may not clearly authorize us to provide all of the services that we offer**

The licensing and regulatory regime in Russia, Ukraine, and the markets in which we operate frequently do not keep pace with the technological advances in the telecommunications industry. Further, a great deal of ambiguity exists in regard to the interpretation of licenses and the application of rules and regulations in regard to our new services, especially those new services enabled by technological developments in telecommunications infrastructure and software. Although our operating companies possess a wide range of licenses issued by the Russian and Ukrainian regulatory agencies, it is possible that the technical means by which we provide some of our services, or the service themselves, may be subject to licensing requirements or restrictions and that our existing licenses do not satisfy these requirements. In such events, we could be subject to fines, penalties or suspension, limitation or revocation of licenses. The suspension, limitation in scope or revocation of a significant license or the levying of substantial fines could have a material adverse effect on our operations and our financial results.

### **Competing commercial interests with ties to the government officials could harm our business**

Competing commercial interests with ties to the government or government officials with interests in competing commercial structures could use government organs (regulators, tax authorities, police and law enforcement agencies) as a means to attack and damage our business and could try to influence the courts in cases brought against us. Any such actions could have a material adverse effect on our operations and business.

### **Review of our operations by the Russian Prosecutor General's office could disrupt our operations**

In a letter dated December 20, 2006, several deputies of the State Duma, wrote to the Russian General Prosecutor alleging that Sovintel was illegally providing domestic and international services prior to receipt of access codes. The letter states that because Sovintel had not yet received access codes to offer such services in the first, second and third quarter of 2006, then Sovintel was operating illegally in this respect. Further, the letter requests that the Prosecutor General's office conduct an investigation of Sovintel's activities and, if appropriate, charge those Sovintel officials responsible for the activities. Sovintel received the access codes in December 2006 and prior to construction of its FTN was operating under its previous licenses. The Company believes that it was acting in accordance with Russian regulations and legislation and its licenses, however, if the Prosecutor General were to launch an investigation, any such investigation could take substantial management time in responding to the allegations. Any charges against the Company or its senior management could have a material adverse effect on our operations and financial results.

### **Special fees and taxes levied against telecommunications operators could adversely affect our results of operations**

From time to time, Ukrainian and Russian government officials seek to offset budgetary shortfalls by increasing levies extracted from the telecommunications industry. The provisions of the Telecommunications Law require that all Russian operators, including fixed-line operators, pay a portion of their revenues to the Universal Service Fund, which was established to support the provision of universal, multipurpose telecommunications services throughout the Russian Federation. The Universal Service Fund has been operating since 2005. The Telecommunications Law states that it will be funded by telecommunications service providers in an amount determined by the Russian government. Currently, operators must make quarterly payment in the amount of 1.2 percent of the difference between their total revenues and revenues generated by interconnection and traffic transmission services. The amount of the Universal Service Fund may be changed by the Russian government at its own discretion. A draft law detailing a universal service charge in Ukraine is currently under consideration. These or other similar industry-specific pieces of legislation may have a material adverse effect on demand for our services and on our results of operations. Similarly, the results of our operations could deteriorate if the government introduces any new frequency or licensing fees substantially in excess of the amounts previously budgeted for such fees.

The Ukrainian regulatory agency may require licensees to pay annual amounts into local network development. If the additional amounts required will be substantial, we cannot predict whether the financial burden associated with compliance may be so burdensome as to cause a deterioration of our financial results. Moreover, in 2004 the State Committee on Telecommunications of Ukraine established new license conditions, which came into force on

August 16, 2004. Under these conditions, any reissue of existing fixed-voice licenses, even related to the change of a licensee's legal address, may require payment of the full license fee. At present we cannot estimate how significantly these changes may impact our operations in Ukraine.

**Russian and Ukrainian legislation may not adequately protect against expropriation and nationalization**

The governments of Russia and Ukraine have enacted legislation to protect foreign investment and other property against expropriation and nationalization. In the event that our property is expropriated or nationalized, legislation provides for fair compensation. However, we cannot assure you that these protections would be enforced. This uncertainty is due to several factors, including:

The lack of state budgetary resources;

The lack of an independent judiciary and sufficient mechanisms to enforce judgments;

Corruption among government officials; and

That any compensation amount would be fair or approximate market value

Russian legislation governing foreign investment activities does not prohibit or restrict foreign investment in the communications industry. However, there are different opinions regarding the manner and scope of government control over the communications industry. Because the communication industry is widely viewed as strategically important to Russia, governmental control over the communications industry may increase and foreign investment or control over the industry may be limited. Any such increase in governmental control or limitation on foreign investment could have a material adverse effect on our company and could hinder our access to additional capital.

In Ukraine, there has been no established history of investor rights protection or responsibility to investors and in certain cases the courts may not enforce these rights. In the event courts enforced rights of investors granted under applicable Ukrainian legislation, the

## **Table of Contents**

government and/or the legislature of Ukraine could attempt to overrule any such court decisions legislatively through retroactive legislative changes.

In addition, social instability in Russia, Ukraine and other CIS countries, coupled with difficult economic conditions, could lead to increased support for centralized authority and a rise in nationalism. These sentiments could lead to restrictions on foreign ownership of companies in the telecommunications industry or large-scale nationalization or expropriation of foreign-owned assets or businesses. Although we do not anticipate the nationalization or expropriation of our assets because we were not created as a result of privatization of any state enterprise, the concept of property rights is not well developed in the laws of these countries and there is not a great deal of experience in enforcing legislation enacted to protect private property against nationalization and expropriation. As a result, we may not be able to obtain proper redress in the courts, and we may not receive adequate compensation if in the future any local government decides to nationalize or expropriate some or all of our assets. If this occurs, our business could be materially harmed.

### **We may be unable to enforce our rights due to ambiguity in the laws and legal structures of the countries where we operate**

Current ambiguity in Russian, Ukrainian and other CIS laws makes it difficult to determine if we would be able to enforce our rights in disputes with our venture partners or other parties. Furthermore, the dispersion of regulatory power among a number of government agencies in Russia, Ukraine and the other countries of the CIS has resulted in inconsistent or contradictory regulations and unpredictable enforcement. The Russian, Ukrainian and other CIS governments have rapidly introduced laws and regulations and have changed their legal structures in an effort to make their economies more market-oriented, resulting in considerable legal confusion, especially in areas of the law that directly affect our operations. We cannot assure you that local laws and regulations will become stable in the future. Our ability to provide services in Russia, Ukraine and other countries of the CIS could be adversely affected by difficulties in protecting and enforcing our rights and by future changes to local laws and regulations. Further, our ability to protect and enforce our rights is dependent on the Russian, Ukrainian and CIS courts which are underdeveloped, inefficient and, in places, corrupt. Enforcement of court orders can in practice be very difficult in Russia and Ukraine. Additionally, court orders are not always enforced or followed by law enforcement agencies.

### **Any unforeseen changes in the tax laws in Russia or Ukraine could have a material adverse effect on our business**

Our Russian tax burden may become greater than the estimated amount that we have expensed to date and paid or accrued on our balance sheets. Because of the need for additional sources of budgetary finance, Russian tax authorities are often arbitrary and aggressive in their interpretation of tax laws and their many ambiguities, as well as in their enforcement and collection activities. Many companies are often forced to negotiate their tax bills with tax inspectors who demand higher taxes than applicable law appears to provide. Any additional tax liability, as well as any unforeseen changes in the tax law, could have a material adverse effect on our future results of operations or cash flows in a particular period. Under Russian accounting and tax principles, financial statements of Russian companies are not consolidated for tax purposes. As a result, each Russian-registered entity in our group pays its own Russian taxes and we cannot offset the profits or losses in any single entity against the profits and losses in any other entity. As a result, our overall effective tax rate may increase as we expand our operations, unless we are able to implement an effective corporate structure that minimizes the effect of these Russian accounting and tax norms.

Similarly, Ukrainian tax law is unpredictable and tax authorities are often arbitrary and aggressive in their interpretation of tax laws and their many ambiguities, as well as in their enforcement and collection activities. The constitution prohibits retroactive legislation, and the Taxation System Law requires new tax laws to be adopted no later than six months prior to the beginning of the next fiscal year in which the new tax laws are to become effective. Nevertheless, sudden shifts in tax law and policy and retroactive legislation are common. For example, in January 2003, the Ukrainian Parliament adopted amendments to the Profits Tax Law which, in part, became effective as of January 1, 2003. The law substantially changes the tax treatment of exchange rate differences, dividends, transfer pricing, goodwill and other transactions. Other amendments to the Profits Tax Law of Ukraine came into effect from January 1, 2004. Although the profit tax rate was decreased from 30% to 25%, some adverse changes were introduced to the calculation of a taxable profit, such as new bad debts deductibility treatment. The impact of the law on our

operations was positive so far, however, the future impact of the mentioned amendments is still uncertain because of ambiguities and inconsistencies in the law that allow different interpretations by the tax authorities. If our interpretation of the amendments differs from those of the local tax authorities, we might be subject to higher tax liability and/or additional fees and penalties, which could materially effect our business.

**Russian and Ukrainian laws may expose us to liability for actions taken by our subsidiaries or venture entities**

Under Russian law, we may be jointly and severally liable for any obligations of a subsidiary or venture entity under a transaction if:

We have the ability to issue mandatory instructions to the subsidiary or venture entity and that ability is provided for by the charter of the subsidiary or venture entity or in a contract between us and them; and

The subsidiary or venture entity concluded the transaction pursuant to our mandatory instructions.

**Table of Contents**

In addition, we may have secondary liability for any obligations of a subsidiary or venture entity if:

§ The subsidiary or venture entity becomes insolvent or bankrupt due to our actions or our failure to act; and

§ We have the ability to make decisions for the subsidiary or venture entity as a result of our ownership interest, the terms of a contract between us and them, or in any other way.

In either of these circumstances, the shareholders of the subsidiary or venture entity may seek compensation from us for the losses sustained by the subsidiary or a venture entity if we knew that the action taken pursuant to our instructions or the failure to act would result in loss. This type of liability could result in significant obligations and adversely affect our business.

Under Ukrainian laws, we may be held jointly and severally liable for any obligations of our Ukrainian subsidiaries if we fail to initiate bankruptcy proceedings with respect to such Ukrainian subsidiaries when required to do so by law.

**Risks Associated with Our Business**

**We may encounter difficulties expanding and operating our business, including the integration of acquired companies**

We have experienced significant growth as a result of acquisitions and expect such growth to continue. As we grow, it will become increasingly difficult and more costly to manage our business.

Acquisition transactions are accompanied by a number of risks, including risks related to:

§ The consolidation of the operations and personnel of the acquired companies;

§ The potential disruption of our ongoing business and distraction of management;

§ The introduction of acquired technology content or rights into our products and unanticipated expenses related to such integration;

§ The potential negative impact on reported earnings;

§ The possibility that revenues from acquired businesses and other synergies may not materialize as anticipated;

§ The deterioration of relationships with employees and customers as a result of any integration of new management personnel; and

§ Contingent liabilities associated with acquired businesses, especially in the markets where we operate.

We may not be successful in addressing these risks or any other problems encountered in connection with our completed and future acquisitions and our operating results may suffer as a result of any failure to integrate these businesses with our existing operations.

In addition, we may encounter difficulties in building our networks with respect to:

§ Delivering services that are technically and economically feasible;

§ Financing increases in the regional network construction and development area;

§ Obtaining in a timely manner and maintaining licenses, permissions to operate telecommunications equipment, frequency allocations and other governmental permissions sufficient to provide services to our customers;

§ Marketing our services in a large geographic area to new potential customers;

§ Obtaining sufficient interconnect arrangements;



- § Meeting demands of local special interest groups;
- § Obtaining compliance certificates for our telecommunications equipment in a timely and cost-efficient manner;  
and
- § Obtaining adequate supplies of network equipment.

**Table of Contents**

**Reorganizations in the Ukrainian telecommunications sector may have strengthened the position of the monopoly incumbent and encouraged unfair competition**

In preparation for a large-scale privatization of the telecommunications industry, the Ukrainian government reorganized the state telecommunications sector so that Ukrtelecom, the state telecommunications operator, holds all the government's interests in the telecommunications industry. The Ukrainian government owns approximately 93% of Ukrtelecom and intends to partially sell its stake in Ukrtelecom in the near future. In anticipation of the privatization of Ukrtelecom, Ukrtelecom has been transferred back from the Ukrainian Telecommunications Committee to the State Property Fund. The new Ukrainian government is preparing Ukrtelecom for privatization in 2007. It is expected that the Ukrainian government will continue to control at least 51% of Ukrtelecom's shares. This will allow the Ukrainian government to control Ukrtelecom and will afford the Ukrainian government the opportunity to further control the telecommunications industry through this ownership.

The emergence of a single self-regulating Ukrainian telecommunications monopoly may have adverse financial consequences for us because:

We may have no effective recourse against the state monopoly carrier since the state regulator controls and manages the monopoly carrier and the judiciary system is severely underdeveloped and cannot be relied upon to protect and enforce unfair competition;

A single Ukrainian self-regulating monopoly is able to create favorable market conditions for itself and cause unfavorable conditions for us;

Our ability to negotiate reasonable interconnection agreements and rates may suffer; and

Any subsequent privatization of Ukrtelecom may bring in strong management and resources from a major telecommunications operator, increasing its competitive strengths.

**Failure to obtain sufficient and reliable transmission capacity at reasonable costs could cause us to incur losses**

Historically, we have leased a substantial portion of our network transmission capacity under agreements that generally have one to three-year fixed terms. We rely on third parties' ability to provide data transmission capacity to us. These third parties themselves, in turn, may be receiving capacity from others. If our lease arrangements deteriorate or terminate and we are unable to enter into new arrangements or if the entities from which we lease such capacity are unable to perform their obligations under these arrangements, our cost structure, service quality and network coverage could be adversely affected.

We currently provide international switched voice, data and IP services in Russia by relying on Rostelecom, Transtelecom, and to provide leased transmission capacity within Russia. We rely on local operators for last-mile access to end-users. These companies may be subject to political and economic pressures not to lease capacity to foreign operators or competitors. Any changes in regulation or policies that restrict us from leasing adequate capacity could have an adverse effect on our business. Local telecommunications operators may, for business reasons or otherwise, resist giving us access to the last mile.

The failure of Rostelecom, Transtelecom, local operators or any other provider to comply with lease arrangements or our inability to obtain other long-term leases on a timely basis or maintain existing leases for fiber optic cable or transmission capacity would prevent us from deploying and operating our network as planned. This could have a material adverse effect on our ability to operate.

**Our ability to provide our services is dependent on securing and maintaining interconnection agreements with Svyazinvest, Ukrtelecom and other facilities providers**

Our ability to provide telecommunications services depends on our ability to secure and maintain interconnection agreements with Svyazinvest, Ukrtelecom and other incumbent owners of networks. Since we do not currently anticipate owning all the facilities we need to operate our networks, we will always rely on the telecommunications networks of other providers to some degree. Interconnection is required to complete calls that originate on our networks but terminate outside our networks, or that originate from outside our networks and terminate on our networks. Our current interconnection agreements with incumbent operators expire in various years between 2007 and 2014. We have experienced substantial increases in interconnection costs with incumbent operators. It is possible that

in the future our interconnection agreements may not be renewed or not renewed on a timely basis or on commercially reasonable terms, thus possibly having a material adverse effect on our business.

In Russia, we are dependent on Svyazinvest for the provision of leased lines and/or interconnect circuits used to connect our points of interconnection to our network backbones. A failure by Svyazinvest to provide such leased lines and/or interconnect circuits in accordance with our plans, or to satisfy our customers' demands on certain routes, has in the past given rise to capacity constraints in our network on certain routes. While we believe that these capacity constraints have been eliminated, we may continue to

## **Table of Contents**

experience capacity constraints until we increase the number of points of interconnection to our network, allowing us to route a greater proportion of traffic over our network.

In Ukraine, we are, to a great extent, dependent on Ukrtelecom for the provision of leased lines and/or interconnect circuits used to connect our indirect access customers throughout Ukraine. A failure by Ukrtelecom to provide such leased lines and/or interconnect circuits in accordance with our plans, or to satisfy our customer demand on certain routes, could give rise to capacity constraints in our network on certain routes in Ukraine if we are not able to find an alternative circuit provider.

### **Our network may not be able to support the growing demands of our customers**

The uninterrupted operation of our networks is vital to our success. The stability of our systems depends on our ability to provide sufficient capacity to meet the needs of our customers, and that, in turn, depends on the integration of suitable technology into our networks. As we continue to increase both the capacity and the reach of our networks, and as traffic volume continues to grow, we will face greater demands and challenges in managing our circuit capacity and traffic management systems. Any prolonged failure of our communications network or other systems or hardware that causes significant interruptions to our operations could seriously damage our reputation and result in customer attrition and financial losses.

It is possible that the current economic difficulties and historical circumstances in Russia and Ukraine may create difficulties in maintaining our network. We rely to a significant degree on the Russian and Ukrainian networks being able to deliver our services, and the underdevelopment of such networks may hinder our ability to obtain sufficient capacity for our traffic volumes, especially as we expand our Internet access business. Moreover, it is increasingly difficult to expand within Moscow because the existing city network does not have sufficient capacity, and we may be unable to procure enough telephone numbers and connection lines for our customers utilizing our services. These factors may have a material adverse effect on our expansion plans and our ability to provide services to new customers.

### **Russian companies may be required to adopt a plan of liquidation when their net assets are negative**

Under Russian law, in the event the value of a company's net assets is less than the minimum charter capital allowed by law, such company may be required to adopt a decision to liquidate. Even if the company declines to approve its liquidation, governmental agencies responsible for the State registration of companies, as well as other designated State bodies, for example, the Federal Service for the Financial Markets, are authorized to bring a lawsuit seeking liquidation of the company until the expiration of the relevant statute of limitation. Some of our subsidiaries had in the past negative net asset values which could make them subject to the legal requirement to adopt a plan of liquidation. Any voluntary or forced liquidation could have material adverse effect on our business.

### **We may have difficulty scaling and adapting our existing architecture to accommodate increased traffic and technology advances**

Most of the telecommunication network architecture that we employ and the architecture of local public networks were not originally designed to accommodate levels or types of services we provide and it is unclear whether current or future anticipated levels of traffic will result in delays or interruptions in our services. In the future, we may be required to make significant changes to our architecture, including moving to a completely new architecture, or we may be required to invest in order to upgrade local public networks. If we are required to switch architectures, we may incur substantial costs and experience delays or interruptions in our operations. If we experience delays or interruptions in our operations due to inadequacies in our current architecture or as a result of a change in architectures, users may become dissatisfied with our services and move to competing providers. Any loss of traffic, increased costs, inefficiencies or failures to adapt to new technologies and the associated adjustments to our architecture could have a material adverse effect on our business.

### **We are in a competitive industry and our competitors may be more successful in attracting and retaining customers**

The market for our products and services is competitive and we expect that competition, especially in underdeveloped markets, will continue to intensify. As we expand the scope of our offerings, we will compete directly with a greater number of competitors providing business services in the same markets. Negative competitive developments could have a material adverse effect on our business.

Our competitors include incumbent Russian and Ukrainian operators, alternative operators, mobile operators and other large international telecommunications providers doing business in the CIS. Our competitors may have substantially greater resources, closer ties to governmental authorities and longer operating histories. These advantages may give them a competitive edge over alternative providers like us. This competition may result in a loss of customers, falling prices and a decline in revenues.

**Table of Contents**

We are operating in recently liberalized markets in an evolving and highly competitive industry. We expect our competitors to continually improve their products and services while also reducing their prices. Our success will depend on our ability to compete effectively in this environment.

The telecommunications market in Russia has historically been dominated by Svyazinvest and in Ukraine by Ukrtelecom, both being former state monopoly telecommunications services providers. These companies and other established competitors have significant competitive advantages over us which include:

- § Greater resources, market presence and network coverage;
- § Greater brand name recognition, customer loyalty and goodwill;
- § Control over domestic transmission lines and over access to these lines by other participants; and
- § Close ties to national and local regulatory authorities which may be reluctant to adopt policies that would give rise to increased competition for Svyazinvest or Ukrtelecom.

Recently, Comstar strengthened its position in the market by receiving approximately \$1 billion as a result of its IPO. MGTS is controlled by Comstar. As a result Comstar has an advantage in broadband access. In 2006, Comstar has also purchased a 25% plus one share in Svyazinvest which means that it may be able to influence the intra-zonal operators which compete with us.

**Our existing billing and management information systems may not be able to meet our future needs**

We may encounter difficulties in enhancing our billing and management information systems and in integrating new technology into such systems. We have historically operated through distinct companies, but we are in the process of integrating our billing and management information systems so that we will be able to bill our customers and to manage other administrative tasks through unified systems. If we are unable to integrate and upgrade our billing and management information systems to support our integrated operations, our billing may suffer which could have a material adverse effect on our revenues.

In addition, in order to comply with the new regulations effective January 1, 2006, we entered into service contracts with the local and intra-zonal operators to act as our regional agents for the provision of DLD/ILD services. In our operations outside Moscow and St. Petersburg, we rely on our agents' billing and information systems to provide information necessary to generate invoices. Thus, we are subject to risks associated with verification and calculation of volumes of long-distance services provided to end users, invoicing and revenue recognition. The absence in the regulations of a mandatory provision for local and intra-zonal network subscriber information to be shared with long-distance operators represents a substantial potential risk to us. This information could be critical to our ability to properly record traffic transit from subscribers, calculate charges for services rendered, and issue invoices.

Any damage to our network management center or our major switching centers could harm our ability to monitor and manage network operations and generate accurate call detail reports from which we derive our billing information.

In our operations outside Moscow, Kiev and St. Petersburg, we rely on our ventures' switches to provide information necessary to generate invoices. We cannot ensure that their systems will meet our needs or the needs of our customers.

**Our ability to close certain transactions or develop the acquired businesses will determine our ability to develop our broadband strategy**

We recently announced the signing of key transaction documents for the purchase of companies known as Corbina Telecom. Corbina Telecom offers several telecommunications services including Fiber-to-the-Building ( FTTB ) broadband Internet services in several Russian cities. If we are not able to close the Corbina Telecom acquisition, our ability to further develop our broadband strategy will be adversely affected and our business could suffer. If we close the transaction, our ability to develop broadband service offerings in Moscow will depend on our ability to obtain the necessary permits and licenses and to compete with companies that are substantially owned by local authorities, which are those authorities which will be granting some of the necessary permits and licenses.

We also recently announced the closing of the acquisition of a 65% interest in Fortland Limited, which owns 100% of Kolangon-Optim LLC ( Kolangon ). Kolangon and its six wholly-owned subsidiaries hold permits to operate frequencies in the 8 MHz bandwidth in Moscow and St. Petersburg. Kolangon also possesses a license to provide communications services for the purpose of digital TV broadcasting. The successful development of this business depends on several factors, including our ability to deploy transmitters and negotiate with television channels and large content providers to secure access to content. If we are not able to deploy the transmitters or receive content as we anticipate, our ability to expand our operations into the media market will be disrupted and our broadband strategy and business could be materially adversely affected.

## **Table of Contents**

The integration of acquired businesses requires significant time and effort of our senior management, who are also responsible for managing our existing operations. The integration of new businesses may be difficult for a number of reasons, including differing management styles, systems and infrastructure and poor records of internal controls. In addition integrating acquired companies may require significant capital expenditures. Further, even if we are successful in integrating our existing and new businesses, expected synergies and cost savings may not materialize, resulting in lower than expected profit margins. If we do not realize the expected synergies from the integration of newly acquired companies, our financial condition, results of operations and prospects could be materially adversely affected.

### **We may encounter difficulties in fully complying with applicable laws due to confusion and contradictions in the laws and legal structures of the countries where we operate**

The application of the laws of any particular country is not always clear or consistent. This is particularly so in Russia, Ukraine and other CIS countries where the legislative drafting has not always kept pace with the demands of the marketplace. These countries often have commercial practices and legal and regulatory frameworks that differ significantly from those in the US and other Western countries. As a result, it is often difficult to ensure that we are in compliance with changing legal requirements. If we, any of our ventures, or any of our acquired companies are found to be involved in practices that do not comply with local laws or regulations, then we may be exposed, among other things, to significant fines, the risk of prosecution or the suspension or loss of our licenses, frequency allocations, authorizations or various permissions, any of which could have a material adverse effect on us.

The Russian Ministry of Telecommunications, the Ukrainian Telecommunications Committee and Russian Rossvyaznadzor regularly check our compliance with the requirements of the applicable legislation and our telecommunications licenses. We use our best efforts to comply with all such requirements. However, we cannot assure you that in the course of future inspections we will not be found to be in violation of the applicable legislation. Any such finding could have a material adverse effect on our operations. For example, we received a warning from Rossvyaznadzor that Sovintel should remedy certain alleged violations in traffic routing. The allegation follows an inspection by Rossvyaznadzor of an independent operator. We have reviewed the allegations and believe that we are in compliance with our licenses, however, we cannot be certain that Rossvyaznadzor will agree with us in the future.

It may be difficult and prohibitively expensive for us to comply with applicable Russian telecommunications regulations related to state surveillance of communications traffic. Currently, Ukrainian authorities are also trying to implement state surveillance of communications traffic. Full compliance with these regulations that allow the state to monitor voice and data traffic may be overly burdensome, expensive and lead to a drop in quality of service. Noncompliance may lead to the imposition of fines or penalties on us, or the revocation of our operating licenses. Further, some customers may decline to utilize the services of a telecommunications provider whose networks facilitate state surveillance of communications traffic.

On May 31, 2005, we received a DLD/ILD license in Russia which is valid until May 31, 2012. On January 16, 2006, we announced that the construction of our FTN was completed in compliance with the Telecommunications Law and our DLD/ILD license was finally confirmed by Rossvyaznadzor on November 27, 2006. On December 15, 2006, the Russian Ministry of Telecommunications granted us access codes to operate our FTN. We have obtained the required governmental permissions for operation of all of the international and intercity communication transit nodes that are part of the FTN. Prior to the construction of our FTN, we provided domestic and international long distance services pursuant to other licenses. We believe that we were offering such services in compliance with Russian regulations and legislation.

If regulatory agencies and tax authorities consider that our routing of traffic or offering of DLD/ILD services violated Russian regulations and legislation, we could be subject to license suspensions, revocations, fines and penalties. Any of these events could have a material adverse effect on our operations.

### **Our telecommunications licenses may not be extended or may be suspended or revoked**

Our telecommunications licenses expire in various years from 2007 to 2016. If renewed, our licenses may contain additional obligations, including payment obligations, or may cover reduced service areas. If our telecommunications licenses for provision of local, intercity, interzonal and international telephone services are not renewed, our business could be adversely affected. For example, following our acquisition of S-Line in Ukraine, our application for



re-issuance of wireless broadband frequencies (to account for a change in legal address) was rejected by the relevant regulatory authorities and is currently under appeal. In addition, new regulations adopted in furtherance of the Telecommunications Law, effective from January 1, 2006, provide that the Russian Ministry of Telecommunications may amend the conditions of the license, which can negatively affect our business by increasing our costs for providing telephone services. Depending on the growth of our business in the other license areas, the failure to have any other particular license renewed could also materially adversely affect our business.

If we fail to completely fulfill specific terms of any of our telecommunications licenses related to line and operational capacity, investment requirements, territorial or other technical requirements, payment or reporting obligations, local registrations of our

## **Table of Contents**

telecommunications licenses, frequency permissions or other governmental permissions or if we provide our services in a manner that violates applicable law, Rossvyaznadzor may suspend our licenses, frequency permissions or other governmental permissions, or in the case of continued non-compliance, initiate court proceedings for the revocation of our licenses. If any of our telecommunications licenses are suspended or terminated or if extensions requested are not granted and action is taken against our company or our subsidiaries, our business could be adversely affected.

In addition, many of our telecommunications licenses have not been registered with local offices of the Russian Ministry of Telecommunications in the regions where we do not operate our own equipment. Although, the Russian Ministry of Telecommunications has informed us, in many cases only verbally, that we do not need a local registration until we start to operate our equipment in the area, failure to register contradicts the terms of our licenses. We cannot guarantee that the Russian Ministry of Telecommunications will maintain this position and will not take action against us for not registering our telecommunication licenses, which could have a negative impact on our business.

### **We may fail to obtain renewals or extensions of our frequency allocations for our earth stations and other radio frequency equipment that we use in our operations**

Our frequency allocations for most of our license areas expire on the expiration date of our corresponding licenses. We cannot predict whether we will be able to obtain extensions of our frequency allocations and whether extensions will be granted in a timely manner and without any significant additional costs. It is possible that there could be a reallocation of frequencies upon the expiration of existing allocations or the granting of frequency allocations for the same channels as our frequency allocations, requiring that we coordinate the use of our frequencies with the other license holders and/or experience a loss of quality in our network.

If we fail to obtain renewals or extensions of our frequency allocations for parts of our network based on radio frequencies, which expire on various dates between 2007 and 2008, or if other license holders are granted overlapping frequencies, our business could be adversely affected.

### **Certain of our loan agreements contain restrictive covenants**

Certain of our loan agreements contain covenants limiting our ability to incur debt and assume debt and requiring us to maintain certain financial ratios. Failure to comply with these covenants could cause a default and result in the debt becoming immediately due and payable, which would materially adversely affect our business, financial condition and results of operation.

### **We may lose a majority stake of Kubtelecom**

A minority shareholder of Kubtelecom, our subsidiary, filed a lawsuit against us and a number of other shareholders claiming that we and the other shareholders violated the minority shareholder's right of first refusal when Sovintel acquired a majority ownership interest in Kubtelecom. The court of first instance ruled in favor of the minority shareholder, Sovintel then appealed and the court of second instance repealed the first instance decision on March 6, 2007. The minority shareholder is likely to appeal the ruling of the second instance. If we lose the case, our subsidiary will lose its majority stake and thus our position and operations in the Krasnodar Region of Russia will be materially adversely affected. The other lawsuit filed by the same minority shareholder against other shareholders, except Sovintel, relates to alleged violation of her preemptive right to acquire 9.45% in the charter capital of Kubtelecom. The decision on the latter lawsuit is expected on May 3, 2007. We intend to acquire and pay for the aforementioned 9.45% of the ownership interest provided a court decision dismissing the claims of the minority shareholder takes effect.

## **Risks Associated With Our Shareholder Structure**

### **Our significant shareholders have other interests which may conflict with our interests**

One of our significant shareholders, Rostelecom, is one of our direct competitors. Two of our shareholders, Alfa and Telenor, have ownership interests in Vimpelcom and Kyivstar, with whom we have commercial relationships. Although we structure transactions so that they are at arm's length, we cannot be certain that these shareholders will not apply pressure on us to enter into transactions which may not be the most commercially favorable to us.

### **Alfa's dispute with the Russian Ministry of Telecommunications may adversely affect our business**

It has been widely reported that Alfa is involved in a dispute with the IPOC Fund, which has been allegedly associated with high-ranking officials at the Russian Ministry of Telecommunications, regarding Alfa's ownership interest in the mobile operator Megafon. Should that dispute continue or escalate then the Russian Ministry of

Telecommunications may put pressure on Alfa and its holdings. One of Alfa's other holdings is Vimpelcom, our largest customer. Should the Russian Ministry of Telecommunications apply pressure on us or Vimpelcom, it could have serious adverse effects on our operations and financial results.

**Table of Contents**

**Certain disagreements between our shareholders may adversely affect our business**

On November 14, 2005 in response to alleged breaches by Alfa of the provisions of the Vimpelcom Shareholders Agreement, Telenor, commenced an arbitration proceeding against Alfa's affiliates. Because of the dispute, Vimpelcom's Board of Directors has had difficulties agreeing on the company's budget. In January 2007, a Geneva arbitration panel ruled in favor of Telenor on several issues relating to the dispute although the dispute continues. At the present time we do not know what impact this dispute between our two largest shareholders may have on our business.

**Our significant shareholders have entered into a Shareholders Agreement whereby these shareholders exercise substantial control over our Board of Directors**

In August 2003, our major shareholders entered into a Shareholders Agreement which became effective in December 2003. Although the Shareholders Agreement and other agreements among the shareholders reduce the chance for conflicts of interest, we cannot assure that any conflicts of interest will be resolved in our favor. We cannot assure you that any group of directors will not take any actions that may adversely affect the interests of minority shareholders. Further, if we consummate any future acquisitions, such agreements may be amended or we and our shareholders may enter into new agreements.

**Risks Associated With Our Shares of Common Stock**

**Our ability to pay dividends on our common stock may be limited**

During 2005, our Board of Directors declared four dividends of \$0.20 per common share each to shareholders. In 2006, the Board of Directors declared three dividends of \$0.20 per common share each to shareholders. The Board of Directors reviews our policy on dividends annually. Even if we continue to generate significant cash flows in the future, our Board of Directors may elect to retain earnings for our future development or for other reasons and, consequently, not declare a dividend. Further, if we raise any capital in the future, we may be restricted from paying dividends under the terms of such financings. In addition, the governments in the countries where we operate may further devalue their currencies and take other actions that may restrict the ability of our subsidiaries to declare and pay dividends to us which in turn will limit our ability to pay dividends to our shareholders.

**Our share price has been and may continue to be highly volatile**

The price of our shares has been subject to significant volatility since our IPO in 1999. In addition, a number of particular factors may adversely affect the market price of our shares or cause the market price to fluctuate and decline materially. These factors include:

- § Issues concerning the perceived risks of investing in Russia and the CIS, including significant ownership of our shares by a company that is part of a large Russia-based financial and industrial concern;
- § The limited number of our shares available for trading in public markets;
- § The potential sale of any large blocks of our shares by our management or large shareholders, including the shares to be issued as part of the consideration for the Corbina transaction;
- § Mergers and strategic alliances in the telecommunications industry; and
- § Inconsistent or restrictive government regulation in the Russian and Ukrainian telecommunications industries.

In recent years, the market for stock in technology, telecommunications and computer companies has been highly volatile. This is particularly true for companies with relatively small capitalization, such as ours.

**Item 1B. Unresolved Staff Comments**

None

**Table of Contents****Item 2. Properties**

## Major Facilities

We possess the right to occupy and utilize eight floors, 9,081 square meters, of a building in central Moscow, which houses our call center, customer care center, Information technology, accounting, administrative, marketing and ROL offices for EDN Sovintel LLC ( Sovintel ). The right to occupy and utilize this space is through leases, which expire between April 2007 and November 2009.

We possess the right to occupy and utilize four floors, 5,722 square meters, of a building in central Moscow which serves as the principal sales and marketing office for Sovintel and which houses our Representative Office. The right to occupy and utilize this space is through a ten-year lease. This lease expires in August 2012.

We possess the right to occupy and utilize three floors, 4,114 square meters, of a building in central Moscow, which serves as the principal technical department for Sovintel. The right to occupy and utilize this space expires in December 2007. In addition, we occupy and utilize four floors, 1,450 square meters, of another building in central Moscow, which also serves the technical department of Sovintel. The right to occupy and utilize this space is through a one-year lease which can be extended indefinitely.

We possess the right to occupy and utilize six floors, 3,899 square meters, of a building in eastern Moscow, which serve as additional space for the technical department for Sovintel. This lease expires between November 2007 and December 2007. We own 2,830 square meters of the same building.

We possess the right to occupy and utilize 1,162 square meters, of a building in St. Petersburg. The right to occupy and utilize this space is through a lease, which expires in October 2007. In addition, we possess the right to occupy and utilize five floors, 1,369 square meters, of a building in Ekaterinburg, which serves the technical department of that branch. The right to occupy and utilize this space expires in October 2010.

We possess the right to occupy and utilize 1,000 square meters, of building in Kaliningrad, which expires in December 2007. In addition, we possess the right to occupy and utilize three floors, 1,642 square meters, of a building in St. Petersburg. This lease expires in July 2010.

We possess the right to occupy and utilize 2,068 square meters in Samara. The right to occupy and utilize this space is through a lease which expires in 2008.

We own a five floor, 2,672 square meters, building in Nizhny Novgorod which serves as the principal office for ADS. We possess the right to occupy and utilize 1,389 square meters as technical premises. We own a five floor, 4,432 square meters, building in Krasnoyarsk which serves as the principal office for Krasnoyarsk branch.

We own 1,327 square meters and we possess the right to occupy and utilize 1,371 square meters of premises in Krasnodar. We own 1,117 square meters in Anapa. In Sakhalin, we possess the right to occupy and utilize 740 square meters of premises.

Golden Telecom (Ukraine) occupies office and technical premises located in Kiev under leases which expire in 2012. Additionally they lease a dealer-center and shop premises. We possess 1,792 square meters of office premises in Lvov, lease expiring in July 2008.

In Kazakhstan, we possess the right to occupy and utilize two floors, 793 square meters, of building in central Almaty which houses SA Telcom under a long-term lease which expires in August, 2009. In Uzbekistan, we possess the right to occupy and utilize two floor, 650 square meters, of a building in central Tashkent which houses Buzton under a long-term lease which expires in September 2013.

We lease various buildings and space in buildings throughout the Commonwealth of Independent States that we use for our offices. Beside these office spaces, our principal facilities consist of telecommunications installations, including switches of various sizes, cables and VSAT and other transmission devices located throughout the Commonwealth of Independent States. We believe that our facilities are adequate for our current needs.

**Item 3. Legal Proceedings**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Table of Contents****PART II****Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities****a) Market Information**

Our common stock has traded on the NASDAQ Global Select Market since September 30, 1999 under the symbol GLDN. The following table sets forth, for the periods indicated, the high and low closing prices per share for our common stock, as reported on the NASDAQ Global Select Market.

	<b>High</b>	<b>Low</b>
<b>2005:</b>		
First quarter	\$31.25	\$25.41
Second quarter	30.75	25.36
Third quarter	31.57	27.52
Fourth quarter	31.62	25.59
<b>2006:</b>		
First quarter	\$31.00	\$27.01
Second quarter	32.00	21.73
Third quarter	31.89	22.09
Fourth quarter	47.56	30.49

**b) Holders**

As of March 12, 2007, there were approximately 20 holders of record of our common stock.

**c) Dividends**

During 2005, we paid four quarterly dividends of \$0.20 per common share, for a total of \$0.80 per common share for each year. During 2006, we paid three quarterly dividends of \$0.20 per common share, for a total of \$0.60 per common share for each year. We expect, subject to changes in our business, that a dividend will continue to be paid in the future. However, the Board of Directors reviews our policy on dividends periodically.

**d) Recent Sales of Unregistered Securities**

None

For information regarding securities issued under our equity participation plans, see Item 12. Security Ownership of Certain Beneficial Owners and Management Equity Compensation Plans Information

**Table of Contents****Item 6. Selected Financial Data**

The following selected historical consolidated financial data at December 31, 2002, 2003, 2004, 2005 and 2006, and for all of the years presented are derived from consolidated financial statements of Golden Telecom, Inc. (the Company) which have been audited by Ernst & Young (CIS) Limited and Ernst & Young LLC, independent registered public accounting firms.

The data should be read in conjunction with the consolidated financial statements, related notes, and other financial information included in this document.

	<b>2002</b>	<b>For the Years Ended December 31,</b>			<b>2006</b>
		<b>2003</b>	<b>2004</b>	<b>2005</b>	
		<b>(in thousands, except per share data)</b>			
<b>Statement of Operations Data:</b>					
Revenues	\$ 198,727	\$ 360,534	\$ 583,978	\$ 667,379	\$ 854,617
Cost of revenues (excluding depreciation and amortization)	91,189	181,085	300,588	347,532	474,389
Gross margin	107,538	179,449	283,390	319,847	380,228
Selling, general and administrative (excluding depreciation and amortization)	46,147	64,384	112,855	119,890	152,808
Depreciation and amortization	29,961	45,334	74,999	84,015	100,209
Income (loss) from operations	31,430	69,731	95,536	115,942	127,211
Equity in earnings of ventures	4,375	4,687	278	460	1,867
Interest income (expense), net	(667)	(872)	559	1,677	631
Foreign currency gain (loss)	(1,174)	(232)	660	(1,212)	1,697
Minority interest	527	480	1,506	2,978	4,808
Provision for income taxes	4,627	17,399	30,744	37,816	40,417
Net income before cumulative effect of change in accounting principle	28,810	55,435	64,783	76,073	86,181
Cumulative effect of change in accounting principle	974				681
Net income	29,784	55,435	64,783	76,073	85,500
Net income per share before cumulative effect of change in accounting principle - basic	1.20	1.95	1.79	2.09	2.36
Cumulative effect of change in accounting principle	0.04				0.02
Net income per share - basic	1.24	1.95	1.79	2.09	2.34
Weighted average shares - basic	24,102	28,468	36,226	36,378	36,591
Net income per share before cumulative effect of change in accounting principle - diluted	1.17	1.90	1.77	2.08	2.35
Cumulative effect of change in accounting principle	0.04				0.02
Net income per share - diluted	1.21	1.90	1.77	2.08	2.33
Weighted average shares - diluted	24,517	29,107	36,553	36,605	36,717
Cash dividends per common share			0.80	0.80	0.60





**Table of Contents**

	<b>At December 31,</b>				
	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
	<b>(in thousands)</b>				
<b>Balance Sheet Data:</b>					
Cash and cash equivalents	\$ 59,625	\$ 65,180	\$ 53,699	\$ 67,176	\$ 18,413
Property and equipment, net	166,121	283,110	347,891	407,907	552,341
Investments in and advances to ventures	721	251	742	10,889	11,886
Goodwill and intangible assets, net	127,669	248,843	247,570	243,129	297,084
Total assets	435,810	729,226	805,768	882,211	1,107,190
Long-term debt, including long-term capital lease obligations	29,732	3,963	1,738	2,367	1,620
Minority interest	2,187	2,722	11,738	19,693	31,263
Shareholders equity	311,506	584,279	626,381	675,103	817,176

Refer to Note 5 to the Consolidated Financial Statements for descriptions of recent acquisitions that impact the comparability of financial information. Other less recent business combinations and information not disclosed in the footnotes were as follows:

In August 2002, the Company acquired approximately 31% of Golden Telecom (Ukraine) ( GTU ) for cash consideration of approximately \$5.2 million, including \$3.7 million recorded as a liability, net of \$0.3 million discount, determined at the rate of 6.11%. The acquisition was accounted for as a purchase business combination under US GAAP. The Company recorded approximately \$1.8 million of contract-based customer relationship intangible assets that will be amortized over a period of approximately 5 years. There was no goodwill recorded as a result of this transaction.

In September 2002, subsidiaries of the Company completed the acquisition of 50% of EDN Sovintel LLC ( Sovintel ) that the Company did not own from OAO Rostelecom ( Rostelecom ), pursuant to an Ownership Interest Purchase Agreement, dated March 13, 2002, by and among subsidiaries of the Company and Rostelecom, bringing the Company's ownership in Sovintel to 100%. The total purchase price of approximately \$113.1 million consisted of approximately \$50.7 million in the Company's common stock, representing 4,024,067 shares, \$10.0 million in cash consideration, \$46.0 million in promissory note consideration, and direct transaction costs of approximately \$7.1 million, including an investment banking fee of approximately \$3.3 million paid to an affiliate of Alfa Group Consortium, a shareholder of the Company. Sovintel provides worldwide communications services, principally to major hotels, business offices and mobile communication companies through its telecommunications network in Russia. The Company began consolidating the results of operations of Sovintel on September 17, 2002.

In August 2003, the Company completed the acquisition of 100% of OOO Sibchallenge ( Sibchallenge ), a telecommunications service provider in Krasnoyarsk, Russia. The total purchase price of approximately \$15.4 million consisted of cash consideration of approximately \$15.0 million and approximately \$0.4 million in direct transaction costs, including an investment banking fee of \$0.3 million paid to Belongers Limited, an affiliate of Alfa, a shareholder of the Company. The acquisition of Sibchallenge established GTI's presence in the Krasnoyarsk region. In addition, Sibchallenge had numbering capacity and interconnect agreements. The Company's financial statements reflect the allocation of the purchase price based on a fair value assessment of the assets acquired and liabilities assumed and, as such, the Company has assigned approximately \$11.2 million to telecommunications service contracts intangible assets. These identified intangible assets will be amortized over a period of 10 years. There was no goodwill recorded as a result of this transaction. The results of operations of Sibchallenge have been included in the Company's consolidated operations since August 31, 2003.

In December 2003, the Company completed the acquisition of 100% of the shares in OAO Comincom ( Comincom ) from Nye Telenor East Invest, pursuant to a Share Exchange Agreement. The total purchase price of

approximately \$195.3 million consisted of approximately \$193.5 million in GTI's common stock, representing 7,007,794 shares and direct transaction costs of approximately \$1.8 million. The purchase consideration has been determined using the closing date of the transaction as December 1, 2003. Accordingly, the GTI shares issued in consideration are valued based on the average closing price of the Company's common stock for the five consecutive trading days between November 26, 2003 and December 2, 2003, which was \$27.61 per share.

In June 2001, the Financial Accounting Standards Board issued Statement on Financial Accounting Standard (SFAS) No. 141, Business Combinations and No. 142, Goodwill and Other Intangible Assets, effective for fiscal years beginning after December 15, 2001. In accordance with SFAS No. 141 and SFAS No. 142, the Company ceased amortizing goodwill as of January 1, 2002.

## **Table of Contents**

### **ITEM 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion and analysis relates to our financial condition and results of operations for each of the years ended December 31, 2004, 2005, and 2006. This discussion should be read in conjunction with the Selected Financial Data and our Consolidated Financial Statements and the notes related thereto appearing elsewhere in this Report.

#### **Overview**

We are a leading facilities-based provider of integrated telecommunication and Internet services in major population centers throughout Russia and other countries of the Commonwealth of Independent States ( CIS ). We offer voice, data and Internet services to corporations, operators and consumers using our metropolitan overlay network in major cities throughout Russia, Ukraine, Kazakhstan, and Uzbekistan, and via leased channels and inter-city fiber optic and satellite-based networks, including approximately 289 access points in Russia and other countries of the CIS as of December 31, 2006, a 12% increase from 259 access points as of December 31, 2005. In addition, we offer mobile services in the Ukrainian cities of Kiev and Odessa.

We organize our operations into four business segments, as follows:

***Business and Corporate Services ( BCS )*** Using our fiber optic and satellite-based networks in and between major metropolitan areas of Russia, Ukraine and other countries of the CIS, we provide business and corporate services including voice and data services to corporate clients across all geographical markets and all industry segments, other than telecommunications operators;

***Carrier and Operator Services.*** Using our fiber optic and satellite-based networks in and between major metropolitan areas of Russia, Ukraine and other countries of the CIS, we provide a range of carrier and operator services including voice and data services to foreign and Russian telecommunications and mobile operators;

***Consumer Internet Services.*** Using our fiber optic and satellite-based networks, we provide Internet access to the consumer market and web content offered through a family of Internet portals throughout Russia, Ukraine, Kazakhstan, and Uzbekistan; and

***Mobile Services.*** Using our mobile networks in Kiev and Odessa, Ukraine, we provide mobile services with value-added features, such as voicemail, roaming and messaging services on a subscription and prepaid basis.

We intend, wherever possible, to offer all of our integrated telecommunication services under the Golden Telecom brand, although, some services still carry local brands because of recent acquisitions. Our dial-up Internet services are distributed under the ROL brand in Russia, Kazakhstan and Uzbekistan and under the Svit-On-Line brand in Ukraine.

Most of our revenue is derived from high-volume business customers and carriers. Our business customers include large multi-national companies, local enterprises, financial institutions, hotels and government agencies. We also believe that carriers derive a portion of their business from high-volume business customers. Thus, we believe that the majority of our ultimate end-users are businesses that require access to highly reliable and advanced telecommunications facilities to sustain their operations.

Traditionally, we have competed for customers on the basis of network quality, customer service and range of services offered. During the past several years, other telecommunications operators have also introduced high-quality services to the segments of the business market in which we operate. Competition with these operators is intense, and frequently results in declining prices for some of our services, which adversely affect our revenues.

In 2006, we continued to experience growth in our main lines of business and benefited from strong macro-economic growth in the markets where we operate. Despite being faced with challenges of continued changes in the regulatory and telecommunications environment in Russia and Ukraine, we remained focused on developing our business through organic growth, acquisitions, and the expansion of our services.

#### **Recent Acquisitions**

We continue to pursue consolidation opportunities through selective acquisitions that will allow us to expand our geographical reach, add to our service offerings, and improve our market share while maintaining operational control.

Described below are our acquisitions occurring in 2005 and 2006. Refer to Note 5 in the financial statements included in Item 8 of this report for more details about acquisitions occurring in 2004, 2005, and 2006.

**Table of Contents**

In March 2005, we completed the acquisition of a 75% ownership interest in Dicom LLC ( Dicom ), an early-stage wireless broadband enterprise, for approximately \$0.5 million in cash. In conjunction with this acquisition, we entered into a participants' agreement which provided the seller with a put option that, if exercised, would require us to purchase the seller's 25% interest at fair market value. The participants' agreement provided us with a call option that, if exercised, would require the seller to sell after February 1, 2008, its 25% interest in Dicom at any time beginning after February 1, 2008, if Dicom's valuation exceeds targeted levels by February 1, 2008.

In September 2005, we completed the acquisition of 60% of Joint Venture Sakhalin Telecom Limited LLC ( Sakhalin Telecom ), a fixed line alternative operator in the Far East region of Russia for approximately \$5.0 million in cash. As a result of this acquisition and combined with our previous ownership interest, we now own 83% of Sakhalin Telecom.

In October 2005, we completed the acquisition of 100% of Antel Rascom Ltd., a British Virgin Islands company that owns a 49% interest in ZAO Rascom ( Rascom ), for approximately \$10.0 million in cash. In November 2005, Antel Rascom Ltd., our wholly owned subsidiary, acquired an additional 5% of Rascom for approximately \$1.1 million in cash, raising our total ownership interest to 54%. Although we now have a majority voting interest, we account for Rascom using the equity method due to certain participating rights of minority shareholders. Rascom has infrastructure and facilities in the Moscow and St. Petersburg regions and elsewhere in northwest Russia.

In October 2005, we completed the acquisition of 100% of ZAO Sochitelecom ( Sochitelecom ), a fixed line alternative operator in the Krasnodar region of Russia for approximately \$2.1 million in cash.

In March 2006, we completed the acquisition of 70% ownership interest in ZAO Tatar Intellectual Communications ( Tatintelcom ), an Internet service provider ( ISP ) in the Russian Republic of Tatarstan, for approximately \$4.0 million in cash.

In April 2006, we completed the acquisition of 100% ownership interest in TTK LLC ( TTK ), a fixed line alternative operator in the Ivano-Frankovsk region of Ukraine, for approximately \$3.8 million consisting of cash consideration of \$3.4 million and \$0.4 million recorded as a liability, to be settled in cash upon the satisfactory achievement of certain conditions.

In June 2006, we completed the acquisition of 74% ownership interest in Kubtelecom LLC ( Kubtelecom ), a fixed line alternative operator in the Krasnodar region of Russia, for approximately \$10.1 million of cash consideration plus the assumption of \$3.9 million of debt and other liabilities. We are currently engaged in litigation with a minority shareholder of Kubtelecom in regard to the shareholder's claim that the shareholder's pre-emptive right to acquire 74% ownership in Kubtelecom was breached. We do not consider an unfavorable outcome probable for this claim. However, in case of an unfavorable outcome of this litigation, we may be forced to unwind the Kubtelecom acquisition.

In August 2006, we completed the acquisition of 100% ownership interest in Telcom LLC ( Telcom ), a fixed line alternative operator in Nizhny Novgorod, Russia, for approximately \$1.7 million in cash.

In October 2006, we completed the acquisition of 75% ownership interest in S-Line LLC ( S-Line ), an early-stage wireless broadband enterprise in Kiev, Ukraine, for approximately \$7.5 million in cash. In conjunction with this transaction, we also entered into agreement whereby we agreed to provide a secured loan of \$2.5 million to the seller. The loan is secured by a pledge of the remaining 25% interest in S-Line and matures in November 2010. We are currently engaged in regulatory dispute with the National Commission for Communication's Regulation in Ukraine ( NCCR ) over the license for wireless broadband radio frequencies. We consider the reissuance of this license probable.

In October 2006, we completed the acquisition of 100% ownership interest in ZAO Corus ISP ( Corus ), an ISP in Ekaterinburg, Russia, for approximately \$1.2 million in cash.

In February 2007, we completed the acquisition of 65% ownership interest in Fortland Limited ( Fortland ), which owns Kolangon-Optim LLC ( Kolangon ), an early-stage digital video broadcast enterprise in Russia, for approximately \$49.7 million consisting of cash consideration of \$38.6 million and \$11.1 million to be settled in cash upon satisfactory achievement of certain conditions plus the assumption of up to \$1.6 million debt. In conjunction with this transaction, we also entered into agreement whereby we agreed to provide a secured loan of \$12.1 million to the seller. The loan is secured by a pledge of the 15% interest in Fortland and matures in April 2011. In conjunction with this

transaction, we also entered into a put option agreement that, if exercised, would require us to purchase the seller's remaining 35% interest in Fortland at fair market value. In conjunction with this transaction, we also entered into a call option agreement that, if exercised, would require the seller to sell the seller's remaining 35% interest in Fortland at fair market value. The put and call options are exercisable on and after September 30, 2010.

On February 22, 2007, we entered into a stock purchase agreement to acquire a 51% ownership interest in ZAO Cortec and its subsidiaries (together Corbina), an integrated provider of telecommunication and Internet services in Russia, for 8% of our common stock outstanding immediately following the closing, \$10.0 million in cash plus the assumption of up to \$9.0 million of debt.

**Table of Contents**

Additionally, we shall refinance \$45.0 million of debt that the seller owes to JSC Vneshtorgbank. The refinancing will be effected through an intercompany loan to Corbina. The closing of this acquisition is subject to the Russian Federal Anti-Monopoly Service approval.

These acquisitions have enabled us to realize new opportunities in Russia and Ukraine by increasing our customer base, increasing our access to critical infrastructure including last mile infrastructure and digital video broadcast technology, and furthering our consumer markets strategy.

**Regulatory Developments**

On January 1, 2004, a new Law on Communications (the Telecommunications Law ) came into effect in Russia. While some of the supporting regulations to implement the Telecommunications Law have not been enacted, the Russian government approved in March 2005 new rules for interconnection (the Interconnection Rules ) that became effective on January 1, 2006. These Interconnection Rules contemplate a new three-layer interconnection system consisting of domestic long distance / international long distance ( DLD/ILD ), zonal, and local operators. Under this new structure, end-users will have the right to choose a long distance operator, and DLD/ILD operators will be required to have interconnection points in each of the 88 constituent territories of the Russian Federation. In addition, the Telecommunications Law created a universal service fund ( USF ) charge, which became effective on May 3, 2005, calculated as 1.2% of revenue from services provided to customers, excluding interconnection and other operators traffic routing revenue. We have incurred approximately \$4.7 million in USF charges for year ended December 31, 2006, which is recorded as part of cost of revenue. However, on February 28, 2006, the Constitutional Court of the Russian Federation ruled that the provisions of the Telecommunications Law relating to the USF charge do not comply with the Constitution of the Russian Federation and shall become null and void as of January 1, 2007, unless the Telecommunications Law is amended prior to that date. The Constitutional Court established that essential criteria for the charge, including the maximum rate and basis of calculation, must be established by legislative action and not by the administration. On December 29, 2006, the Russian President approved amendments to the Telecommunications Law setting forth essential criteria of the USF charge. These amendments became effective on January 1, 2007.

On May 31, 2005, we received a DLD/ILD license in Russia which is valid until May 31, 2012. We are required under the license to begin providing services and fulfil the network requirements specified in the Interconnection Rules not later than May 31, 2007. On January 16, 2006, we announced that the construction of our Federal Transit Network ( FTN ) was complete in compliance with the Telecommunications Law and our DLD/ILD license. The FTN consists of four international communications transit nodes, seven intercity communications transit nodes deployed in each federal district of Russia, and 88 connection points or FTN access nodes located in each constituent territory of Russia. We have obtained the required governmental permissions for operation of all the international and intercity communications transit nodes that are part of the FTN. On April 28, 2006, all of the 88 connection points were formally commissioned by Rossvyaznadzor, a governmental body that reports to the Ministry of Information Technologies and Communications of the Russian Federation (the Russian Ministry of Telecommunications ) that is responsible for the control and the supervision of information technology and communications as well as for commissioning the long distance networks. On June 29, 2006, we announced that we have entered into interconnection agreements with all Russian zonal incumbent fixed line telecommunications operators. On December 15, 2006, the Russian Ministry of Telecommunications granted us access codes to operate our FTN. On January 29, 2007, we launched DLD/ILD services using our FTN. We believe that provision of DLD/ILD services will allow us to gain additional revenues from our international and domestic long distance operations.

We believe that our DLD/ILD license will enable us to protect our relationship with our corporate clients and, in the long term, expand our business into the residential long distance market. Under the previous regulation, the local operators collected full tariffs for DLD/ILD calls and passed only a portion of the revenue to the DLD/ILD operator. However, in the near term, we do not expect significant growth in our DLD/ILD gross margins since we will incur additional costs payable to the incumbent OAO Svyazinvest ( Svyazinvest ) companies in the form of compensatory fees and other surcharges. DLD/ILD carriers will continue to pay this compensatory fee until local tariffs are raised to an economically viable level. This increase in local tariffs is expected to be completed by the end of 2007. Under the new system, the local operators may also act as agents for DLD/ILD carriers, billing clients for long distance calls and

collecting payments on behalf of the DLD/ILD operators. We incur additional costs payable to the local operators acting as our agents in the form of commission fees. We currently anticipate that our new license will result in an increase of DLD/ILD revenues since we will begin to earn long distance revenue directly from end-users. However, the impact on our DLD/ILD revenues is dependent on the contractual arrangements with the end-users. Historically, local operators established the end-user tariffs for our DLD/ILD services within the limits we set for local operators. However, in the future we may change this tariff setting policy and fix end-user tariffs. We are still analyzing these future DLD/ILD revenues to determine the impact on our business and how these will be classified for segment reporting purposes. At present we continue to report DLD/ILD revenues from local operators net of payments to these operators for interconnection and agency fees, since the economic substance of our settlements with local operators has not changed following the introduction of the new Interconnection Rules, and other conditions that might otherwise require us to present those same revenues and costs on a gross basis have not yet been fulfilled.



**Table of Contents**

On March 6, 2007, Rossvyaznadzor warned EDN Sovintel LLC ( Sovintel ), our wholly owned Russian subsidiary, that it should remedy certain alleged violations in traffic routing. The allegation follows an inspection by Rossvyaznadzor of an independent operator, OAO Arctel ( Arctel ). Rossvyaznadzor believes that Sovintel inappropriately converted telephone traffic of Arctel into IP-telephone traffic and then incorrectly routed this traffic abroad. During the inspection of Arctel, representatives of Rossvyaznadzor made thirty-nine test calls, all of which allegedly went through Sovintel s network. Sovintel then tested and carried out a full analysis of the routing of these calls. Following Sovintel s review, we determined that nineteen calls were not made through our network and that the twenty remaining calls were routed in accordance with existing regulations and Sovintel s licenses. We have notified Rossvyaznadzor of the above findings and believe that we have not violated our licenses.

In a letter dated December 20, 2006, several deputies of the State Duma, wrote to the Russian General Prosecutor alleging that Sovintel was illegally providing domestic and international services prior to receipt of access codes. The letter states that because Sovintel had not yet received access codes to offer such services in the first, second and third quarter of 2006, then Sovintel was operating illegally in this respect. Further, the letter requests that the Prosecutor General s office conduct an investigation of Sovintel s activities and, if appropriate, charge those Sovintel officials responsible for the activities. Sovintel received the access codes in December 2006 and prior to construction of its FTN was operating under its previous licenses. We believe that we were acting in accordance with Russian regulations and legislation and it licenses.

On October 19, 2005, the Russian government enacted the Rules on Price Establishment for Interconnection and Traffic Routing. These rules list interconnection services and traffic routing services provided by the incumbent operators that are subject to pricing regulation by the government. The effective utilization and implementation of the Russian long distance license is subject to the establishment of tariffs for interconnection and traffic routing services to be provided by incumbent Svyazinvest state-owned companies and other incumbent operators. The tariffs are paid by long distance operators to the incumbent local and zonal operators for each minute of long distance traffic that is carried such that all long distance operators are cross-subsidizing the local and zonal network of the incumbent operators. Such cross-subsidy will continue until January 1, 2008. By that date, the new pricing setting mechanisms and tariff re-balancing should be fully implemented. During the first half of 2006, in the absence of the regulated tariffs most of the incumbent operators, including all of Svyazinvest companies, imposed their own independently established tariffs on alternative long distance, zonal and local operators. However, on June 19, 2006, Rossvyaznadzor established the maximum limits for such tariffs. As a result, the incumbent operators are permitted to impose tariffs on alternative long distance, zonal and local operators within these established limits. Thus, effective July 1, 2006, tariffs for interconnection with the incumbent zonal operators decreased. To minimize the impact of payments to the incumbent operators, we have received licenses to provide zonal services in all the regions of the Russian Federation. During 2006, we started construction of zonal networks in 12 regions of the Russian Federation. To date, we have completed construction of zonal networks in Moscow, St. Petersburg, Kaliningrad, Pskov, Samara and Sakhalin regions of Russia. In total, we are planning to construct zonal networks in 28 to 30 regions by the end of 2008. However, in those regions where we have not completed construction of zonal networks, we will be required to act as an agent for zonal carriers, billing clients for intra-zonal calls and collecting payments on behalf of the zonal operators. We are still analyzing these changes in settlements with zonal operators to determine the impact on our business.

In the third quarter of 2006, incumbent Svyazinvest operators started introducing new settlement rules for local traffic. Prior to July 1, 2006, we paid fixed monthly fees for interconnection lines with these operators. Under the new rules, the settlements will be based on the actual volume of traffic. The switch to the new rules was not completed in 2006. As a result of these changes, we expect an increase in cost of revenue which could be partially offset by additional revenue for the traffic termination to our network.

In February 2005, we received notice from OAO Vimpel Communications ( Vimpelcom ), our largest customer, that it was diverting a volume of traffic away from our network due to their preliminary interpretation of traffic routing regulations issued by the Russian Ministry of Telecommunications. However, in the third quarter of 2005, Vimpelcom traffic volumes were restored to their previous 2004 levels as a result of our discussions with Vimpelcom and clarification from the regulatory agencies. In April 2006, Vimpelcom received a DLD/ILD license. Vimpelcom is

required under the license to begin providing services and fulfill the network requirements specified in the Interconnection Rules not later than December 12, 2007. However, until Vimpelcom completes all technical requirements and obtains formal commissioning by Rossvyaznadzor, we do not expect this carrier to reduce its traffic volumes with us.

On March 4, 2006, the Russian President approved amendments to the Telecommunications Law that introduced calling party pays rules ( CPP Rules ). Effective July 1, 2006, under the CPP Rules, generally all incoming calls, on fixed and mobile lines, in Russia are free of charge, and only the fixed line or mobile operators originating the call may charge the customer for the call. Subscribers of fixed line telephones did not pay for incoming calls and, therefore, the CPP Rules will not have an impact on fixed-to-fixed line calls, but the CPP Rules impact the fixed-to-mobile calls as mobile companies traditionally charged for incoming calls in Russia. For the year ended December 31, 2006, we have recorded approximately \$31.5 million in additional revenue. However, this increase in revenue was partially offset by approximately \$21.2 million in additional cost of revenue due to the introduction of termination charges to mobile networks.

In March 2006, the Ukrainian government submitted to the Ukrainian Parliament ( Verkhovna Rada ) a draft law introducing a USF charge in Ukraine, calculated as 2% of revenue. In September 2006, this draft law was amended to make a USF charge in Ukraine effective January 1, 2008.

In April 2006, the NCCR issued a license for GSM-1800 radio frequency to Golden Telecom (Ukraine) ( GTU ), our subsidiary in Ukraine. Currently, GTU provides services in Kiev and Odessa. The new license will enable GTU to offer mobile services in 22 out of the remaining 25 regions of Ukraine that GTU does not currently cover. Payment of the \$5.5 million license fee was made on May 10, 2006. In May 2006, we began using the frequencies and submitted registration documents to UkrChastotNadzor, a Ukrainian

**Table of Contents**

governmental body that is responsible for the control and the supervision of the radio frequencies. To date, we have complied with the license requirements related to the use of allocated radio frequencies by launching operations in 4 out of 22 regions.

Effective July 15, 2006, the NCCR introduced new tariffs for provision of voice services to fixed line subscribers. As a result of the tariff re-balancing policy, the tariffs for local calls and monthly fees increased and tariffs for DLD/ILD calls decreased. Effective November 1, 2006, the NCCR continued the tariff re-balancing process by increasing the tariffs for local calls and monthly fees and by decreasing the tariffs for fixed-to-mobile calls. On October 28, 2006, the Verkhovna Rada approved the amendments to the Ukrainian Law on Telecommunications which changed the list of the telecommunication service tariffs subject to the public regulation. Under new regulation, tariffs for DLD/ILD calls were excluded from the public regulation. The amendments also exclude fixed-to-mobile calls from the public tariff regulation. As a result of these changes, we expect increased competition from the incumbent operators in DLD/ILD services market.

Effective January 1, 2007, the NCCR introduced new interconnection settlement rules. During 2006, we paid fixed monthly fees for interconnection lines with other operators. However, under the new rules the settlements will be based on the actual volume of traffic. As a result of these changes, we expect an increase in cost of revenue which could be partially offset by additional revenue for the traffic termination to our network.

**Other Developments**

Historically, our tariffs have been linked to the United States dollar ( USD ). Since early 2000 the Russian ruble ( RUR ) exchange rate against the USD has become relatively stable and has appreciated in 2005 and during 2006. In the second and the third quarters of 2006, Sovintel introduced semi-fixed USD RUR exchange rate for settlements with the majority of its customers. This rate is effective only if the official USD exchange rate set by the Central Bank of Russia ( CBR ) is below the fixed level. If the RUR depreciates against USD so that the CBR exchange rate exceeds the fixed level, Sovintel will resume applying the CBR exchange rate, or floating rate, for settlements with its customers. However, most of our direct competitors continue to link their prices to the USD payable at the CBR exchange rate, so when the RUR appreciates, their prices effectively become lower in the RUR terms in relation with our prices. As a result, if the RUR appreciates against USD so that the CBR exchange rate significantly differs from the fixed level, Sovintel may lower the fixed level in order to respond to the pricing pressure from its competitors. Following the introduction of the semi-fixed USD RUR exchange rate for settlements with its customers, Sovintel introduced the same exchange rate mechanism for settlements with its employees related to salaries, bonuses and unused vacation accrual effective August 1, 2006.

In September 2005, we granted stock appreciation rights ( SARs ) to our Chief Executive Officer ( CEO ) with respect to 200,000 shares of our common stock, at a share price which was the closing price of our common stock on the NASDAQ Global Select Market on July 19, 2005 ( CEO Granting Share Price ), which was \$29.83, one-third of which shall be and become vested and nonforfeitable on each of the first three anniversary dates from September 1, 2005, provided the CEO remains continuously employed by us until each such relevant date. The SARs shall be fully vested if there is a change in control. If, prior to February 28, 2009 and during the CEO s period of employment with us, the average closing stock price of one share of our common stock on the NASDAQ Global Select Market, exceeded \$50.00 during any thirty day consecutive period, the CEO would be granted SARs for an additional 200,000 shares of our common stock at the CEO Granting Share Price, which SARs should be fully vested upon issuance. On February 8, 2007, our common stock achieved the \$50.00 threshold and CEO was granted additional fully vested SARs in respect of 200,000 shares of our common stock. The SARs granted do not have a contractual term. However, all SARs shall be cancelled, and we shall make a payment to the CEO upon the termination of employment for any reason with respect of the SARs vested. The SARs provide for a cash only settlement and the related obligation is recorded as a liability in the consolidated financial statements.

In December 2005, we granted SARs with respect to 851,800 shares of our common stock to senior management and other employees, of which 104,800 were forfeited by employees who left us during 2006. The SARs were granted pursuant to the Golden Telecom, Inc. 2005 Stock Appreciation Rights Plan ( 2005 SAR Plan ) and the EDN Sovintel Stock Appreciation Rights Bonus Plan ( Sovintel SAR Plan ) at a share price which is the lower of: (i) the average between the high and low sales price per share of common stock on the grant date, or in case no such sale takes place

on the grant date, the last date on which a sale occurred or (ii) the average closing sales price per share of our common stock for the fourteen trading days immediately preceding such date, which was \$26.808 ( Granting Share Price ). Seventy-five percent of the SAR grant shall be subject to time vesting, one-third of which shall be and become vested and nonforfeitable on each of the first three anniversary dates from December 12, 2005, provided that the employee remains continuously employed by us until each such relevant date. The Granting Share Price shall increase by five percent on each anniversary date after December 12, 2005, in association with the SARs that shall be and become vested and nonforfeitable on each such anniversary date. Twenty-five percent of the SARs granted were subject to performance vesting upon our common stock achieving a closing trading price of at least \$50.00 per share for thirty consecutive days as determined in our sole discretion. On February 22, 2007, our common stock achieved the \$50.00 threshold and the performance vesting SARs became fully vested. The SARs have a contractual term of 5 years. The aggregate number of shares of common stock which may be issued pursuant to the 2005 SAR Plan at the discretion of the grantees shall be 200,000 shares. The SARs issued pursuant to the Sovintel SAR Plan provide for a cash only settlement. The related obligation is recorded as a liability in the consolidated financial statements.

**Table of Contents**

In 2006, we granted SARs with respect to 177,000 shares of our common stock to senior management, of which 10,000 were forfeited by a senior manager who left us during 2006. The SARs were granted pursuant to the 2005 SAR Plan at the weighted-average exercise price of \$27.94.

We are currently reviewing our SARs program and investigating other forms of equity based compensation for our employees to decrease volatility of related expenses.

During the fourth quarter of 2006, we revised our estimate of allowance for doubtful accounts to reflect changes in the business, recent historical collections experience and other currently available evidence. The change in accounting estimate increased net income for the year ended December 31, 2006 by approximately \$2.4 million, net of tax (equivalent to \$0.07 per common share basic and \$0.07 per common share diluted).

In the fourth quarter of 2006, we reversed a \$2.6 million liability with a former shareholder because of the expiration of the statute of limitations.

**Highlights and Outlook**

Since early 2000 we have witnessed a recovery in the Russian market, but downward pricing pressures persist from increased competition and the global trend toward lower telecommunications tariffs. In 2005 and during 2006, our traffic volume increases exceeded the reduction in tariffs on certain types of voice traffic. This is a contributing factor to the increases in our revenue in 2005 and during 2006. We expect that this trend of year over year increases in traffic volume will continue as long as the Russian economy continues to develop at its current pace. Although our revenue growth is strong, our overall margins continue to be impacted by price increases for services received from monopolistic incumbent operators and competition from other carriers.

In order to handle additional traffic volumes, we have expanded and will continue to expand our fiber optic capacity along our heavy traffic and high cost routes to mitigate declines in traffic margins, reduce our unit transmission costs and ensure sufficient capacity to meet the growing demand for data and Internet services. We expect to continue to add additional transmission capacity, which due to its fixed cost nature can initially depress margins, but will over time allow us to improve or maintain our margins.

We continue to follow our strategy of regional expansion. The project for the construction of the Russian inter-city fiber optic link that we launched in the middle of 2004 has continued throughout 2005 and into 2006. To date, we have completed construction of the inter-city fiber optic cable line from Moscow to Ufa through Nizhny Novgorod and Kazan under a commercial agreement with Vimpelcom. In addition, we have completed construction of the Oktyabrsky to Samara inter-city fiber optic link. This Oktyabrsky to Samara link is part of a larger fiber optic cable line that will run from Ufa to Saratov. We started construction of the Samara to Saratov link. We expect this part of the inter-city fiber optic cable line to be operational in the second quarter of 2007. We have completed construction of the fiber optic link between Kamensk-Shakhtinsky in the southern part of Russia and Lugansk in the eastern part of Ukraine. To date, we have invested approximately \$28.0 million in these projects. In September 2006, we entered into agreement with Vimpelcom which allows us to use the fiber optic cable line from Moscow to Krasnodar through Voronezh and Rostov-on-Don constructed by Vimpelcom. In addition, in 2007 we have started construction of the fiber optic link from Ufa to Perm, and from Samara to Uralsk in the northern part of Kazakhstan. We intend to connect our operations in the European part of Russia to this backbone network and plan to invest a total of approximately \$55.0 million in this and related backbone projects by the end of 2007.

In Ukraine, we have started the construction of a national fiber optic network connecting 16 regional centers with cross border connections to Hungary and Poland. In February 2006, we completed construction of the fiber optic link between Uzhgorod and Lvov with connection to the Hungarian border. In June 2006, we completed construction of the fiber optic link from Lvov to Kiev through Lutsk, Rovno and Zhitomir. In October 2006, we completed construction of the link between Kiev and Kharkov through Chernigov and Sumy. We are currently installing equipment on the Kiev to Kharkov link. We expect that this STM-16 link will be operational in the second quarter of 2007.

The fiber optic communication lines consist of new generation networks that will enable us to provide high quality Internet access, data and voice services. Development of our fiber optic network is part of our broadband access rollout strategy. In addition, it allows us to enter the long distance communication market and take advantage of our DLD/ILD license. By launching our own fiber optic communication lines, we will be able to optimize and

significantly reduce our expenditures associated with the lease of trunk channels from other operators, offer competitive rates on Internet and voice services to the end users in the regions, while maintaining traditionally high quality of the services offered.

The rapid growth of the telecommunications market in Russia, Ukraine, and the CIS is fueled by macroeconomic growth and the inflow of direct foreign investment. We anticipate that the economic growth in these markets will create additional demand for telecommunications services. Additionally, in line with worldwide trends, we are starting to observe new customer demands for more sophisticated telecommunications and Internet services as well as for other new technologies. We are responding to these customer demands by testing and implementing new technologies such as WiFi, voice over Internet protocol ( VoIP ), wireless local loop and high-speed consumer Internet. Such new technologies will remove some of the barriers to access that some of our customers currently face. For example, with wireless local loop, we can connect remote customers to our network by bypassing the incumbents wire network in order to provide higher quality access.

**Table of Contents**

We continue to seek growth opportunities organically, through selective acquisitions, and through the development of new product lines. While our research indicates the telecommunications services sector in business segments in the Moscow and St. Petersburg markets of fixed telecommunications services will continue to grow, we believe that the bulk of our growth will come from key regional cities. Currently, we have a commercial presence in more than 80 cities including 17 out of the 20 largest Russian cities, representing approximately 40% of the total fixed-line telecom market in Russia. In 11 of these cities we have a market share of 10% or higher.

In October 2006, we launched a re-branding campaign with the new logo, color scheme and slogan "Achieve more!" The new brand is primarily targeted at retail customers and maintains various products under one master brand driving up general brand recognition and opportunities for cross-selling. Total costs for the campaign for the year ended December 31, 2006, were approximately \$2.5 million.

We will continue to align the strategy of each of our business segments with market forces in the countries where we operate. In BCS, our strategy is to defend and grow our market share through attractive service offerings supported by excellent customer care. We are focused on expanding into the regions as well as the fast growing small and medium-sized businesses (SMB) and the small office / home office (SOHO) markets. In those cases where the potential SMB and SOHO customer is not on our network, our ability to fully benefit from growth in these market segments largely depends on the regulatory situation and our ability to get access to the copper and other infrastructure of the incumbent operators under reasonable terms and conditions.

Our recently constructed FTN and receipt of access codes will also present new opportunities for growth. Our FTN provides us with a potential customer base across all geographic zones in the Russian Federation of up to 2.2 million businesses, 143 million people, of which there are 32 million residential customers, in the 88 Russian regions. This is an increase from our previous breadth of coverage which only allowed us to reach 25 regions in Russia with up to 0.3 million businesses and a population of 77.1 million people. With the FTN, we will be able to offer our wide range of telecommunications services, including DLD/ILD telecommunications services, to every person and all businesses across Russia's eleven time zones. We estimate that based on the existing client base, an effective marketing campaign and a highly-skilled and experienced direct and indirect sales force we will be able to capture at least 20% market share of the total DLD/ILD market in Russia by the end of 2010.

In Carrier and Operator Services, our strategy focuses on partnering with more operators in the regions to enhance our traffic termination capabilities. We have also launched additional value-added products for our carrier partners that strengthen our leading position in the Russian and CIS markets. These new products are designed to offer best quality voice and data transport to ensure greater customer loyalty while protecting margins.

In Consumer Internet Services, we recognize that new technologies are making their way into Russia, Ukraine, and the CIS. We expect that broadband competition and substitution will increase in the future, and that dial-up margins will continue to decline over time as the average revenue per subscriber continues to decline and as a result of the introduction of origination fees payable. In response to a continuing decline in our dial-up subscriber base in Moscow, we are currently exploring opportunities to enter the broadband market in Moscow and elsewhere in Russia, Ukraine, and the CIS. However, our expansion in this area is currently limited by restrictions on our access to unbundled local loop. So far, we have access to unbundled local loop in Kazan and Tashkent. Therefore, we are currently looking at alternatives to deliver quality broadband Internet services at competitive pricing in our major markets. We plan to provide broadband services through our broadband networks based on such approaches as WiFi/WiMAX, Digital Subscriber Line (DSL), fiber-to-the-building (FTTB), and by selective acquisitions of local loop. The broadband development will enable us to offer high quality services such as broadband Internet access, voice over broadband packaged with our Aport Internet search engine to offer location-based search services. The broadband services will be competitively priced and will offer higher speed services than many other Internet access services currently available in Moscow.

As part of our broadband access strategy, we deployed one of the largest WiFi metropolitan networks in the world. Our WiFi network covers approximately 800,000 households in Moscow and consists of 6,700 WiFi access nodes. In the fourth quarter of 2006, we commenced the final stage of the network testing. More than 90,000 users have registered for the testing since the network became available in trial mode. On March 1, 2007, we launched commercial operations of our WiFi network in Moscow. To date, we have approximately 6,000 customers who use

our paid WiFi services in Moscow. We plan to offer indoor and outdoor access to approximately one-third of the 3.9 million households in Moscow and to migrate our dial-up customers in Moscow onto a new WiFi platform. We estimate that with our wireless broadband access offering we will be able to capture 20% market share in Moscow or 300,000 to 400,000 subscribers by 2010. Following the acquisition of S-Line in October 2006, we intend to roll out wireless broadband network in Kiev and other regions of Ukraine. In addition, we plan to provide wireless broadband coverage in the biggest cities and areas such as St. Petersburg, Nizhny Novgorod, Ekaterinburg, Krasnoyarsk, Sochi, Kazan, Krasnodar, and Tashkent. We plan to continue the deployment of broadband and DSL in other selected regions. To date, we have over 1,300 DSL nodes installed with a combined capacity of approximately 60,000 ports and 33,000 customers using DSL services in Russia and in the CIS. We intend to expand our broadband strategy to be able to provide broadband Internet access, VoIP, digital television and mobile over broadband services to a wider consumer market. In April 2006, we began to provide broadband services based on FTTB technology in



**Table of Contents**

Kiev with the coverage of approximately 24,000 households. We are in the process of rolling out a FTTB based network in Nizhny Novgorod which will cover approximately 250,000 households.

Our Mobile Services line of business allows us to provide additional services to our Ukrainian wireline customers. In the future, we expect to follow a marketing strategy aimed at attracting high revenue customers and maintaining our corporate market share in Kiev and Odessa. Our recently acquired GSM-1800 radio frequency license for an additional 22 regions of Ukraine will also present new opportunities. This license provides us with a potential customer base of 38.1 million people, or approximately 81% of the Ukrainian population, compared with our previous coverage of 5.1 million people. On July 13, 2006, we entered into an agreement with ZAO Ukrainian Radio Systems ( URS ), a subsidiary of Vimpelcom, for the provision of roaming services. This agreement enables our mobile customers to use the national roaming services of URS nationwide network. In addition, we plan to provide mobile over broadband services in Ukraine. On October 5, 2006, we announced the commencement of construction of our fixed-mobile convergent ( FMC ) network in Ukraine. The FMC network combines the advantages of fixed-line and mobile communications and will be the first converging communications network in Ukraine. To date, we have deployed the FMC network in Kiev and Odessa based on our existing GSM-1800 networks and wireless segments of the FMC network in Donetsk, Zaporozhye, and Ivano-Frankovsk. In the second quarter of 2007, we plan to complete network testing and launch commercial operations. In 2007, we plan to deploy the FMC network in an additional 19 regions of Ukraine. However, we do not expect significant growth in mobile revenue from the roaming agreement with URS until our FMC network is fully deployed. We believe that with the launch of the FMC services we will be able to capture 5% of the Ukrainian mobile market by the end of 2010.

The acquisition of Fortland enhances our broadband expansion strategy and will enable us to expand into the media market. Kolangon holds licenses to provide digital television services in Moscow and St. Petersburg. We also plan to apply for the licenses in other major cities of Russia. These licenses will be used to broadcast digital television channels with a higher quality of picture and to provide pay-per-view services using the Digital Video Broadcast Terrestrial ( DVB-T ) standard in MPEG-4 coding. The combination of access to DVB-T technology with our wide geographical presence across Russia will provide us with a potential market of up to 11 million households in 22 major Russian cities with a population of 35 million people. The Fortland acquisition will enable us to deliver a Triple Play service package, including high speed Internet access, digital television with about 50 channels, and VoIP. We plan to begin deployment of DVB-T transmitters in the first half of 2007 in order to start broadcasting in the fourth quarter of 2007.

The acquisition of Corbina, if consummated, will strengthen our position in the Moscow mass market and SMB/SOHO telecommunications market. To date, Corbina's FTTB network covers approximately 2.6 million households in Moscow, St. Petersburg, Yaroslavl, Tula, and Kaluga. Corbina has approximately 170,000 broadband Internet customers. By the end of 2008, Corbina plans to achieve a subscriber base of more than 600,000 broadband subscribers. In addition, Corbina primarily targets SMB customers in the BCS segment, whereas we historically focused on the high-volume business customers. Corbina also provides mobile services in Moscow using its D-AMPS network. To date, Corbina has approximately 35,000 active high-usage customers. The Corbina acquisition will enable us to offer quadric-play products to the mass market as we bundle broadband Internet access, VoIP, internet protocol television ( IPTV ), and mobile virtual network ( MVN ) based services.

**Critical Accounting Policies**

The fundamental objective of financial reporting is to provide useful information that allows a reader to comprehend our business activities. To assist that understanding, management has identified our critical accounting policies. These policies have the potential to have a significant impact on our financial statements, either because of the significance of the financial statement item to which they relate, or because they require judgment and estimation due to the uncertainty involved in measuring, at a specific point in time, events which are continuous in nature.

*Revenue recognition policies;* we recognize operating revenues as services are rendered or as products are delivered to customers and installed. Under multiple-delivery contracts, involving a combination of product delivery, installation and maintenance, connection and service fees, revenues are recognized based on the relative fair value of the respective amounts. Elements are grouped if they are inseparable or objective evidence of fair value does not exist. Certain revenues, such as connection and installation fees, are deferred. We also defer direct incremental costs related

to connection fees, not exceeding the revenue deferred. Deferred revenues are subsequently recognized over the estimated average customer lives, which are periodically reassessed by us, and such reassessment may impact our future operating results. In determining the recording of revenue, estimates and assumptions are required in assessing the expected conversion of the revenue streams to cash collected. DLD/ILD and zonal revenues are recorded gross or net depending on the contractual arrangements with the end-users. We recognize DLD/ILD and zonal revenues from local operators net of payments to these operators for interconnection and agency fees when local operators establish end-user tariffs and assume credit risk.

**Table of Contents**

*Allowance for doubtful accounts policies;* the allowance estimation process requires management to make assumptions based on historical results, future expectations, the economic and competitive environment, changes in the creditworthiness of our customers, and other relevant factors. Changes in the underlying assumptions may have a significant impact on the results of our operations. In particular, we have certain amounts due to and from subsidiaries of a European telecommunications operator who is currently subject to bankruptcy proceedings. The ultimate resolution of this matter will be affected by a number of factors including the determination of legal obligations of each party, the course of the bankruptcy proceedings, and the enforceability of any determinations. We have recognized provisions based on our preliminary estimate of net exposure on the resolution of these receivables and payables. If our assessment proves to be incorrect we may have to recognize an additional provision of up to \$1.9 million, net of tax, although management believes that the possibility of such an adverse outcome is remote.

*Long-lived asset recovery policies;* this policy is in relation to long-lived assets, consisting primarily of property and equipment and intangibles, which comprise a significant portion of our total assets. Changes in technology or changes in our intended use of these assets may cause the estimated period of use or the value of these assets to change. We perform periodic internal studies to confirm the appropriateness of estimated economic useful lives for each category of current property and equipment. Additionally, long-lived assets, including intangibles, are reviewed for impairment whenever events or changes in circumstances have indicated that their carrying amounts may not be recoverable. Estimates and assumptions used in both setting useful lives and testing for recoverability of our long-lived assets require the exercise of management's judgment and estimation based on certain assumptions concerning the expected life of any asset and expected future cash flows from the use of an asset.

*Goodwill and assessment of impairment;* commencing from the adoption of Statement on Financial Accounting Standard ( SFAS ) No. 142, *Goodwill and Other Intangible Assets* , on January 1, 2002, we perform goodwill impairment testing annually as of October 1 or whenever impairment indicators exist. This test requires a significant degree of judgment about the future events and it includes determination of the reporting units, allocation of goodwill to the reporting units and comparison of the fair value with the carrying amount of each reporting unit. Based on the discounted cash flow valuations performed in 2006, we concluded that for all reporting units the fair value is in excess of the respective carrying amounts.

*Valuation allowance for deferred tax asset;* we record valuation allowances related to tax effects of deductible temporary differences and loss carry forwards when, in the opinion of management, it is more likely than not that the respective tax assets will not be realized. Changes in our assessment of probability of realization of deferred tax assets may impact our effective income tax rate.

*Business segment information;* we report four segments within the telecommunications industry: Business and Corporate Services, Carrier and Operator Services, Consumer Internet Services and Mobile Services. A significant portion of our cost structure, including our investment in infrastructure, benefits multiple segments. As a result, we perform allocations of certain costs in order to report business segment information for management and financial reporting purposes. Applying different allocation techniques and parameters could impact the reported results of individual business segments.

*Functional currency;* prior to the third quarter of 2006, the functional currency for all of our foreign subsidiaries was the USD. In the second and the third quarters of 2006, Sovintel introduced a semi-fixed USD – RUR exchange rate for settlements with a majority of its customers. This rate is applicable if the official USD exchange rate set by the CBR is below the fixed level. If the RUR depreciates against the USD so that the CBR exchange rate exceeds the fixed level, Sovintel will resume applying the CBR exchange rate, or floating rate, for settlements with its customers. As a result of these changes, we re-evaluated the functional currency criteria under SFAS No. 52, *Foreign Currency Translation* , and determined that, beginning July 1, 2006, the functional currency of our subsidiaries domiciled in Russia is the RUR. The change was adopted prospectively beginning July 1, 2006 in accordance with SFAS No. 52. No restatement of comparative amounts was made for the change in functional currency. Therefore, the financial statements of our subsidiaries domiciled in Russia on December 31, 2006, were translated into USD using the current rate method. Assets and liabilities were translated at the rate of exchange prevailing at the balance sheet date. Stockholders' equity was translated at the applicable historical rate. Revenue and expenses were translated at the monthly average rates of exchange. Translation gains and losses were included as part of accumulated other

comprehensive income.

The change in functional currency resulted in a translated value for the opening (i) property and equipment, net, (ii) goodwill and (iii) intangible assets, net, that is approximately \$35.6 million, \$19.5 million, and \$9.4 million higher, respectively, than the amounts reported on June 30, 2006, when the USD was the subsidiaries' functional currency. This change in the carrying amount of property and equipment, goodwill and intangible assets has been reflected directly in shareholders' equity as part of other comprehensive income. In addition, we recorded an opening deferred tax liability of \$2.2 million and an opening minority interest of \$1.3 million in association with the change in functional currency. The impact of the change in functional currency resulted in a \$3.7 million increase in depreciation and amortization, a \$1.3 million decrease in foreign currency gain, and a \$1.8 million decrease in income taxes for the year ended December 31, 2006.

*Stock-based compensation;* effective January 1, 2006, we adopted SFAS No. 123R to account for Share Based Payments. Under SFAS No. 123R, we are required to calculate and record the cost of equity instruments, such as stock options or restricted stock,

**Table of Contents**

awarded to employees for services received in the income statement. The cost of the equity instruments is to be measured based on the fair value of the instruments on the date they are granted or, if the number of shares to be issued or the exercise price is unknown, re-measured at each reporting date and is required to be recognized over the period during which the employees are required to provide services in exchange for the equity instruments. The fair value of a SAR is estimated using the Monte Carlo simulation-based valuation model that incorporates the assumptions of the stock volatility, risk-free interest rates, dividend yield, employee exercise patterns and forfeiture rates.

**Critical Accounting Estimates**

Accounting estimates are an integral part of the financial statements prepared by management and are based upon management's current judgments. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgment. We believe the following items represent such particularly sensitive accounting estimates:

*Allowance for doubtful accounts;* any changes in the underlying assumptions of recoverability of accounts receivable by respective aging group or certain specific accounts that are excluded from the specific and general allowances could have a material effect on our current and future results of operations. We believe that the allowance for doubtful accounts is adequate to cover estimated losses in our accounts receivable balances under current conditions.

*Tax provisions;* in the course of preparing financial statements in accordance with US GAAP, we record potential tax loss provisions under the guidelines of SFAS No. 5, *Accounting for Contingencies*. In general SFAS No. 5 requires loss contingencies to be recorded when they are both probable and reasonably estimable. In addition, we record other deferred tax provisions under the guidelines of SFAS No. 109, *Accounting for Income Taxes*. Significant judgment is required to determine when such provisions should be recorded, and when facts and circumstances change, when such provisions should be released.

*Useful lives of property and equipment and certain intangible assets;* our network assets and amortizable intangible assets are depreciated and amortized over periods generally ranging from five to ten years. Any reduction or increase in the estimated useful lives for a particular category of fixed assets or intangible assets could have a material effect on our future results of operations.

*Business combinations;* SFAS No. 141, *Business Combinations*, requires us to recognize the share in the assets of businesses acquired and respective liabilities assumed based on their fair values. Our estimates of the fair value of the identified intangible assets of businesses acquired are based on our expectations of future results of operations of such businesses.

**Recent Accounting Pronouncements**

Until January 1, 2006, we followed the provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, for our Equity Participation Plan and SARs Plans. SFAS No. 123 generally allowed companies to either account for stock-based compensation under the fair value method of SFAS No. 123 or under the intrinsic value method of Accounting Principles Board (APB) No. 25, *Accounting for Stock Issued to Employees*. The fair value method required compensation cost to be measured at the grant date based on the value of the award and to be recognized over the service period. We had elected to account for our stock-based compensation in accordance with the provisions of APB No. 25 and present pro forma disclosures of results of operations as if the fair value method had been adopted.

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123R (revised 2004), *Share Based Payment*, which is a revision of SFAS No. 123. SFAS No. 123R supersedes APB No. 25, *Accounting for Stock Issued to Employees* and amends SFAS No. 95, "Statement of Cash Flows". Under SFAS No. 123R, companies must calculate and record the cost of equity instruments, such as stock options or restricted stock, awarded to employees for services received in the income statement; pro forma disclosure is no longer permitted. The cost of the equity instruments is to be measured based on the fair value of the instruments on the date they are granted or, if the number of shares to be issued or the exercise price is unknown, remeasured at each reporting date and is required to be recognized over the period during which the employees are required to provide services in exchange for the equity instruments. In April 2005, the Securities and Exchange Commission delayed the effective date of SFAS No. 123R

until January 1, 2006 for calendar year companies.

We adopted SFAS No. 123R as of January 1, 2006 using the modified prospective method which requires the application of the SFAS No. 123R in our accounting for SARs and stock options. Prior to the adoption of SFAS No. 123R, we accounted for SARs by remeasuring the intrinsic value of the SARs at each reporting period and adjusted compensation expense and the related liability for the change in the intrinsic value. From January 1, 2006, we account for SARs at fair value. In accordance with the modified prospective method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123R.

**Table of Contents**

The impact of the adoption of SFAS No. 123R was an increase in cost of revenue of approximately \$0.2 million, an increase in selling, general and administrative expense of approximately \$1.9 million, including the associated payroll taxes, and a deferred tax benefit of approximately \$0.3 million for the year ended December 31, 2006. In addition, we recorded a cumulative effect of a change in accounting principle of \$0.7 million, net of tax, representing the difference between the fair value and the intrinsic value of SARs at January 1, 2006. The total impact of the adoption of SFAS No. 123R was a reduction in net income of approximately \$2.5 million, net of tax, for the year ended December 31, 2006, equivalent to \$0.07 per common share basic and \$0.07 per common share diluted, representing compensation expense in connection with SARs. Compensation expense recorded in connection with outstanding SARs was \$19.5 million and a related tax benefit of \$2.7 million for the year ended December 31, 2006. Compensation expense recorded in connection with outstanding stock options was negligible for the year ended December 31, 2006, because the stock options were primarily vested at December 31, 2005.

The weighted-average fair value of SARs outstanding as of December 31, 2006 was \$21.50 per SAR. As of December 31, 2006, there was \$8.3 million of total unrecognized compensation cost related to non-vested SARs awards. That cost is expected to be recognized over a weighted-average requisite service period of 0.7 years.

The impact of the adoption of SFAS No. 123R depends on, among other things, the price of our stock, as well as the assumptions used to value SARs granted, such as the volatility of our stock, risk-free interest rates, employee exercise patterns and forfeiture rates. The impact of additional SARs grant, if any, cannot be estimated at this time.

In June 2006, the FASB issued FASB Interpretation No. 48 ( FIN No. 48 ), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 which is effective for fiscal years beginning after December 15, 2006. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We will adopt FIN No. 48 as of January 1, 2007. We are currently evaluating the impact of adopting FIN No. 48 on our financial condition, results of operations and cash flows.

**Results of Operations**

The results of our four business segments from the operations of our consolidated entities combined with the non-consolidated entities where we are actively involved in the day-to-day management, are shown in Note 14

Segment Information Line of Business Data to our consolidated financial statements. In addition, revenue and costs from related parties are shown in Note 13 Related Party Transactions .

According to Russian government estimates, inflation in Russia was 12% in 2004, 11% in 2005 and 9% in 2006. The Russian government expects inflation to be approximately 7% to 8% in 2007. Although the rate of inflation has been declining, any return to heavy and sustained inflation could lead to market instability, new financial crises, reduction in consumer buying power and erosion of consumer confidence.

**The discussion of our results of operations is organized as follows:**

*Consolidated Results.* Consolidated Results of Operations for the Year Ended December 31, 2006, compared to the Consolidated Results of Operations for the Year Ended December 31, 2005

*Consolidated Financial Position.* Consolidated Financial Position at December 31, 2006, compared to Consolidated Financial Position at December 31, 2005

*Consolidated Results.* Consolidated Results of Operations for the Year Ended December 31, 2005, compared to the Consolidated Results of Operations for the Year Ended December 31, 2004

*Consolidated Financial Position.* Consolidated Financial Position at December 31, 2005, compared to Consolidated Financial Position at December 31, 2004

**Table of Contents****Consolidated Results of Operations for the Year Ended December 31, 2006, Compared to the Consolidated Results of Operations for the Year Ended December 31, 2005****Revenue**

Our revenue increased by 28% to \$854.6 million for the year ended December 31, 2006 from \$667.4 million for the year ended December 31, 2005. The breakdown of revenue by business group was as follows:

	<b>Consolidated Revenue For the Year Ended December 31, 2005</b>	<b>Consolidated Revenue For the Year Ended December 31, 2006 (in millions)</b>
REVENUE		
Business and Corporate Services	\$ 387.4	\$ 487.2
Carrier and Operator Services	221.4	309.1
Consumer Internet Services	44.5	48.7
Mobile Services	14.1	9.6
<b>TOTAL REVENUE</b>	<b>\$ 667.4</b>	<b>\$ 854.6</b>

The breakdown of revenue by geographic regions was as follows:

	<b>Consolidated Revenue For the Year Ended December 31, 2005</b>	<b>Consolidated Revenue For the Year Ended December 31, 2006 (in millions)</b>
REVENUE		
Moscow	\$ 436.6	\$ 535.6
Northwest region of Russia	59.9	79.6
Other regions of Russia and CIS	122.9	185.9
Ukraine	73.8	82.3
Eliminations	(25.8)	(28.8)
<b>TOTAL REVENUE</b>	<b>\$ 667.4</b>	<b>\$ 854.6</b>

*Business and Corporate Services.* Revenue from Business and Corporate Services increased by 26% to \$487.2 million for the year ended December 31, 2006 from \$387.4 million for the year ended December 31, 2005. Macro-economic growth in Russia, Ukraine, and the CIS and continuing demand for our telecommunications solutions have continued to help us increase revenue in this line of business. Our total number of contracts in this line of business increased from 184,206 on December 31, 2005, to 253,133 on December 31, 2006, an increase of 37%.

Revenue from the BCS division of Sovintel increased by 24% to \$395.8 million for the year ended December 31, 2006, from \$318.0 million for the year ended December 31, 2005. Sovintel BCS revenue increased by approximately \$12.7 million in 2006 due to the introduction of the semi-fixed USD-RUR exchange rate for settlements with the majority of its customers. In 2006, Sovintel recorded approximately \$14.6 million of additional revenue related to the introduction of CPP. BCS revenue in Moscow, our largest market, increased by \$46.4 million, or 19%, to \$292.5 million in 2006 from \$246.1 million in 2005. However, as a percentage of total Sovintel BCS revenue,



Moscow decreased from approximately 77% in 2005 to approximately 74% of Sovintel's total BCS revenue in 2006. This decrease is the result of the expansion of Sovintel's BCS business in the Russian regions. Our BCS Moscow voice revenue continues to grow as we expand our client base and comprises over half of our total BCS revenue in that market. Additionally, we experienced a decrease in the competitive pressures affecting rates. In 2006, BCS Moscow revenue from data and Internet services grew significantly not only due to an increase in our customer base, but also due to increased business from existing customers. We expect our revenue from BCS Moscow to continue to grow as we continue to experience significant investment in the Moscow commercial real-estate market. Our ongoing relationships with Moscow real-estate developers should enable us to continue to grow the number of trade and business centers where we provide services to end users. Furthermore, we have implemented a key account program in Moscow to protect our relationships with our largest clients and to foster cross selling. Additionally, we expect demand for call center and data center services to continue to demonstrate strong growth in Moscow. Our revenue from call centers and data centers increased by approximately \$3.4 million, or 180%, in between 2005 and 2006. These services now account for approximately \$7.7 million in revenue in BCS Sovintel. Refer to the table below for key operating statistics for BCS Moscow.

**Table of Contents**

<b>(in whole numbers)</b>	<b>2005</b>	<b>2006</b>	<b>% Change</b>
<i>BCS Moscow customer statistics on December 31:</i>			
Total clients	23,013	23,456	2%
Business centers	791	920	16%
Trade centers	68	94	38%
Hotels	48	53	10%
Direct inward dialing lines	127,000	138,000	9%
Ethernet / Metropolitan Ethernet Network connections	1,708	2,652	55%
High speed Internet active contracts	485	976	101%

Sovintel regional BCS revenue increased by 44% to \$103.3 million in 2006 from \$71.9 million in 2005. As a percentage of total Sovintel BCS revenue, regional BCS revenue increased from approximately 23% in 2005 to approximately 26% of Sovintel's total BCS revenue in 2006. Sovintel regional BCS business continues to grow as we assist our customers in developing their businesses in Russian regions outside of Moscow.

Revenue from the BCS division of GTU increased by 24% to \$49.8 million for the year ended December 31, 2006, from \$40.1 million for the year ended December 31, 2005. This increase in revenue was due to a 21% increase in the minutes of use resulting from a 53% increase in the number of serviced voice lines. Partly offsetting these increasing factors was a 1% decrease in the average rate per minute of use per line per month due to more residential, SMBs, and regional customers in the client base, and traffic migration to mobile networks. In 2005, GTU began providing voice services to residential customers and had approximately 9,370 residential customers as of December 31, 2006, and 4,648 as of December 31, 2005. GTU expects revenue from residential customers to increase in the future as it expands its network to reach more residential buildings in Ukraine. Additionally, data and Internet revenue increased by approximately \$4.5 million due to increase in the number of ports in service.

Our acquisition strategy also contributed to the overall BCS growth in 2006. Our revenue increased by approximately \$5.3 million due to the acquisitions of Sakhalin Telecom and Sochitelecom in 2005 and by \$4.5 million due to the acquisitions of Tatintelcom, TTK, Kubtelecom and Telecom in 2006. Our regional acquisition strategy has enabled us to increase our access to last mile infrastructure, thus enabling us to expand our corporate client base.

*Carrier and Operator Services.* Revenue from Carrier and Operator Services increased by 40% to \$309.1 million for the year ended December 31, 2006, from \$221.4 million for the year ended December 31, 2005. Our total number of contracts in this line of business grew by 31% to 2,388 as of December 31, 2006, from 1,827 as of December 31, 2005.

Carrier and Operator Services revenue from Sovintel increased by 39% to \$279.5 million for the year ended December 31, 2006, from \$200.8 million for the year ended December 31, 2005. In Sovintel, we have expanded our operations with existing partners and added a number of new carriers in the regions with increased volumes of traffic. Additionally, our revenue from international traffic increased as we carried larger volumes of lower-margin traffic destined to CIS countries. We also observed significant increase in Internet traffic. During 2006 Sovintel recorded approximately \$14.8 million of additional revenue related to the introduction of CPP. Sovintel carrier's carrier revenue increased by approximately \$0.7 million in 2006 due to the introduction of the semi-fixed USD-RUR exchange rate for settlements with its customers. We expect that our revenues in this line of business will continue to increase in future periods as we expand our termination capabilities and continue to develop our network. Following the introduction of the new Interconnection Rules, we observed less competitive pressure on revenues.

Revenue for the Carrier and Operator Services division of GTU increased by 9% to \$21.5 million for the year ended December 31, 2006, from \$19.7 million for the year ended December 31, 2005. Carrier's carrier revenue increased due to a 62% increase in transit traffic from local operators following a decrease of rates to mobile networks and additional revenue from increased traffic volume from URS. This increase was partially offset by a decrease in the incoming international minutes of use due to increase in termination rates as a result of changes in VAT regulations.

Carrier and Operator Services revenue increased by approximately \$0.3 million due to the acquisitions of Sakhalin Telecom and Sochitelecom in 2005, and by \$3.8 million due to the acquisitions of Tatintelcom and Kubtelecom in

2006.

*Consumer Internet Services.* Revenue from Consumer Internet Services increased by 9% to \$48.7 million for the year ended December 31, 2006, from \$44.5 million for the year ended December 31, 2005. Consumer Internet Services revenue increased by approximately \$2.5 million due to the acquisitions of Sakhalin Telecom and Sochitelecom in 2005, and by \$0.5 million due to the acquisitions of Kubtelecom and Corus in 2006. Our revenue from consumer dial-up Internet decreased by approximately \$1.3 million between 2005 and 2006. The average revenue per dial-up Internet subscriber decreased from \$6.85 per month for the year ended December 31, 2005, to approximately \$6.68 per month for the year ended December 31, 2006, the number of dial-up Internet subscribers decreased from 422,480 at December 31, 2005, to 401,098 at December 31, 2006. The demographics of our dial-up subscriber base continue to change as we add regional subscribers and lose subscribers in Moscow. The consumer Internet market in Moscow has become more competitive due to the increasing availability of other Internet access technologies. Offsetting the decrease

**Table of Contents**

in dial-up revenue was a \$5.5 million increase in other consumer Internet products, such as consumer broadband, primarily from customers outside of Moscow. We anticipate that our revenue from consumer broadband will increase as we embark on our broadband access rollout. Our current and past base of dial-up Internet subscribers in Moscow and throughout Russia will allow us to specifically target subscribers that currently use or have previously used our Internet services.

*Mobile Services.* Revenue from Mobile Services decreased by 32% to \$9.6 million for the year ended December 31, 2006, from \$14.1 million for the year ended December 31, 2005. The decline in revenue was primarily due to increased competition in the Ukrainian mobile market, lack of network coverage and the restrictions on national roaming services, which has led to significant churn of high usage contract subscribers. Active subscribers increased from 47,502 at December 31, 2005, to 48,448 at December 31, 2006, due to a decrease in churn of prepaid services subscribers following the introduction of the customer loyalty program. However, the average revenue per active subscriber decreased by 25% from approximately \$22.73 per month to approximately \$17.13 per month primarily due to a decrease in the average subscription fee and traffic revenue due to higher share of prepaid subscribers with lower usage compared to contract subscribers.

**Expenses**

The following table shows our principal expenses for the years ended December 31, 2006 and December 31, 2005:

	<b>Consolidated Expenses For the Year Ended December 31, 2005</b>	<b>Consolidated Expenses For the Year Ended December 31, 2006 (in millions)</b>
<b>COST OF REVENUE</b>		
Business and Corporate Services	\$ 165.7	\$ 213.4
Carrier and Operator Services	145.7	218.4
Consumer Internet Services	29.9	37.4
Mobile Services	6.2	5.2
<b>TOTAL COST OF REVENUE</b>	<b>347.5</b>	<b>474.4</b>
Selling, general and administrative	119.9	152.8
Depreciation and amortization	84.0	100.2
Equity in earnings of ventures	(0.4)	(1.9)
Interest income	(2.3)	(1.2)
Interest expense	0.6	0.6
Foreign currency (gain)/ loss	1.2	(1.7)
Minority interest	3.0	4.8
Provision for income taxes	37.8	40.4
Cumulative effect of a change in accounting principle, net of tax	\$	\$ 0.7
<i>Cost of Revenue</i>		

Our cost of revenue increased by 37% to \$474.4 million for the year ended December 31, 2006 from \$347.5 million for the year ended December 31, 2005.

*Business and Corporate Services.* Cost of revenue from BCS increased by 29% to \$213.4 million, or 44% of revenue, for the year ended December 31, 2006 from \$165.7 million, or 43% of revenue, for the year ended December 31, 2005. We continue to maintain robust gross margins in this line of business due to the continued demand for high-volume and high-margin services from our customers.

Cost of revenue for the BCS division of Sovintel increased by 30% to \$173.9 million, or 44% of revenue, for the year ended December 31, 2006, from \$133.6 million, or 42% of revenue, for the year ended December 31, 2005. The increase in cost of revenue as a percentage of revenue is primarily due to an increased volume of lower margin products and continuing pressure on our margins in this line of business from our existing customers. In 2006, Sovintel recorded approximately \$6.5 million of additional costs related to the introduction of CPP, \$0.8 million related to our SARs plans, and \$0.7 million related to the introduction of fixed USD-RUR exchange rate for payroll related costs.

Cost of revenue for the BCS division of GTU increased by 5% to \$21.4 million, or 43% of revenue, for the year ended December 31, 2006, from \$20.3 million, or 51% of revenue, for the year ended December 31, 2005. Cost of revenue decreased as a percentage of revenue primarily due to a decrease in the settlement rates for traffic termination to mobile networks according to the agreements with Ukrainian Mobile Communications ( UMC ) and Kyivstar GSM effective from the first quarter of 2006. Additionally, in October 2005, we started routing Internet traffic via our STM-4 channel to Frankfurt bypassing local incumbent operators and reducing Internet transmission costs.

**Table of Contents**

BCS cost of revenue increased by approximately \$2.6 million due to the acquisitions of Sakhalin Telecom and Sochitelem in 2005, and by \$2.5 million due to the acquisitions of Tatintelcom, TTK, Kubtelecom and Telcom in 2006.

*Carrier and Operator Services.* Cost of revenue from Carrier and Operator Services increased by 50% to \$218.4 million, or 71% of revenue, for the year ended December 31, 2006, from \$145.7 million, or 66% of revenue, for the year ended December 31, 2005. We continue to observe pressure on our operating margins in this line of business, attributable to competition and to a change in our traffic mix.

Cost of revenue for the Carrier and Operator Services division of Sovintel increased by 50% to \$207.8 million, or 74% of revenue, for the year ended December 31, 2006, from \$138.7 million, or 69% of revenue, for the year ended December 31, 2005. The increase in cost of revenue as a percentage of revenue is primarily due to an increased volume of lower margin products and continuing pressure on our margins in this line of business from our existing customers. In 2006, Sovintel recorded approximately \$13.7 million of additional costs related to the introduction of CPP, \$0.6 million related to our SARs plans, and \$0.4 million related to the introduction of fixed USD-RUR exchange rate for payroll related costs.

Cost of revenue for the Carrier and Operator Services division of GTU decreased to \$14.8 million, or 69% of revenue for the year ended December 31, 2006, from \$15.5 million, or 79% of revenue for the year ended December 31, 2005. Cost of revenue decreased as a percentage of revenue primarily due to lower margin incoming international traffic accounting for a smaller portion of our total wholesale traffic in 2006. In addition, our transmission optimization program enabled us to reduce costs associated with the lease of trunk channels from other operators.

Carrier and Operator Services cost of revenue increased by approximately \$0.6 million due to the acquisitions of Sakhalin Telecom and Sochitelem in 2005, and by \$2.2 million due to the acquisitions of Tatintelcom and Kubtelecom in 2006.

*Consumer Internet Services.* Cost of revenue from Consumer Internet Services increased by 25% to \$37.4 million, or 77% of revenue, for the year ended December 31, 2006, from \$29.9 million, or 67% of revenue, for the year ended December 31, 2005. The increase in cost of revenue as a percentage of revenue was mainly the result of the new settlement rules for interconnection with other operators. We incurred approximately \$2.6 million of origination fees for calls terminated to our dial-up Internet services network. In addition, network costs not decreasing in line with revenue declines from dial-up Internet. As regional subscribers account for a larger portion of our total subscriber base, margins in this line of business have decreased due to incremental network costs incurred to provide access to regional customers. Furthermore, the impact of a decline in subscribers in Moscow has not resulted in an immediate decline of network costs, which are more fixed in nature.

Consumer Internet Services cost of revenue increased by approximately \$1.8 million due to the acquisitions of Dicom, Sakhalin Telecom and Sochitelem in 2005, and by \$0.3 million due to the acquisitions of Kubtelecom and Corus in 2006.

*Mobile Services.* Cost of revenue from Mobile Services decreased by 16% to \$5.2 million, or 54% of revenue for the year ended December 31, 2006, from \$6.2 million, or 44% of revenue for the year ended December 31, 2005. The increase in cost of revenue as a percentage of revenue is mainly due to additional payments for the frequencies received under the new GSM-1800 license and network costs related to the FMC network development.

*Selling, General and Administrative*

Our selling, general and administrative expenses increased by 27% to \$152.8 million, or 18% of revenue, for the year ended December 31, 2006, from \$119.9 million, or 18% of revenue, for the year ended December 31, 2005. Ongoing employee related costs such as salaries, bonuses, insurance and other benefits increased by approximately \$28.7 million, or 54%, primarily due to a \$18.0 million charge recorded in 2006 related to our SARs plans, a \$2.0 million additional charge recorded in 2006 related to introduction of fixed USD-RUR exchange rate for payroll related costs, and a 16% increase in consolidated headcount, increased executive officer costs, and ongoing salary increases. In the fourth quarter of 2006, we reversed a \$2.6 million liability with a former shareholder because of the expiration of the statute of limitations. Additionally, in 2005, we reversed a \$1.4 million accrued liability related to estimated payroll taxes recorded upon the acquisition of one of our Russian subsidiaries. Furthermore, in 2005, we

recorded a \$1.1 million charge for the revision of our estimate for unused vacation. Bad debt expense decreased by approximately \$3.8 million compared to the year ended December 31, 2005, mainly due to the revision of our estimate for allowance for doubtful accounts. Taxes, other than income taxes, increased by \$3.1 million between years due to an increase in property taxes and non-recoverable VAT. Our advertising costs increased by \$5.3 million due to intensified marketing campaign of our new products and re-branding. The remaining \$1.9 million net increase is the result of other selling, general and administrative expenses increasing in line with the growth in our business.

*Depreciation and Amortization*

Our depreciation and amortization expenses increased by 19% to \$100.2 million for the year ended December 31, 2006, from \$84.0 million for the year ended December 31, 2005. Depreciation expense increased by \$13.9 million, or 21%, primarily due to depreciation on capital expenditures to further develop our network. Depreciation expense increased by \$3.2 million due to the

**Table of Contents**

change in functional currency effective July 1, 2006. Amortization expense also increased by \$2.3 million, or 12%, primarily due to amortization on intangible assets arising from acquisitions consummated in 2005 and 2006. Amortization expense increased by \$0.5 million due to the change in functional currency effective July 1, 2006.

*Equity in Earnings of Ventures*

The earnings after interest and tax charges from our investments in non-consolidated ventures increased to \$1.9 million for the year ended December 31, 2006 from \$0.4 million for the year ended December 31, 2005. The increase is mainly due to the acquisition of 54% of Rascom in the fourth quarter of 2005. We account for our investments in Rascom under the equity method because the rights of the minority shareholder represent substantive participating rights, and as result, such rights overcome the presumption that we control Rascom.

*Interest Income*

Our interest income for the year ended December 31, 2006, decreased to \$1.2 million from \$2.3 million for the year ended December 31, 2005. The decrease in interest income is due to decreased cash balances held in interest bearing accounts.

*Interest Expense*

Our interest expense was \$0.6 million for the year ended December 31, 2006, unchanged from the year ended December 31, 2005.

*Foreign Currency Gain (Loss)*

Our foreign currency gain was \$1.7 million for the year ended December 31, 2006, compared with a loss of \$1.2 million for the year ended December 31, 2005. The increase in foreign currency gain is due to the combination of movements in exchange rates and change in functional currency effective July 1, 2006. The impact of the change in functional currency resulted in a \$1.3 million decrease in foreign currency gain.

*Minority Interest*

Our minority interest was \$4.8 million for the year ended December 31, 2006, compared to \$3.0 million for the year ended December 31, 2005. Minority interest in our earnings increased due to an increase in earnings and consolidation of recently acquired entities where our ownership interest is less than 100%. In 2006, we acquired less than 100% of Tatintelcom and Kubtelecom.

*Provision for Income Taxes*

Our charge for income taxes was \$40.4 million for the year ended December 31, 2006, compared to \$37.8 million for the year ended December 31, 2005. Our effective tax rate was 31% for the year ended December 31, 2006, down from 32% for the year ended December 31, 2005. Tax expense decreased by \$1.8 million due to the change in functional currency effective July 1, 2006. We recognized approximately \$2.2 million in additional tax expense in 2005 since we changed our valuation allowance for United States ( US ) deferred tax assets due to our reassessment of sources of future taxable income in the US. Refer to Note 11 in the financial statements included in Item 8 of this form 10-K for a reconciliation of our statutory tax rate to the effective tax rate.

*Net Income and Net Income per Share*

Our net income for the year ended December 31, 2006 was \$85.5 million, compared to a net income of \$76.1 million for the year ended December 31, 2005.

Our net income per share of common stock increased to \$2.34 for the year ended December 31, 2006, compared to a net income per share of \$2.09 for the year ended December 31, 2005. The increase in net income per share of common stock was due to the increase in net income partly offset by the cumulative effect of a change in accounting principle related to accounting for share-based payments of \$0.02 per share of common stock, and an increase in the number of weighted average shares to 36,591,097 in the year ended December 31, 2006, compared to 36,378,175 in the year ended December 31, 2005. The increase in outstanding shares was a direct result of the employee stock option exercises and the issuance of restricted stock to certain members of management.

Our net income per share of common stock on a fully diluted basis increased to \$2.33 for the year ended December 31, 2006, compared to a net income per common share of \$2.08 for the year ended December 31, 2005. The increase in net income per share of common stock on a fully diluted basis was due to the increase in net income partly offset by the cumulative effect of a change in accounting principle related to accounting for share-based payments of \$0.02 per share of common stock, and an increase in the number of weighted average shares assuming



dilution to 36,716,600 the year ended December 31, 2006, compared to 36,605,075 the year ended December 31, 2005.

**Table of Contents****Consolidated Financial Position Significant Changes in Consolidated Financial Position at December 31, 2006, compared to Consolidated Financial Position at December 31, 2005***Accounts Receivable*

Accounts receivable increased by \$56.0 million from \$91.7 million at December 31, 2005, to \$147.7 million at December 31, 2006, as a result of increased revenue when comparing the month of December 2006 with the month of December 2005, and due to the changes in the settlements with local operators following the introduction of the new Interconnection Rules.

*Intangible Assets*

Our intangible assets increased by \$22.6 million from \$93.9 million at December 31, 2005, to \$116.5 million at December 31, 2006, due to a \$10.5 million impact of the change in functional currency effective July 1, 2006, and as a result of additional intangible assets recorded upon the acquisitions of Tatintelcom, TTK, Kubtelecom and S-Line, and the purchase of additional numbering capacity, offset by amortization on continuing intangible assets of the consolidated subsidiaries.

*Other Non-Current Liabilities*

Our other non-current liabilities increased by \$2.3 million from negligible amount at December 31, 2005, to \$2.3 million at December 31, 2006, as a result of the adoption of SFAS No. 123R related to accounting for share-based payments.

*Minority Interest*

Our minority interest increased by \$11.6 million from \$19.7 million at December 31, 2005, to \$31.3 million at December 31, 2006, due to a \$1.8 million impact of the change in functional currency effective July 1, 2006, \$4.8 million minority interest in earnings for the year ended December 31, 2006, and consolidation of recently acquired Tatintelcom, Kubtelecom and S-Line where our ownership interest is less than 100%.

*Stockholders Equity*

Shareholders equity increased by \$142.1 million from \$675.1 million at December 31, 2005, to \$817.2 million at December 31, 2006, as a result of our net income of \$85.5 million offset by declaring and paying \$22.0 million in dividends in the year ended December 31, 2006, and a \$75.1 million impact of the change in functional currency effective July 1, 2006, recorded as accumulated other comprehensive income. Also, shareholders equity increased by \$3.2 million due to stock option exercises and by \$0.3 million due to vesting of restricted shares.

**Consolidated Results Consolidated Results of Operations for the Year Ended December 31, 2005, Compared to the Consolidated Results of Operations for the Year Ended December 31, 2004***Revenue*

Our revenue increased by 14% to \$667.4 million for the year ended December 31, 2005 from \$584.0 million for the year ended December 31, 2004. The breakdown of revenue by business group was as follows:

	<b>Consolidated Revenue For the Year Ended December 31, 2004</b>	<b>Consolidated Revenue For the Year Ended December 31, 2005 (in millions)</b>
REVENUE		
Business and Corporate Services	\$ 324.8	\$ 387.4
Carrier and Operator Services	198.9	221.4
Consumer Internet Services	45.5	44.5
Mobile Services	15.8	14.1
Eliminations	(1.0)	

TOTAL REVENUE	\$ 584.0	\$	667.4
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*Business and Corporate Services.* Revenue from Business and Corporate Services increased by 19% to \$387.4 million for the year ended December 31, 2005 from \$324.8 million for the year ended December 31, 2004. Macro-economic growth in Russia, Ukraine, and the CIS and continuing demand for our telecommunications solutions have continued to help us increase revenue in this line of business. Our total number of contracts in this line of business increased from 162,728 on December 31, 2004, to 184,206 on December 31, 2005, an increase of 13%.

**Table of Contents**

Revenue from the BCS division of Sovintel increased by 16% to \$318.0 million for the year ended December 31, 2005, from \$273.1 million<sup>1</sup> for the year ended December 31, 2004. BCS revenue in Moscow, our largest market, increased by \$23.2 million, or 10%, to \$246.1 million in 2005 from \$222.9 million in 2004. However, as a percentage of total Sovintel BCS revenue, Moscow decreased from approximately 82% in 2004 to approximately 77% of Sovintel's total BCS revenue in 2005. This decrease is the result of the expansion of Sovintel's BCS business in the Russian regions. Our BCS Moscow voice revenue continues to grow as we expand our client base and comprises over half of our total BCS revenue in that market. In 2005, Moscow BCS revenue from data and Internet services grew significantly not only due to an increase in our customer base, but also due to increased business from existing customers. In 2005, we experienced significant growth in our data and Internet service offerings. Data and Internet services comprised approximately 38% of our total billings in 2005, up from 34% in 2004. We expect our revenue from BCS Moscow to continue to grow as we continue to experience significant investment in the Moscow commercial real-estate market. Our ongoing relationships with Moscow real-estate developers should enable us to continue to grow the number of trade and business centers where we provide services to end users. Furthermore, we have implemented a key account program in Moscow to protect our relationships with our largest clients and to foster cross selling. Additionally, we expect demand for call center and data center services to continue to demonstrate strong growth in Moscow. Our revenue from call centers and data centers increased by approximately \$1.2 million, or 34%, in between 2004 and 2005. These services now account for approximately \$4.7 million in revenue in BCS Sovintel. Refer to the table below for key operating statistics for BCS Moscow.

<b>(in whole numbers)</b>	<b>2004</b>	<b>2005</b>	<b>% Change</b>
<i>BCS Moscow customer statistics on Dec 31:</i>			
Total clients	22,657	23,013	2%
Business centers	686	791	15%
Trade centers	50	68	36%
Hotels	45	48	7%
Direct inward dialing lines	116,668	127,000	9%
Ethernet / Metropolitan Ethernet Network connections	1,138	1,708	50%
High speed Internet active contracts	251	485	93%

Between 2004 and 2005, Sovintel regional BCS revenue increased in both absolute terms and as a percentage of Sovintel BCS revenue. Sovintel's regional BCS business continues to grow as we assist our customers in developing their businesses in Russian regions outside of Moscow.

Revenue from the BCS division of GTU increased by 39% to \$40.1 million for the year ended December 31, 2005, from \$28.8 million for the year ended December 31, 2004. This increase in revenue was due to a 61% increase in the number of serviced voice lines partially resulting from growth in residential customers and a 10% increase in the average rate per minute of use resulting from a change in traffic mix in favor of higher-rated traffic to mobile networks. Additionally, data and Internet revenue increased by approximately \$4.3 million due to an increase in the number of ports in service. Partly offsetting these increasing factors was a 21% decrease in average minutes of use per line per month due to more residential, SMBs, and regional customers in the client base. In 2005, GTU began providing voice and Internet services to residential customers and had approximately 4,000 residential customers as of December 31, 2005. GTU expects revenue from residential customers to increase in the future as it expands its network to reach more residential buildings in Ukraine.

Our acquisition strategy also contributed to the overall BCS growth in 2005. Our revenue increased by approximately \$3.8 million due to the acquisitions of ST-HOLDING, Balticom, and Buzton in 2004 and by \$1.7 million due to the acquisitions of Sakhalin Telecom and Sochitelecom in 2005. Our regional acquisition strategy has enabled us to increase our access to last mile infrastructure, thus enabling us to expand our corporate client base.

*Carrier and Operator Services.* Revenue from Carrier and Operator Services increased by 11% to \$221.4 million for the year ended December 31, 2005, from \$198.9 million for the year ended December 31, 2004. Our total number of contracts in this line of business grew by 13% to 1,827 as of December 31, 2005, from 1,618 as of December 31,

2004.

Carrier and Operator Services revenue from Sovintel increased by 12% to \$200.8 million for the year ended December 31, 2005, from \$179.8 million<sup>2</sup> for the year ended December 31, 2004. In Sovintel, we have expanded our operations with existing partners and added a number of new carriers in the regions with increased volumes of traffic. Additionally, our revenue from international traffic increased as we carried larger volumes of lower-margin traffic destined to CIS countries. We expect that our revenues in this line of business will continue to increase in future periods as we expand our termination capabilities as we continue to develop our network.

<sup>1</sup> For comparability, the amounts shown for Sovintel in 2004 include adjustments to combine Sovintel and Comincom for the full year of 2004 since Comincom was merged into Sovintel in December 2004.

<sup>2</sup> For comparability, the amounts shown for Sovintel in 2004 include adjustments to combine Sovintel and Comincom for the full year of 2004 since Comincom was merged into Sovintel in December 2004.

**Table of Contents**

However, we continue to observe competitive pressure on revenues in the major cities and in the regions from established and new local competitors.

Revenue for the Carrier and Operator Services division of GTU decreased by 1% to \$19.7 million for the year ended December 31, 2005, from \$19.8 million for the year ended December 31, 2004. \$2.5 million of this decrease was the result of a decrease in incoming international revenue. Incoming international minutes of use decreased by 24% during the year due to a sharp decrease in incoming international minutes from UMC along with a decrease in transit traffic from various international operators. As mentioned previously, UMC received an international carrier license in the third quarter of 2004, allowing it to operate independently on the international markets without using the GTU network for transit purposes. The decrease in incoming international revenue was offset by a \$1.3 million increase in carrier's carrier revenue due to a 15% increase in carrier's carrier minutes of use resulting from a rise in low margin transit traffic on mobile networks. Additionally, data revenues increased by \$0.9 million due to an increase in ports in service as we added capacity between Kiev and Frankfurt via two VC3 channels. In the future, we expect a further decline in GTU voice wholesale revenues as major operators in the Ukrainian market establish direct interconnection between their networks.

Our acquisition strategy in Russia also contributed to the overall Carrier and Operator Services growth in 2005. Our revenue increased by approximately \$1.1 million due to the acquisitions of ST-HOLDING, Balticom, and Buzton in 2004 and by \$0.3 million due to the acquisitions of Sakhalin Telecom and Sochitelecom in 2005.

*Consumer Internet Services.* Revenue from Consumer Internet Services decreased by 2% to \$44.5 million for the year ended December 31, 2005, from \$45.5 million for the year ended December 31, 2004. This decrease was primarily the result of our revenue from consumer dial-up Internet decreasing by approximately \$7.8 million between the years. Although the average revenue per dial-up Internet subscriber decreased from \$9.03 per month for the year ended December 31, 2004, to approximately \$6.85 per month for the year ended December 31, 2005, the number of dial-up Internet subscribers increased from 413,351 at December 31, 2004, to 422,480 at December 31, 2005. The demographics of our dial-up subscriber base continue to change as we add regional subscribers and lose subscribers in Moscow. The consumer Internet market in Moscow has become more competitive due to the increasing availability of other Internet access technologies. Offsetting the decrease in dial-up revenue was a \$6.8 million increase in other consumer Internet products, such as consumer broadband, primarily from customers outside of Moscow. We anticipate that our revenue from consumer broadband will increase as we embark with our broadband access rollout. Our current and past base of dial-up Internet subscribers in Moscow and throughout Russia will allow us to specifically target subscribers that currently use or have previously used our Internet services.

*Mobile Services.* Revenue from Mobile Services decreased by 11% to \$14.1 million for the year ended December 31, 2005, from \$15.8 million for the year ended December 31, 2004. Active subscribers decreased from 57,490 at December 31, 2004, to 47,502 at December 31, 2005, due to increased competition in the Ukrainian mobile market. The average revenue per active subscriber has decreased by 17% from approximately \$27.23 per month to approximately \$22.73 per month primarily due to a 20% decrease in the number of contract subscribers with average monthly revenue per subscriber of approximately \$36.92. Furthermore, promotions and pricing concessions are increasingly necessary due to increased competition in the Ukrainian mobile market.

**Expenses**

The following table shows our principal expenses for the years ended December 31, 2005 and December 31, 2004:

<b>Consolidated Expenses For the Year Ended December 31, 2004</b>	<b>Consolidated Expenses For the Year Ended December 31, 2005 (in millions)</b>
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COST OF REVENUE			
Business and Corporate Services	\$ 141.2	\$	165.7
Carrier and Operator Services	127.5		145.7
Consumer Internet Services	26.9		29.9
Mobile Services	6.0		6.2
Eliminations	(1.0)		
TOTAL COST OF REVENUE			
	300.6		347.5
Selling, general and administrative	112.9		119.9
Depreciation and amortization	75.0		84.0
Equity in earnings of ventures	(0.3)		(0.4)
Interest income	(1.1)		(2.3)
Interest expense	0.6		0.6
Foreign currency (gain)/ loss	(0.7)		1.2
Provision for income taxes	\$ 30.7	\$	37.8

**Table of Contents***Cost of Revenue*

Our cost of revenue increased by 16% to \$347.5 million for the year ended December 31, 2005 from \$300.6 million for the year ended December 31, 2004.

*Business and Corporate Services.* Cost of revenue from BCS increased by 17% to \$165.7 million for the year ended December 31, 2005 from \$141.2 million for the year ended December 31, 2004. Cost of revenue as a percentage of revenue remained unchanged at 43% between the periods. We continue to maintain strong gross margins in this line of business due to the continued demand for high-volume and high-margin services from our customers.

Cost of revenue for the BCS division of Sovintel increased by 13% to \$133.6 million, or 42% of revenue, for the year ended December 31, 2005, from \$118.0 million<sup>3</sup>, or 43% of revenue, for the year ended December 31, 2004. Cost of revenue as a percentage revenue remained relatively unchanged between the years.

Cost of revenue for the BCS division of GTU increased by 39% to \$20.3 million, or 51% of revenue, for the year ended December 31, 2005, from \$14.6 million, or 51% of revenue, for the year ended December 31, 2004. Cost of revenue as a percentage of revenue remained unchanged between the years.

BCS cost of revenue increased by approximately \$1.1 million due to the acquisitions of ST-HOLDING, Balticom, and Buzton in 2004 and by \$1.1 million due to the acquisitions of Sakhalin Telecom and Sochitelecom in 2005.

*Carrier and Operator Services.* Cost of revenue from Carrier and Operator Services increased by 14% to \$145.7 million, or 66% of revenue, for the year ended December 31, 2005, from \$127.5 million, or 64% of revenue, for the year ended December 31, 2004. We continue to observe pressure on our operating margins in this line of business, attributable to competition and to a change in our traffic mix.

Cost of revenue for the Carrier and Operator Services division of Sovintel increased by 13% to \$138.7 million, or 69% of revenue, for the year ended December 31, 2005, from \$123.0 million<sup>3</sup>, or 68% of revenue, for the year ended December 31, 2004. The increase in cost of revenue as a percentage of revenue is primarily due to a change in our traffic mix to favor traffic terminated in CIS countries, which have higher settlement rates, and due to an increase in traffic terminated to mobile networks, which typically have higher settlement rates than fixed networks.

Cost of revenue for the Carrier and Operator Services division of GTU decreased to \$15.5 million, or 79% of revenue for the year ended December 31, 2005, from \$16.0 million, or 81% of revenue for the year ended December 31, 2004. Cost of revenue decreased as a percentage of revenue primarily due to lower margin incoming international traffic accounting for a smaller portion of our total wholesale traffic in 2005.

Carrier and Operator Services cost of revenue increased by approximately \$0.9 million due to the acquisitions of ST-HOLDING, Balticom, and Buzton in 2004 and by \$0.2 million due to the acquisitions of Sakhalin Telecom and Sochitelecom in 2005.

*Consumer Internet Services.* Cost of revenue from Consumer Internet Services increased by 11% to \$29.9 million, or 67% of revenue, for the year ended December 31, 2005, from \$26.9 million, or 59% of revenue, for the year ended December 31, 2005. The increase in cost of revenue as a percentage of revenue was mainly the result of network costs not decreasing in line with revenue declines from dial-up Internet. As regional subscribers account for a larger portion of our total subscriber base, margins in this line of business have decreased due to incremental network costs incurred to provide access to regional customers. Furthermore, the impact of a decline in subscribers in Moscow has not resulted in an immediate decline of network costs, which are more fixed in nature.

*Mobile Services.* Cost of revenue from Mobile Services increased by 3% to \$6.2 million, or 44% of revenue for the year ended December 31, 2005, from \$6.0 million, or 38% of revenue for the year ended December 31, 2004. The increase in cost of revenue as a percentage of revenue is mainly due to an increase in hryvna based settlement rates due to a devaluation of the USD in April 2005 and to an increase in traffic to other mobile networks with higher settlement rates.

*Selling, General and Administrative*

Our selling, general and administrative expenses increased by 6% to \$119.9 million, or 18% of revenue, for the year ended December 31, 2005, from \$112.9 million, or 19% of revenue, for the year ended December 31, 2004. During the year ended December 31, 2004, we incurred \$3.6 million in consulting fees in association with the transfer of 20% of our ownership interest in GTU to a Ukrainian partner in exchange for services provided by the partner. Bad



debt expense decreased by approximately \$2.0 million

<sup>3</sup> For comparability, amounts shown for Sovintel in 2004 include adjustments to combine Sovintel and Comincom for the full year of 2004 since Comincom was merged into Sovintel in December 2004.

**Table of Contents**

compared to the year ended December 31, 2004, due to improved collections resulting from integrating Comincom into Sovintel's operations late in 2004. Additionally, the reversal of a \$1.4 million tax contingency accrual decreased payroll and other taxes in the first quarter of 2005. These decreasing factors were partly offset by expensing \$1.8 million of capitalized acquisition costs in the year ended December 31, 2005, related to acquisition opportunities that we decided not to pursue. Furthermore, severance costs increased by approximately \$0.8 million since we recorded approximately \$2.2 million of charges in the second half of 2005 related to separation payments paid to our former Chief Operating Officer, Chief Financial Officer, and other senior employees. Ongoing employee related costs such as salaries, bonuses, insurance and other benefits increased by approximately \$8.2 million, or 14%, primarily due to a 7% increase in consolidated headcount, increased executive officer costs, and ongoing salary increases. Included in the increase in employee related costs is a \$1.1 million charge recorded in the second quarter of 2005 for the revision of our estimate for unused vacation. The remaining \$3.2 million net increase is the result of other office expenses increasing in line with the growth in our business.

*Depreciation and Amortization*

Our depreciation and amortization expenses increased by 12% to \$84.0 million for the year ended December 31, 2005, from \$75.0 million for the year ended December 31, 2004. Depreciation expense increased by \$8.5 million, or 15%, primarily due to depreciation on capital expenditures to further develop our network. Amortization expense also increased by \$0.5 million due to amortization on intangible assets arising from acquisitions consummated in 2004 and 2005 offset by certain intangible assets related to interconnection contracts in Ukraine becoming fully amortized.

*Equity in Earnings of Ventures*

The earnings after interest and tax charges from our investments in non-consolidated ventures increased to \$0.4 million for the year ended December 31, 2005 from \$0.3 million for the year ended December 31, 2004. We recognized earnings at Sakhalin Telecom of \$0.6 million, primarily due to Sakhalin Telecom's gain on the sale of its ownership interest in ZAO Sakhalin Telecom Mobile which occurred in September 2005, prior to our purchase of an additional 60% ownership interest in Sakhalin Telecom. In addition, we recognized losses of \$0.2 million from our other Russian ventures.

*Interest Income*

Our interest income for the year ended December 31, 2005, increased to \$2.3 million from \$1.1 million for the year ended December 31, 2004. The increase in interest income is due to increased cash balances held in interest bearing accounts and an increase in interest rates applicable to these accounts.

*Interest Expense*

Our interest expense was \$0.6 million for the year ended December 31, 2005, unchanged from the year ended December 31, 2004.

*Foreign Currency Gain (Loss)*

Our foreign currency loss was \$1.2 million for the year ended December 31, 2005, compared with a gain of \$0.7 million from the year ended December 31, 2004. The increase in foreign currency loss is due to the combination of movements in exchange rates and changes in the amount of net monetary assets that we have denominated in foreign currencies.

*Minority Interest*

Our minority interest was \$3.0 million for the year ended December 31, 2005, compared to \$1.5 million for the year ended December 31, 2004. Minority interest increased primarily due to \$3.8 million in cash contributed to GTU by our minority partner in Ukraine. Additionally, minority interest in our earnings increased due to the consolidation of recently acquired entities where our ownership interest is less than 100%. In the first half of 2004 we acquired less than 100% ownership in ZAO Samara Telecom, ZAO WestBalt Telecom, and Buzton. Minority interests in the earnings of GTU also arose in 2004 due to the sale of a non-controlling interest to our local partners in Ukraine. In 2005, we acquired less than 100% ownership in Dicom and Sakhalin Telecom.

*Provision for Income Taxes*

Our charge for income taxes was \$37.8 million for the year ended December 31, 2005, compared to \$30.7 million for the year ended December 31, 2004. Our effective tax rate was 32% for the year ended December 31, 2005, unchanged from the year ended December 31, 2004. We recognized approximately \$2.2 million in additional tax

expense in 2005 since we changed our valuation allowance for United States ( US ) deferred tax assets due to our reassessment of sources of future taxable income in the US. Our effective tax rate for the year ended December 31, 2004, was impacted by \$3.6 million of non-deductible consulting expenses incurred in association with the transfer of 20% of our ownership interest in GTU to a Ukrainian partner in exchange for services provided by

**Table of Contents**

that partner. Refer to Note 11 in the financial statements included in Item 8 of this form 10-K for a reconciliation of our statutory tax rate to the effective tax rate.

*Net Income and Net Income per Share*

Our net income for the year ended December 31, 2005 was \$76.1 million, compared to a net income of \$64.8 million for the year ended December 31, 2004.

Our net income per share of common stock increased to \$2.09 for the year ended December 31, 2005, compared to a net income per share of \$1.79 for the year ended December 31, 2004. The increase in net income per share of common stock was due to the increase in net income partly offset by an increase in the number of weighted average shares to 36,378,175 in the year ended December 31, 2005, compared to 36,255,531 in the year ended December 31, 2004. The increase in outstanding shares was a direct result of the employee stock option exercises and the issuance of restricted stock to certain members of management.

Our net income per share of common stock on a fully diluted basis increased to \$2.08 for the year ended December 31, 2005, compared to a net income per common share of \$1.77 for the year ended December 31, 2004. The increase in net income per share of common stock on a fully diluted basis was due to the increase in net income partly offset by an increase in the number of weighted average shares assuming dilution to 36,605,075 the year ended December 31, 2005, compared to 36,552,547 for the year ended December 31, 2004.

**Consolidated Financial Position Significant Changes in Consolidated Financial Position at December 31, 2005, compared to Consolidated Financial Position at December 31, 2004***Accounts Receivable*

Accounts receivable increased from December 31, 2004, to December 31, 2005, as a result of increased revenue when comparing the month of December 2005 with the month of December 2004.

*Intangible Assets*

Our intangible assets decreased at December 31, 2005, as compared to December 31, 2004, as a result of amortization on continuing intangible assets of the consolidated subsidiaries exceeding intangible asset additions. Also contributing to the decrease was the reversal of an income tax contingent liability related to an acquisition as described in more detail in the Other Non-current liabilities discussion below. Offsetting these decreasing factors were additional intangible assets recorded upon the acquisitions of Dicom, Sakhalin Telecom, and Sochitelem and the purchase of additional numbering capacity.

*Other Non-Current Liabilities*

Our other non-current liabilities decreased at December 31, 2005, as compared to December 31, 2004, as a result of the reversal of a \$2.0 million accrued liability related to a tax contingency. This accrued liability was recorded upon the acquisition of one of our Russian subsidiaries. Management has concluded that the probability of this accrued liability arising in the future is remote due to the expiry of Russian regulatory statutes of limitations for any potential tax claims from the Russian tax inspectorate.

*Minority Interest*

Our minority interest increased at December 31, 2005, as compared to December 31, 2004, due to the consolidation of recently acquired entities where our ownership interest is less than 100%. In the first half of 2004 we acquired less than 100% ownership in ZAO Samara Telecom, ZAO WestBalt Telecom, and Buzton. Minority interests in the earnings of GTU also arose in 2004 due to the sale of a non-controlling interest to our local partners in Ukraine. In 2005, we began to consolidate Dicom and Sakhalin Telecom. Both of these entities have minority ownership interests. Additionally, minority interest increased due to \$3.8 million in cash contributed to GTU by our minority partner in Ukraine.

*Stockholders Equity*

Shareholders equity increased from December 31, 2004, to December 31, 2005, as a result of our net income of \$76.1 million offset by declaring and paying \$29.1 million in dividends in the year ended December 31, 2005. Also, shareholders equity increased by \$1.8 million due to stock option exercises and the issuance of restricted shares to certain members of management.

**Table of Contents****Income Taxes**

Our effective rate of income tax differs from the US statutory rate due to the impact of the following factors: (1) different income tax rates and regulations apply in the countries where we operate; (2) expenses that are non-deductible on the income tax return; (3) write-offs of certain assets that are not deductible for tax purposes; and (4) changes in the valuation allowance for deferred tax assets. We currently have deferred tax assets arising from deductible temporary differences in our non-US subsidiaries. Due to the continued profitability of these subsidiaries, we anticipate that these deferred tax assets will be realized through deduction against future taxable income. We also have deferred tax assets related to net operating loss carry-forwards and deductible temporary differences for US federal income tax purposes. We have recorded a full valuation allowance against these deferred tax assets due to our assessment of sources of future taxable income in the United States. We have also recorded a deferred tax asset related to net operating loss carry-forwards for Cyprus tax purposes. However, we have recorded a full valuation allowance since we do not anticipate recognizing taxable income in our Cyprus entity in the foreseeable future.

**Liquidity and Capital Resources**

The following table shows our cash flows for the years ended December 31, 2006, and December 31, 2005:

	<b>Consolidated Cash Flows For the Year Ended December 31, 2005</b>	<b>Consolidated Cash Flows For the Year Ended December 31, 2006 (in millions)</b>
<b>CASH FLOWS</b>		
Provided by operating activities	\$ 174.3	\$ 160.7
Used in investing activities	(133.1)	(201.1)
Used in financing activities	(27.3)	(9.8)
Effect of exchange rate changes	(0.4)	1.4
Net increase (decrease) in cash and cash equivalents	\$ 13.5	\$ (48.8)

Our cash and cash equivalents was \$18.4 million and \$67.2 million as of December 31, 2006, and December 31, 2005, respectively. Our total restricted cash was \$0.2 million and \$0.6 million as of December 31, 2006, and December 31, 2005, respectively. The restricted cash is maintained in connection with certain of our equity investee's debt obligations as described below.

Net cash provided by our operating activities decreased by \$13.6 million to \$160.7 million for the year ended December 31, 2006, from \$174.3 million for the year ended December 31, 2005. This decrease in net cash inflows from operating activities at December 31, 2006, is mainly due to the effects of changes in the settlements with local operators following the introduction of the new Interconnection Rules and to the changes in Russian legislation related to VAT partially offset by increase in net income. As a result of the changes in the settlements with local operators, accounts receivable balances increased from December 31, 2005 to December 31, 2006, partially offset by increases in related accounts payable balances. Under the change, effective January 1, 2006, VAT is accounted for on an accrual basis rather than on a cash basis such that we must pay VAT prior to such time as we receive corresponding VAT payments from our customers. As a result of this change, VAT payable balances decreased from December 31, 2005 to December 31, 2006.

During the year ended December 31, 2006, we received approximately \$802.1 million in cash from our customers for services and we paid approximately \$598.5 million to suppliers and employees. During the year ended December 31, 2005, we received approximately \$662.9 million in cash from our customers for services and we paid approximately \$449.0 million to suppliers and employees.

We used cash of \$201.1 million and \$133.1 million for investing activities for the year ended December 31, 2006, and 2005, respectively, which were principally attributable to building our telecommunications networks and acquisitions. Network investing activities totaled \$175.6 million for the year ended December 31, 2006, of which \$8.6 million was related to purchases in 2005, and included cash paid for capital expenditures principally attributable to building out our telecommunications network. The majority of network investing activities related to the construction of last mile access, the inter-city fiber optic network and network upgrades as a result of increased customer connections. Network investing activities totaled \$118.2 million for the year ended December 31, 2005.

We used cash of \$26.8 million, net of cash acquired, for the year ended December 31, 2006, for the acquisition of Tatintelcom, TTK, Kubtelecom, Telcom, S-Line and Corus. We used cash of \$18.1 million for the year ended December 31, 2005, for the acquisition of Dicom, Sakhalin Telecom, Sochitelecom, Rascom and payment of a holdback amount related to the 2004 SP Buzton acquisition.

For the year ended December 31, 2006, we received \$3.2 million net proceeds from the exercise of employee stock options and for the year ended December 31, 2005, we received \$1.4 million net proceeds from the exercise of employee stock options.

**Table of Contents**

We paid dividends of \$22.0 million and \$29.1 million during the year ended December 31, 2006 and 2005, respectively.

We had working capital of \$42.8 million as of December 31, 2006 and \$79.1 million as of December 31, 2005. Our working capital ratio (current assets divided by current liabilities) was 1.23 as of December 31, 2006, and 1.60 as of December 31, 2005.

As part of our drive to increase our network capacity, reduce costs and improve the quality of our service, we have leased fiber optic and satellite-based network capacity; the terms of these leases are generally five years or more and can involve significant advance payments. As demand for our telecommunication services increases we expect to enter into additional capacity agreements and may make significant financial commitments, in addition to our existing commitments.

Approximately half of the capital expenditures, or approximately 10-12% of our revenues, is necessary to sustain growth in line with the market growth rates and maintain, upgrade and develop existing infrastructure. To gain additional market share we expect to invest additional 9-10% of our revenues in new projects. We estimate that between 2007 and 2010 we will invest approximately 20% of our revenues in business development and construction of broadband networks. We expect capital expenditures to decline as percentage of revenues once the deployment of broadband networks is completed.

In February 2007, we entered into a lease agreement with Eurotel LLC for STM-1 fiber optic capacity from Ufa to Krasnoyarsk. The lease has a term of five years and total payments of \$9.8 million. In conjunction with this transaction, we also entered into agreement whereby we agreed to provide a loan of \$9.8 million to the lessor. The loan matures in 2012.

Some of our operating companies have received debt financing through direct loans from affiliated companies. In addition, certain operating companies have borrowed funds under a back-to-back, seven-year credit facility for up to \$22.7 million from ZAO Citibank ( Citibank ), a Russian subsidiary of Citibank. Under this facility, we provide full cash collateral, held in London, and recorded on our balance sheet as restricted cash, for onshore loans made by the bank to our Russian registered joint ventures. In a second, similar facility, we provide full cash collateral for a short term back-to-back, revolving, credit facility for up to \$10.0 million from the same bank for Sovintel. The funding level as of December 31, 2006, for all these facilities, totaled \$0.2 million was funded to our non-consolidated entities. The loan facilities carry interest at a rate equal to the three-month London Inter-Bank Offering Rate ( LIBOR ) plus 1.0 percent per annum (equivalent to approximately 6.9%, on average for loans outstanding, at December 31, 2006) and mature in July 2007.

In July 2006, GTU entered into one-year revolving credit facility for up to \$3.5 million plus a cash coverage facility of up to \$2.0 million with Calyon Bank Ukraine ( Calyon ). As of December 31, 2006, GTU had borrowed \$3.9 million under this credit facility. The credit facility carries interest at a rate equal to the between LIBOR plus 2% to 8.5%. The credit facility requires GTU to maintain accounts with Calyon in the currencies of the loan and ensure that the aggregate amount of incoming payments credited to GTU's accounts with Calyon in any calendar month is equal to, or greater than 30% of the aggregate amount of the loans outstanding as of the last day of such month.

In September 2006, Sovintel entered into a 90 day short-term revolving credit facility for up to \$15.0 million with Citibank. As of December 31, 2006, Sovintel had borrowed \$6.6 million under this credit facility. The credit facility carries interest at a rate equal to the LIBOR plus 1.0% per annum. The credit facility requires Sovintel to maintain accounts with Citibank in the currencies of the loan and ensure that the aggregate amount of incoming payments credited to Sovintel's accounts with Citibank in any calendar month is equal to, or greater than 30% of the aggregate amount of the loans outstanding as of the last day of such month.

In October 2006, Sovintel entered into short term, revolving, credit facility for up to 518,000,000 RUR, equivalent to \$19.7 million, with ZAO International Moscow Bank ( IMB ), a related party. As of December 31, 2006, Sovintel had not borrowed funds under this facility. The credit facility carries interest at a rate equal to the Moscow Prime Offered Rate plus 3%. The credit facility requires Sovintel to maintain accounts with IMB in the currencies of the loan and ensure that the aggregate amount of deposits credited to Sovintel's accounts with IMB is at least 150,000,000 RUR, equivalent to \$5.7 million, for each interest period during the term of the credit facility.

In January 2007, we entered into a five-year term Facility Agreement (the Facility Agreement ) with banks, financial institutions and other institutional lenders, Citibank, N.A. London Branch and ING Bank N.V. as mandated lead arrangers, and Citibank International plc as agent. The Facility Agreement established an unsecured credit facility under which we, GTS Finance, Inc., our wholly-owned subsidiary, and Sovintel may borrow up to an aggregate of \$275.0 million. Funds borrowed may be used for general corporate purposes, including acquisitions, the payment of dividends and capital expenditures. The Facility Agreement places various restrictions on us related to incurrence of debt, asset disposals, mergers and acquisitions, and negative pledges. The Facility Agreement also requires us to meet various financial and non-financial covenants, including several restrictions related to financial condition.



**Table of Contents**

In the future, we may execute large or numerous acquisitions, which may require external financing, most likely to be raised through secured or unsecured borrowings. However, we may also raise the required funding through a dilutive equity issuance, through the divestment of non-core assets, or combinations of the above. In case large or numerous acquisitions do not materialize, we expect our current sources of funding to finance our capital requirements. The actual amount and timing of our future capital requirements may differ materially from our current estimates because of changes or fluctuations in our anticipated acquisitions, investments, revenue, operating costs, technology and network expansion plans and access to alternative sources of financing on favorable terms. Further, in order for us to compete successfully, we may require substantial capital to continue to develop our networks and meet the funding requirements of our operations. We will also require capital for other acquisition and business development initiatives. We expect to fund these requirements through cash on hand, cash flow from operations, proceeds from additional equity and debt offerings, and debt financing facilities.

As of December 31, 2006, our credit ratings were as follows:

<b>Credit Rating Agency</b>	<b>Rating</b>	<b>Outlook</b>
Standard & Poor's	BB	Stable
Moody's	Ba3	Stable

The cost of our borrowings is affected by our credit ratings. If our credit ratings were downgraded, we could be required to pay higher interest rates on secured or unsecured borrowings and could be subject to more restrictive financial covenants. We may not be able to obtain additional financing on favorable terms. As a result, we may become subject to additional or more restrictive financial covenants, our interest obligations may increase significantly and our shareholders may be adversely diluted. Our failure to generate sufficient funds in the future, whether from operations or by raising additional debt or equity capital, may require us to delay or abandon some or all of our anticipated expenditures, to sell assets, or both, which could have a material adverse effect on our operations.

In 2007 and subsequent years, we may incur significant cash outlays to settle SARs granted in 2005 and first quarter of 2006 to our CEO, senior management, and other employees. The terms of these SARs are described in detail in the "Other developments" section in this Management's Discussion and Analysis of Financial Condition and Results of Operations.

**Contractual Obligations**

As of December 31, 2006, we had the following contractual obligations, including long-term debt arrangements, capital leases, commitments for future payments under non-cancelable lease arrangements and purchase obligations:

	<b>Total</b>	<b>Payments Due by Period (3)</b>			
		<b>Less than 1 year</b>	<b>1 - 3 years</b>	<b>4 - 5 years</b>	<b>Thereafter</b>
Long-term debt	\$ 29	\$	\$ 29	\$	\$
Capital lease obligations	2,583	876	1,707		
Non-cancelable lease obligations	28,645	9,876	14,550	4,044	175
Purchase obligations (1)	75,485	27,985	31,163	10,976	5,361
Other long-term liabilities (2)	2,321		2,321		
<b>Total</b>	<b>\$ 109,063</b>	<b>\$ 38,737</b>	<b>\$ 49,770</b>	<b>\$ 15,020</b>	<b>\$ 5,536</b>

(1) Purchase obligations primarily include our

contractual legal obligations for the future purchase of equipment, interconnect, and satellite transponder capacity.

- (2) Other long-term liabilities primarily include obligations related to the SARs we have granted.

- (3) Amounts include interest.

**Table of Contents****Special Note Regarding Forward Looking Statements**

Certain statements contained in Management's Discussion and Analysis of Financial Condition and Results of Operations and other parts of this document, including, without limitation, those concerning (i) future acquisitions and capital expenditures including our strategy of regional expansion; (ii) projected traffic volumes and other growth indicators; (iii) anticipated revenues and expenses; (iv) our competitive environment; (v) the future performance of consolidated and equity method investments; (vi) our intention to offer our services under the Golden Telecom brand; (vii) our business and growth strategy, including our strategy to develop into residential markets; (viii) our intentions to expand our fiber optic capacity, broadband capacity, including rollout of our FTTB network, and add transmission capacity; (ix) our intention to offer VoIP services; (x) our plans to migrate our products and services to a new generation network; (xi) our plans to expand into the media market; (xii) our intention to continue to use the assets of recently acquired companies in the manner such assets were previously used; (xiii) our plans to deploy the FMC network and launch FMC services; (xiv) the deployment of our FTN and the effect of such deployment including expected increases in revenues from our DLD/ILD license, (xv) the impact of critical accounting policies, (xvi) application of the CBR exchange rate by Sovintel; and (xvii) the political, regulatory and financial situation in the markets in which we operate, including macroeconomic growth, the inflow of direct foreign investment and the effect of the Telecommunications Law and its supporting regulations, are forward-looking and concern the Company's projected operations, economic performance and financial condition. These forward-looking statements are made pursuant to the safe harbor provisions of the Securities Litigation Reform Act of 1995. It is important to note that such statements involve risks and uncertainties and that actual results may differ materially from those expressed or implied by such forward-looking statements. Among the key factors that have a direct bearing on the Company's results of operations, economic performance and financial condition are the commercial and execution risks associated with implementing the Company's business plan, including our assessment of additional provisions, our ability to effectively deploy our FTN, our ability to develop our fiber optic, broadband and DSL strategies, including developing FTTB and VoIP services, our ability to deploy and integrate the technology necessary to migrate to a new generation network, our ability to offer services under our DLD/ILD and compete with others offering the same services, our ability to move into the media market and offer new services in that area, our ability to develop a FMC network in Ukraine and expand our mobile service offerings, our ability to integrate recently acquired companies into our operations, and the political, economic and legal environment in the markets in which the Company operates, including the impact of the new Telecommunications Law and its supporting regulations, increasing competitiveness in the telecommunications and Internet-related businesses that may limit growth opportunities, and increased and intense downward price pressures on some of the services that we offer. These and other factors are discussed herein under Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Report.

Additional information concerning factors that could cause results to differ materially from those in the forward-looking statements are contained in this Form 10-K.

In addition, any statements that express, or involve discussions as to, expectations, beliefs, plans, objectives, assumptions or future events or performance (often, but not always, through the use of words or phrases such as "will likely result," "are expected to," "estimated," "intends," "plans," "projection" and "outlook") are not historical facts and are forward-looking and, accordingly, such statements involve estimates, assumptions and uncertainties which could cause actual results to differ materially from those expressed in the forward-looking statements. Accordingly, any such statements are qualified in their entirety by reference to, and are accompanied by, the factors discussed throughout this Report and investors, therefore, should not place undue reliance on any such forward-looking statements.

Further, any forward-looking statement speaks only as of the date on which such statement is made, and the Company undertakes no obligation to update any forward-looking statement or statements to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events. New factors may emerge from time to time, and it is not possible for management to predict all of such factors. Further, management cannot assess the impact of each such factor on the Company's business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking

statements.

**Table of Contents****ITEM 7A. Quantitative and Qualitative Disclosure About Market Risk**

Our treasury function has managed our funding, liquidity and exposure to interest rate and foreign currency exchange rate risks. Our investment treasury operations are conducted within guidelines that have been established and authorized by our audit committee. In accordance with our policy, we do not enter into any treasury management transactions of a speculative nature.

We are exposed to market risk from changes in foreign currency exchange rates. We do not currently use derivative financial instruments, such as foreign exchange forward contracts or foreign currency options, to manage our foreign exchange risk because the market for these types of financial instruments in Russia is not well developed and the cost of these instruments is relatively high. We do not hold or issue derivatives or other financial instruments for trading purposes.

Prior to 2006, our principal sources of revenues were denominated primarily in USD. Because our expenses were also primarily denominated in USD, the impact on our results of RUR depreciation was insignificant.

We shifted a substantial majority of our expenditures from USD to RUR. Nevertheless, we can give no assurance that we are adequately protected from the impact of currency fluctuations. Moreover, given that our reporting currency is the USD, rubles held in banks and other ruble-denominated assets and liabilities could fluctuate in line with any change in the value of the RUR. Prior to July 2006, changes in the value of our RUR denominated monetary assets and liabilities resulted in foreign currency gains or losses in our income statement. However, effective July 1, 2006 we determined that the functional currency of our subsidiaries domiciled in Russia is the RUR. Therefore, the financial statements of these subsidiaries are translated into USD using the current rate method and translation gains and losses are no longer included in net income, but are instead included as part of other comprehensive income.

We can, however, provide no assurance that these measures will adequately protect us from the impact of currency fluctuations. A substantial decline in the value of the RUR against the USD could materially adversely affect our results of operations.

Our cash and cash equivalents are held largely in interest bearing accounts, in USD, however we do have bank accounts denominated in RUR and Ukrainian hryvna. The book values of such accounts at December 31, 2006 and 2005 approximate their fair value.

We are exposed to market risk from changes in interest rates on our obligations and we also face exposure to adverse movements in foreign currency exchange rates. We have developed risk management policies that establish guidelines for managing foreign currency exchange rate risk and we also periodically evaluate the materiality of foreign currency exchange exposures and the financial instruments available to mitigate this exposure.

The following table provides information (in thousands) about our cash equivalents and debt obligations that are sensitive to changes in interest rates.

	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>Thereafter</b>	<b>2006 Total</b>	<b>2005 Total</b>
Cash equivalents	\$18,413	\$	\$	\$	\$	\$	\$18,413	\$67,176
Note receivable	\$ 2,879	\$	\$	\$2,500	\$	\$	\$ 2,879	\$ 1,494
Average fixed rate	9.8%			10.0%			9.8%	7.0%
Long-term debt, including current portion								
Variable rate	\$12,305	\$	\$	\$	\$	\$	\$12,305	\$ 92
Average interest rate	10.5%						10.5%	

**Table of Contents**

The following table provides information about our financial instruments by local currency and where applicable, presents such information in USD equivalents (in thousands). The table summarizes information on instruments that are sensitive to foreign currency exchange rates, including foreign currency denominated debt obligations.

	2007	2008	2009	2010	2011	Thereafter	2006 Total	2005 Total
<b>Assets</b>								
Current assets								
Russian rubles	\$ 122,664	\$	\$	\$	\$	\$	\$ 122,644	\$ 73,463
Closing foreign currency exchange rate	26.33							
Ukrainian Hryvna	\$ 11,068	\$	\$	\$	\$	\$	\$ 11,068	\$ 7,135
Closing foreign currency exchange rate	5.05							
Kazakhstan Tenge	\$ 1,652	\$	\$	\$	\$	\$	\$ 1,652	\$ 1,267
Closing foreign currency exchange rate	127							
Uzbekistan Soom	\$ 1,948	\$	\$	\$	\$	\$	\$ 1,948	\$ 1,073
Closing foreign currency exchange rate	1,240							
<b>Liabilities</b>								
Current liabilities								
Russian rubles	\$ 27,961	\$	\$	\$	\$	\$	\$ 27,961	\$ 21,528
Closing foreign currency exchange rate	26.33							
Ukrainian Hryvna	\$ 15,192	\$	\$	\$	\$	\$	\$ 15,192	\$ 3,696
Closing foreign currency exchange rate	5.05							
Kazakhstan Tenge	\$ 35	\$	\$	\$	\$	\$	\$ 35	\$ 57
Closing foreign currency exchange rate	127							
Uzbekistan Soom	\$ 184	\$	\$	\$	\$	\$	\$ 184	\$ 156
Closing foreign currency exchange rate	1,240							

Our interest income and expense are most sensitive to changes in the general level of US interest rates. In this regard, changes in US interest rates affect the interest earned on our cash equivalents and short-term investments as well as interest paid on debt.

**Table of Contents**

**ITEM 8. *Financial Statements and Supplementary Data***

**INDEX TO FINANCIAL STATEMENTS  
GOLDEN TELECOM, INC.**

	<b>Page</b>
<b><u>Financial Statements</u></b>	
<u>Report of Independent Registered Public Accounting Firm</u>	76
<u>Consolidated Balance Sheets as of December 31, 2005 and 2006</u>	77
<u>Consolidated Statements of Operations for the years ended December 31, 2004, 2005 and 2006</u>	79
<u>Consolidated Statements of Cash Flows for the years ended December 31, 2004, 2005 and 2006</u>	80
<u>Consolidated Statements of Shareholders' Equity for the years ended December 31, 2004, 2005 and 2006</u>	81
<u>Notes to Consolidated Financial Statements</u>	82
74	

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**Table of Contents**

**AUDITED CONSOLIDATED FINANCIAL STATEMENTS  
GOLDEN TELECOM, INC.  
Years Ended December 31, 2004, 2005 and 2006  
With Report of Independent Registered Public Accounting Firm**

75

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**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Shareholders of Golden Telecom, Inc.

We have audited the accompanying consolidated balance sheets of Golden Telecom, Inc. as of December 31, 2005 and 2006, and the related consolidated statements of operations, cash flows, and shareholders' equity for each of the three years in the period ended December 31, 2006. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Golden Telecom, Inc. at December 31, 2005 and 2006, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 2 to the consolidated financial statements, in 2006 Golden Telecom, Inc. adopted the provisions of the Financial Accounting Standards Board's Statement No. 123R, Share-Based Payment.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Golden Telecom, Inc.'s internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 15, 2007 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG  
LLC

Moscow, Russia  
March 15, 2007

**Table of Contents**

**GOLDEN TELECOM, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(In Thousands, Except Share Data)

	December 31,	
	2005	2006
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 67,176	\$ 18,413
Accounts receivable, net of allowance for doubtful accounts of \$27,327 and \$25,224 at December 31, 2005 and 2006, respectively	91,709	147,719
VAT receivable	21,986	21,486
Prepaid expenses	8,083	11,371
Deferred tax asset	8,994	11,098
Other current assets	13,009	21,318
<b>TOTAL CURRENT ASSETS</b>	<b>210,957</b>	<b>231,405</b>
Property and equipment:		
Telecommunications equipment	494,097	707,431
Telecommunications network held under capital leases	32,538	23,867
Furniture, fixtures and equipment	41,524	50,217
Other property	16,374	20,401
Construction in progress	70,470	103,190
	655,003	905,106
Accumulated depreciation	(247,096)	(352,765)
Net property and equipment	407,907	552,341
Goodwill and intangible assets:		
Goodwill	149,249	180,539
Telecommunications service contracts, net of accumulated amortization of \$32,009 as of December 31, 2005 and \$49,450 as of December 31, 2006	67,357	69,983
Contract-based customer relationships, net of accumulated amortization of \$18,241 as of December 31, 2005 and \$28,578 as of December 31, 2006	18,608	13,526
Licenses, net of accumulated amortization of \$3,182 as of December 31, 2005 and \$4,295 as of December 31, 2006	3,994	22,653
Other intangible assets, net of accumulated amortization of \$7,216 as of December 31, 2005 and \$7,991 as of December 31, 2006	3,921	10,383
Net goodwill and intangible assets	243,129	297,084
Restricted cash	566	233
Other non-current assets	19,652	26,127
<b>TOTAL ASSETS</b>	<b>\$ 882,211</b>	<b>\$ 1,107,190</b>

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



**Table of Contents**

**GOLDEN TELECOM, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(In Thousands, Except Share Data)

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable and accrued expenses	\$ 89,404	\$ 146,058
VAT Payable	17,190	2,725
Current capital lease obligations	1,941	753
Debt maturing within one year	65	12,305
Deferred revenue	16,799	21,634
Due to related parties	2,470	4,505
Other current liabilities	4,014	611
<b>TOTAL CURRENT LIABILITIES</b>	<b>131,883</b>	<b>188,591</b>
Long-term debt, less current portion	27	29
Long-term deferred tax liability	22,287	29,268
Long-term deferred revenue	30,878	36,951
Long-term capital lease obligations	2,340	1,591
Other non-current liabilities		2,321
<b>TOTAL LIABILITIES</b>	<b>187,415</b>	<b>258,751</b>
Minority interest	19,693	31,263
<b>SHAREHOLDERS EQUITY</b>		
Preferred stock, \$0.01 par value (10,000,000 shares authorized; none issued and outstanding at December 31, 2005 and 2006)		
Common stock, \$0.01 par value (100,000,000 shares authorized; 36,458,490 and 36,673,015 shares issued and outstanding at December 31, 2005 and 2006, respectively)	365	367
Additional paid-in capital	671,998	674,993
Deferred equity compensation	(455)	
Retained earnings	3,195	66,744
Accumulated other comprehensive income		75,072
<b>TOTAL SHAREHOLDERS EQUITY</b>	<b>675,103</b>	<b>817,176</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>\$ 882,211</b>	<b>\$ 1,107,190</b>

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



**Table of Contents**

**GOLDEN TELECOM, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In Thousands, Except Per Share Data)

	Year Ended December 31,		
	2004	2005	2006
REVENUE:			
Telecommunication services	\$ 581,521	\$ 662,742	\$ 846,740
Revenue from related parties	2,457	4,637	7,877
TOTAL REVENUE	583,978	667,379	854,617
OPERATING COSTS AND EXPENSES:			
Access and network services (excluding depreciation and amortization)	300,588	347,532	474,389
Selling, general and administrative (excluding depreciation and amortization)	112,855	119,890	152,808
Depreciation and amortization	74,999	84,015	100,209
TOTAL OPERATING EXPENSES	488,442	551,437	727,406
INCOME FROM OPERATIONS	95,536	115,942	127,211
OTHER INCOME (EXPENSE):			
Equity in earnings of ventures	278	460	1,867
Interest income	1,131	2,295	1,211
Interest expense	(572)	(618)	(580)
Foreign currency gain (loss)	660	(1,212)	1,697
TOTAL OTHER INCOME	1,497	925	4,195
Income before minority interest and income taxes	97,033	116,867	131,406
Minority interest	1,506	2,978	4,808
Income taxes	30,744	37,816	40,417
Income before cumulative effect of a change in accounting principle	64,783	76,073	86,181
Cumulative effect of a change in accounting principle, net of tax of \$52			681

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NET INCOME	\$ 64,783	\$ 76,073	\$ 85,500
Basic earnings per share of common stock:			
Income before cumulative effect of a change in accounting principle	\$ 1.79	\$ 2.09	\$ 2.36
Cumulative effect of a change in accounting principle			0.02
Net income per share basic	\$ 1.79	\$ 2.09	\$ 2.34
Weighted average common shares outstanding basic	36,226	36,378	36,591
Diluted earnings per share of common stock:			
Income before cumulative effect of a change in accounting principle	\$ 1.77	\$ 2.08	\$ 2.35
Cumulative effect of a change in accounting principle			0.02
Net income per share diluted	\$ 1.77	\$ 2.08	\$ 2.33
Weighted average common shares outstanding diluted	36,553	36,605	36,717
Cash dividends per share	\$ 0.80	\$ 0.80	\$ 0.60

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



**Table of Contents**

**GOLDEN TELECOM, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In Thousands)

	<b>Year Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
<b>OPERATING ACTIVITIES</b>			
Net income	\$ 64,783	\$ 76,073	\$ 85,500
Adjustments to reconcile net income to Net Cash Provided by Operating Activities:			
Depreciation	56,818	65,329	79,219
Amortization	18,181	18,686	20,990
Equity in earnings of ventures	(278)	(460)	(1,867)
Minority interest	1,506	2,978	4,808
Foreign currency (gain) loss	(660)	1,212	(1,697)
Deferred tax benefit	(4,606)	(3,815)	(3,825)
Bad debt expense	10,065	7,967	4,128
Stock appreciation rights compensation expense			19,475
Cumulative effect of a change in accounting principle, net of tax of \$52			681
Other	(41)	1,223	52
Changes in assets and liabilities:			
Accounts receivable	(22,964)	(10,316)	(55,960)
Accounts payable and accrued expenses	26,288	4,295	27,730
VAT, net	66	(88)	(13,800)
Other assets and liabilities	(3,974)	11,222	(4,665)
<b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>	<b>145,184</b>	<b>174,306</b>	<b>160,769</b>
<b>INVESTING ACTIVITIES</b>			
Purchases of property and equipment and intangible assets	(114,649)	(118,170)	(175,598)
Acquisitions, net of cash acquired	(15,522)	(18,085)	(26,778)
Restricted cash	(7)	446	333
Other investing	1,705	2,743	924
<b>NET CASH USED IN INVESTING ACTIVITIES</b>	<b>(128,473)</b>	<b>(133,066)</b>	<b>(201,119)</b>
<b>FINANCING ACTIVITIES</b>			
Repayments of debt	(950)	(253)	(643)
Proceeds from debt			11,621
Contribution from minority partner		3,840	
Net proceeds from exercise of employee stock options	4,895	1,435	3,154
Cash dividends paid	(28,998)	(29,119)	(21,951)
Other financing	(3,385)	(3,210)	(1,954)
<b>NET CASH USED IN FINANCING ACTIVITIES</b>	<b>(28,438)</b>	<b>(27,307)</b>	<b>(9,773)</b>

Effect of exchange rate changes on cash and cash equivalents	246	(456)	1,360
Net increase (decrease) in cash and cash equivalents	(11,481)	13,477	(48,763)
Cash and cash equivalents at beginning of year	65,180	53,699	67,176
<b>CASH AND CASH EQUIVALENTS AT END OF YEAR</b>	<b>\$ 53,699</b>	<b>\$ 67,176</b>	<b>\$ 18,413</b>

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

**Table of Contents**

**GOLDEN TELECOM, INC.**  
**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY**  
**For the Years Ended December 31, 2004, 2005, and 2006**  
(In Thousands)

	<b>Common Shares</b>	<b>Stock Amount</b>	<b>Additional Paid-In Capital</b>	<b>Deferred Equity (Accumulated Compensation Deficit)</b>	<b>Retained Earnings (Accumulated Deficit)</b>	<b>Accumulated Other Comprehensive Income</b>	<b>Total Equity</b>
Balance at December 31, 2003	35,948	\$ 359	\$ 663,464	\$	\$ (79,544)	\$	\$ 584,279
Exercise of employee stock options	374	4	4,775				4,779
Sale of 20% of Golden Telecom (Ukraine) (see Note 17)			1,538				1,538
Cash dividends paid					(28,998)		(28,998)
Net income					64,783		64,783
Balance at December 31, 2004	36,322	\$ 363	\$ 669,777	\$	\$ (43,759)	\$	\$ 626,381
Issuance of restricted shares	27	1	771	(772)			
Compensation expense				317			317
Exercise of employee stock options	109	1	1,450				1,451
Cash dividends paid					(29,119)		(29,119)
Net income					76,073		76,073
Balance at December 31, 2005	36,458	\$ 365	\$ 671,998	\$ (455)	\$ 3,195	\$	\$ 675,103
Adoption of SFAS 123R adjustment to remove unearned compensation			(455)	455			
Cancellation of restricted shares	(8)						
Issuance of restricted shares	8						
Compensation expense			298				298
Exercise of employee stock options	215	2	3,152				3,154
Cash dividends paid					(21,951)		(21,951)
Comprehensive income:							
Foreign currency translation adjustment, net of tax of \$2,181						75,072	75,072
Net income					85,500		85,500
Comprehensive income							160,572
Balance at December 31, 2006	36,673	\$ 367	\$ 674,993	\$	\$ 66,744	\$ 75,072	\$ 817,176

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

**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****Note 1: Nature of Business Operations**

Golden Telecom, Inc. ( GTI or the Company ) is a leading facilities-based provider of integrated telecommunication and Internet services in major population centers throughout Russia and other countries of the Commonwealth of Independent States ( CIS ). The Company offers voice, data and Internet services to corporations, operators and consumers using its metropolitan overlay network in major cities throughout Russia, Ukraine, Kazakhstan, and Uzbekistan, and via intercity fiber optic and satellite-based networks, including approximately 289 combined access points in Russia and other countries of the CIS. The Company offers mobile services in Kiev and Odessa in Ukraine. GTI was incorporated in Delaware on June 10, 1999 for the purpose of acting as a holding company for Global TeleSystems, Inc. s ( GTS ) operating entities within the CIS and supporting non-CIS holding companies (the CIS Entities ). On September 29, 1999, GTS transferred its ownership rights in the CIS Entities to the Company in anticipation of the Company s initial public offering which closed on October 5, 1999.

**Note 2: Summary of Significant Accounting Policies and Recent Accounting Pronouncements***Principles of Consolidation*

Wholly owned subsidiaries and majority owned ventures where the Company has operating and financial control are consolidated. All significant inter-company accounts and transactions are eliminated upon consolidation. Results of subsidiaries acquired and accounted for by the purchase method have been included in operations from the relevant date of acquisition.

Those ventures where the Company exercises significant influence, but does not exercise operating and financial control are accounted for by the equity method. The Company will discontinue applying the equity method of accounting for the Company s equity method investments when its share of the investees losses reduces the investments in and advances to ventures to zero. Thereafter, the Company will not provide for additional losses unless the Company has guaranteed obligations of the investee or is otherwise committed to provide further support for the investee. If the investee subsequently reports net income, the Company will resume the equity method only after the Company s share of net income equals the share of net loss not recognized during the period the equity method was suspended.

*Sale of Subsidiary Stock*

The Company recognizes gains in the consolidated statement of operations for sales of subsidiary stock where the value of the proceeds can be objectively determined and realization of the gain is reasonably assured. The Company accounts for sales of subsidiary stock where the value of the proceeds can not be objectively determined or realization of the gain is not reasonably assured as an equity transaction in the Company s consolidated financial statements. Once the accounting treatment of the gain or loss on issuance of shares by a specific entity has been determined, the Company consistently follows that treatment for all future issuances of shares by that particular subsidiary.

*Foreign Currency Translation*

Prior to the third quarter of 2006, the functional currency for all of the Company s foreign subsidiaries was the United States dollar ( USD ). In the second and the third quarters of 2006, EDN Sovintel LLC ( Sovintel ), the Company s wholly-owned Russian subsidiary, introduced a semi-fixed USD Russian ruble ( RUR ) exchange rate for settlements with the majority of its customers. This rate is applicable if the official USD exchange rate set by the Central Bank of Russia ( CBR ) is below the semi-fixed level. If the RUR depreciates against the USD so that the CBR exchange rate exceeds the semi-fixed level, Sovintel will resume applying the CBR exchange rate, or floating rate, for settlements with its customers. As a result of these changes, the Company reevaluated the functional currency criteria under Statement of Financial Accounting Standard ( SFAS ) SFAS No. 52, *Foreign Currency Translation* , and determined that, beginning July 1, 2006, the functional currency of the Company s subsidiaries domiciled in Russia is the RUR. The change was adopted prospectively beginning July 1, 2006 in accordance with SFAS No. 52. No restatement of comparative amounts was made for the change in functional currency. Therefore, the financial statements of the Company s subsidiaries domiciled in Russia on December 31, 2006, were translated into USD using the current rate method. Assets and liabilities were translated at the rate of exchange prevailing at the balance sheet date. Stockholders equity was translated at the applicable historical rate. Revenue and expenses were translated at the

monthly average rates of exchange. Translation gains and losses were included as part of accumulated other comprehensive income.

**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The change in functional currency resulted in a translated value for the July 1, 2006 (i) property and equipment, net, (ii) goodwill and (iii) intangible assets, net, that is approximately \$35.6 million, \$19.5 million, and \$9.4 million higher, respectively, than the amounts reported on June 30, 2006, when the USD was the subsidiaries' functional currency. This change in the carrying amount of property and equipment, goodwill and intangible assets has been reflected directly in shareholders' equity as part of other comprehensive income. In addition, the Company recorded a related deferred tax liability of \$2.2 million and a related minority interest of \$1.3 million in association with the change in functional currency. The impact of the change in functional currency resulted in a \$3.7 million increase in depreciation and amortization, a \$1.3 million decrease in foreign currency gain, and a \$1.8 million decrease in income taxes for the year ended December 31, 2006.

The functional currency of the Company's remaining foreign subsidiaries is the USD because a majority of their revenues, costs, property and equipment purchased, debt and trade liabilities is either priced, incurred, payable or otherwise measured in USD.

*Comprehensive Income*

SFAS No. 130, *Reporting Comprehensive Income*, requires the reporting of comprehensive income in addition to net income. Accumulated other comprehensive income includes foreign currency translation adjustments. For the year ended December 31, 2006, as a result of the change in functional currency total comprehensive income included, in addition to net income, the effect of translating RUR denominated financial statements of the Company's subsidiaries domiciled in Russia into the Company's reporting currency, in accordance with SFAS No. 52.

Comprehensive income comprises the following:

	<b>Year Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
		<b>(in thousands)</b>	
Net income, as reported	\$ 64,783	\$ 76,073	\$ 85,500
Foreign currency translation adjustment, net of tax of \$2,181			75,072
Comprehensive income	\$ 64,783	\$ 76,073	\$ 160,572

*Cash and Cash Equivalents and Restricted Cash*

The Company classifies cash on hand and deposits in banks, including commercial paper, money market accounts, and any other investments with an original maturity of three months or less from the date of purchase, that the Company may hold from time to time, as cash and cash equivalents. Restricted cash is primarily related to cash held in escrow at a financial institution for the collateralization of debt obligations that certain of the Company's consolidated subsidiaries and equity ventures have borrowed from such financial institution.

*Accounts Receivable*

Accounts receivable are shown at their net realizable value which approximates their fair value. The Company makes judgments as to the collectability of accounts receivable based on historical trends and future expectations. To determine the allowance for doubtful accounts, management reviews specific customer risks and the Company's accounts receivable aging. The allowance for doubtful accounts is estimated by applying estimated loss percentages against the aging of accounts receivable. Bad debt expense for the years ended December 31, 2004, 2005 and 2006 was \$10.1 million, \$8.0 million and \$4.1 million, respectively.

*Inventories*

Inventories, which are classified as other current assets, are stated at the lower of cost or market. Cost is computed on either a specific identification basis or a weighted average basis.

**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Property and Equipment*

Property and equipment is stated at cost. Depreciation is calculated on a straight-line basis over the lesser of the estimated lives, ranging from five to ten years for telecommunications equipment, and three to five years for furniture, fixtures and equipment, and five to twenty years for other property, or their contractual term. Spare parts held for stand-by use are depreciated over the estimated useful life of the related equipment. Construction in process reflects amounts incurred for the configuration and build-out of telecommunications equipment not yet placed into service. Maintenance and repairs are charged to expense as incurred. The Company has included in property and equipment, capitalized leases in the amount of \$32.5 million and \$23.9 million at December 31, 2005 and 2006, respectively, with associated accumulated depreciation of \$17.7 million and \$10.4 million as of December 31, 2005 and 2006, respectively. Amortization of assets recorded under capital leases is included with depreciation expense for the years ended December 31, 2004, 2005, and 2006.

*Goodwill and Intangible Assets*

Goodwill represents the excess of acquisition costs over the fair value of the net assets of acquired businesses. Beginning January 1, 2002, goodwill has been identified as an indefinite lived asset in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, and accordingly amortization of goodwill ceased as of that date. Intangible assets, which are stated at cost, consist principally of telecommunications service contracts, contract based customer relationships, licenses, software and content and are amortized on a straight-line basis over the lesser of their estimated useful lives, generally five to ten years, or their contractual term. In accordance with Accounting Principles Board ( APB ) Opinion No. 17, *Intangible Assets* and SFAS No. 142 *Goodwill and Other Intangible Assets*, the Company continues to evaluate the amortization period to determine whether events or circumstances warrant revised amortization periods. Additionally, the Company considers whether the carrying value of such assets should be reduced based on the future benefits.

*Goodwill Impairment Assessment*

Goodwill is reviewed annually, as of the beginning of the fourth quarter, for impairment or whenever it is determined that impairment indicators exist. The Company determines whether an impairment has occurred by assigning goodwill to the reporting units identified in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, and comparing the carrying amount of the reporting unit to the fair value of the reporting unit. If a goodwill impairment has occurred, the Company recognizes a loss for the difference between the carrying amount and the implied fair value of goodwill. No such losses were recognized in the three years ended December 31, 2004, 2005 and 2006.

*Long-Lived Assets Impairment*

Long-lived assets to be held and used by the Company are reviewed to determine whether an event or change in circumstances indicates that the carrying amount of the asset may not be recoverable. For long-lived assets to be held and used, the Company bases its evaluation on such impairment indicators as the nature of the assets, the future economic benefit of the assets, any historical or future profitability measurements, as well as other external market conditions or factors that may be present. If such impairment indicators are present or other factors exist that indicate that the carrying amount of the asset may not be recoverable, the Company determines whether an impairment has occurred through the use of an undiscounted cash flows analysis of assets at the lowest level for which identifiable cash flows exist. If impairment has occurred, the Company recognizes a loss for the difference between the carrying amount and the fair value of the asset. The fair value of the asset is measured using discounted cash flow analysis or other valuation techniques. No such losses were recognized in the three years ended December 31, 2004, 2005 and 2006.

*Income Taxes*

The Company accounts for income taxes using the liability method required by SFAS No. 109, *Accounting for Income Taxes*. Deferred income taxes result from temporary differences between the tax basis of assets and liabilities and the basis as reported in the consolidated financial statements, as well as the expected tax benefits of net operating loss carryforwards which are expected to be realized. Additionally SFAS No. 109 requires that a valuation allowance

must be established when it is more likely than not that all or a portion of deferred tax assets will not be realized. The Company does not provide for deferred taxes on the undistributed earnings of its foreign subsidiaries, as such earnings are intended to be reinvested in those operations permanently. In the case of non-consolidated entities, where the Company's partner requests that a dividend be paid, the amounts are not expected to have a material impact on the Company's income tax liability. It is not practical to determine the amount of unrecognized deferred tax liability for such reinvested earnings.



**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Revenue Recognition*

The Company records as revenue the amount of telecommunications and Internet services rendered, as measured primarily by the minutes of traffic processed and the time spent online using our Internet services. Revenue from service contracts is accounted for when the services are provided. Billings received in advance of service being performed are deferred and recognized as revenue as the service is performed. The Company also defers up front connection fees which are recognized over the estimated life of the customer. The Company recognizes revenue from equipment sales when title to the equipment passes to the customer. The Company defers the revenue on installed equipment until installation and testing are completed and accepted by the customer. Domestic Long Distance/International Long Distance ( DLD/ILD ) and zonal revenues are recorded gross or net depending on the contractual arrangements with the end-users. The Company recognizes DLD/ILD and zonal revenues from local operators net of payments to these operators for interconnection and agency fees when local operators establish end-user tariffs and assume credit risk. Revenues are stated net of any value-added taxes charged to customers.

The Company has deferred connection fees and capitalized direct incremental costs related to connection fees, not exceeding the revenue deferred. The deferral of revenue and capitalization of cost of revenue related to connection fees will be recognized over the estimated life of the customer, which is five years in the Business and Corporate Services division and Operator and Carrier Services division and eighteen months for the customers in the Mobile Services division. The total amount of deferred connection fees revenue was \$47.7 million and \$55.3 million as of December 31, 2005 and 2006, respectively. The total amount of capitalized direct incremental costs related to connection fees was \$11.5 million and \$13.0 million as of December 31, 2005 and 2006, respectively.

*Advertising*

The Company expenses the cost of advertising as incurred. Advertising expenses for the years ended December 31, 2004, 2005 and 2006 were \$4.7 million, \$4.4 million and \$9.7 million, respectively.

*Government Pension Funds*

The Company contributes to the local state pension funds and social funds, on behalf of all its CIS employees. In Russia, all social contributions, including contributions to the pension fund, are made through a unified social tax ( UST ) calculated by the application of a regressive rate from 26% to 2% to the annual gross remuneration of each employee which was 35.6% to 2% before January 1, 2005. In 2004, the Company allocated UST to three social funds, including the pension fund, where the rate of contributions to the pension fund varied from 28% to 2%, respectively, depending on the annual gross salary of each employee. Starting from January 1, 2005, the Company allocates UST to the three social funds, including the pension fund, where the rate of contribution to the pension fund varies from 20% to 2%. The contributions are expensed as incurred.

*Off Balance Sheet Risk and Concentration of Credit Risk*

Financial instruments that potentially subject the Company to concentration of credit risk consist primarily of cash, cash equivalents, and accounts and notes receivable. Of the \$18.4 million of cash and cash equivalents held at December 31, 2006, \$4.7 million was held in the United States ( US ) in US financial institutions. The remaining balance is being principally maintained in US-owned banks and local financial institutions within the CIS. The Company extends credit to various customers, principally in Russia and Ukraine, and establishes an allowance for doubtful accounts. The Company generally does not require collateral to extend credit to its customers.

*Stock-Based Compensation*

Until January 1, 2006, the Company followed the provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, for its Equity Participation Plan and Stock Appreciation Rights ( SARs ) Plans. SFAS No. 123 generally allowed companies to either account for stock-based compensation under the fair value method of SFAS No. 123 or under the intrinsic value method of APB No. 25, *Accounting for Stock Issued to Employees*. The fair value method required compensation cost to be measured at the grant date based on the value of the award and to be recognized over the service period. The Company had elected to account for its stock-based compensation in accordance with the provisions of APB No. 25 and present pro forma disclosures of results of operations as if the fair value method had been adopted.



**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The effect of applying SFAS No. 123 on the reported net income and net income per share for the years ended December 31, 2004 and 2005 are as follows:

	<b>Year Ended December 31,</b>	
	<b>2004</b>	<b>2005</b>
	<b>(in thousands, except per share data)</b>	
Net income, as reported	\$ 64,783	\$ 76,073
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	1,922	620
Pro forma net income	\$ 62,861	\$ 75,453
Net income per share:		
Basic as reported	\$ 1.79	\$ 2.09
Basic pro forma	1.74	2.07
Diluted as reported	1.77	2.08
Diluted pro forma	1.72	2.06

In December 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 123R (revised 2004), *Share Based Payment* , which is a revision of SFAS No. 123. SFAS No. 123R supersedes APB No. 25, and amends SFAS No. 95, *Statement of Cash Flows* . Under SFAS No. 123R, companies must calculate and record the cost of equity instruments, such as stock options or restricted stock, awarded to employees for services received in the income statement; pro forma disclosure is no longer permitted. The cost of the equity instruments is to be measured based on the fair value of the instruments on the date they are granted or, if the number of shares to be issued or the exercise price is unknown, remeasured at each reporting date and is required to be recognized over the period during which the employees are required to provide services in exchange for the equity instruments. In April 2005, the Securities and Exchange Commission ( SEC ) delayed the effective date of SFAS No. 123R until January 1, 2006 for calendar year companies.

The Company adopted SFAS No. 123R as of January 1, 2006 using the modified prospective method which requires the application of SFAS No. 123R in its accounting for SARs and stock options. Prior to the adoption of SFAS No. 123R, the Company accounted for SARs by remeasuring the intrinsic value of the SARs at each reporting period and adjusted compensation expense and the related liability for the change in the intrinsic value. From January 1, 2006, the Company accounts for SARs at fair value. In accordance with the modified prospective method, the consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123R.

The impact of the adoption of SFAS No. 123R was an increase in cost of revenue of approximately \$0.2 million, an increase in selling, general and administrative expense of approximately \$1.9 million, including the associated payroll taxes, and a deferred tax benefit of approximately \$0.3 million for the year ended December 31, 2006. In addition, the Company recorded a cumulative effect of a change in accounting principle of \$0.7 million, net of tax, representing the difference between the fair value and the intrinsic value of SARs at January 1, 2006. The total impact of the adoption of SFAS No. 123R was a reduction in net income of approximately \$2.5 million, net of tax, for the year ended December 31, 2006, equivalent to \$0.07 per common share basic and \$0.07 per common share diluted, representing compensation expense in connection with SARs (see Note 10). Compensation expense recorded in connection with outstanding SARs was \$19.5 million and a related tax benefit of \$2.7 million for the year ended December 31, 2006. Compensation expense recorded in connection with outstanding stock options was negligible for the year ended December 31, 2006, because the stock options were primarily vested at December 31, 2005.



**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Consolidation of Variable Interest Entities*

In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* ( FIN No. 46 ). FIN No. 46 amended Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, and established standards for determining under what circumstances a variable interest entity ( VIE ) should be consolidated with its primary beneficiary. FIN No.46 also requires disclosure about VIEs that are not required to be consolidated but in which the reporting entity has a significant variable interest. In December 2003, the FASB revised certain implementation provisions of FIN No. 46. The revised interpretation ( FIN No. 46R ) substantially retained the requirements of immediate application of FIN No. 46 to VIEs created after January 31, 2003. With respect to older VIEs, the consolidation requirements under FIN No. 46R apply not later than for the first financial year or interim period ending after December 15, 2003, if such VIE is a special-purpose entity ( SPE ), and no later than for the first financial year or interim period ending after March 15, 2004, if such a VIE is not a SPE. The Company did not identify any previously formed VIEs. Therefore the adoption of FIN No. 46R did not have an impact on the financial position or results of operations.

*Fair Value of Financial Instruments*

The carrying amounts for cash and cash equivalents, accounts receivable, notes receivable, accounts payable, accrued liabilities, and short- and long-term debt approximate their fair value. At December 31, 2005 and 2006, the Company held no debt at fixed rates.

*Exchanges of Nonmonetary Assets*

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets*. SFAS No. 153 addresses the measurement of exchanges of nonmonetary assets. SFAS No. 153 amends APB No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. 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. The provisions of SFAS No. 153 are effective for financial statements for fiscal years beginning after June 15, 2005. Earlier application is permitted for nonmonetary asset exchanges incurred during fiscal years beginning after the date SFAS No. 153 was issued. The adoption of the provisions of SFAS No. 153 did not have a material impact on the Company's results of operations, financial position or cash flow.

*Accounting Changes and Error Corrections*

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*, which is a replacement of APB Opinion No. 20, *Accounting Changes* and SFAS No. 3, *Reporting Changes in Interim Financial Statements*. SFAS No. 154 applies to all voluntary changes in accounting principle and changes the accounting for and reporting of a change in accounting principle. SFAS No. 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle unless it is impracticable. In addition, SFAS No. 154 requires that a change in method of depreciation, amortization, or depletion for long-lived, nonfinancial assets be accounted for as a change in accounting estimate that is effected by a change in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. No such accounting changes are currently contemplated.

*Changes in Accounting Estimates*

Prior to the second quarter of 2005, the Company recorded estimates for unused vacation based on the average salary levels for the Company's employees and total days of unused vacation of employees. During the second quarter of 2005, the Company revised estimates for unused vacation based on the actual daily salary and unused vacation of each employee. Management determined that this methodology results in a more accurate estimate of the amount of the Company's obligations for unused vacation. The change in accounting estimate decreased net income for the years ended December 31, 2005 by approximately \$1.3 million, net of tax, including the associated payroll taxes, (equivalent to \$0.04 per common share basic and \$0.04 per common share diluted).

During the fourth quarter of 2006, the Company revised its estimate of allowance for doubtful accounts to reflect changes in the business, recent historical collections experience and other currently available evidence. The change in

accounting estimate increased net income for the year ended December 31, 2006 by approximately \$2.4 million, net of tax (equivalent to \$0.07 per common share basic and \$0.07 per common share diluted).

87

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**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)***Use of Estimates in Preparation of Financial Statements*

The preparation of consolidated financial statements, in conformity with accounting principles generally accepted in the US, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent liabilities as of the date of the financial statements and reported amounts of revenues and expenses during the reported period. Significant estimates, among others, include the allowance for doubtful accounts, the allocation of purchase price to the fair value of net assets acquired in connection with business combinations, fair values used in goodwill impairment evaluations, and valuations of liabilities established as of the date of business acquisitions, including certain long-term contractual obligations. Actual results could differ from these estimates.

*Comparative Figures*

Certain prior year amounts have been reclassified to conform to the presentation adopted in the current year. Such reclassifications did not affect the consolidated statements of operations.

**Recent Accounting Pronouncements***Accounting for Uncertainty in Income Taxes*

In June 2006, the FASB issued FASB Interpretation No. 48 ( FIN No. 48 ), *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109* which is effective for fiscal years beginning after December 15, 2006. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company will adopt FIN No. 48 as of January 1, 2007. The Company is currently evaluating the impact of adopting FIN No. 48 on its financial condition and results of operations.

*Fair Value Measurements*

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* . SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands disclosure requirements of fair value measurements. SFAS No. 157 is applicable to other accounting pronouncements that require or permit fair value measurements, and accordingly, does not require any new fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the provisions of SFAS No. 157 to determine the potential impact, if any, the adoption of SFAS No. 157 will have on the Company's financial position or results of operations.

*Consideration of Effects of Prior Year Misstatements*

In September 2006, the SEC staff issued Staff Accounting Bulletin No. 108 ( SAB 108 ), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB 108 eliminates the diversity of practice surrounding how public companies quantify financial statement misstatements. It establishes an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the Company's financial statements and the related financial statement disclosures. SAB 108 must be applied to annual financial statements for their first fiscal year ending after November 15, 2006. The adoption of SAB 108 did not have any impact on the Company's results of operations, financial position or cash flows.

*Income Statement Presentation of Taxes Collected from Customers and Remitted to Government Authorities*

In June 2006, the Emerging Issues Task Force reached a consensus on EITF Issue No. 06-03 ( EITF No. 06-03 ), *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)* . EITF No. 06-03 provides that the presentation of taxes assessed by a governmental authority that is directly imposed on a revenue-producing transaction between a seller and a customer on either a gross basis (included in revenues and costs) or on a net basis (excluded from revenues) is an accounting policy decision that should be disclosed. The provisions of EITF No. 06-03 become effective for fiscal years beginning after December 15, 2006. The adoption of EITF No. 06-03 is not expected to have a material effect on the Company's consolidated financial position or results of operations.





**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 3: Net Income Per Share**

Basic earnings per share at December 31, 2004, 2005 and 2006 is computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share at December 31, 2004, 2005 and 2006 is computed on the basis of the weighted average number of common shares outstanding plus the effect of outstanding employee stock options using the treasury stock method. The number of stock options excluded from the diluted earnings per share computation, because their effect was antidilutive for the years ended December 31, 2004 and 2005 was 10,000 stock options and for the year ended December 31, 2006 was zero stock options.

The components of basic and diluted earnings per share were as follows:

	<b>Year Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
	<b>(in thousands, except per share data)</b>		
Net Income	\$ 64,783	\$ 76,073	\$ 85,500
Weighted average shares outstanding of:			
Common stock	36,226	36,378	36,591
Dilutive effect of:			
Employee stock options	327	227	126
Common stock and common stock equivalents	36,553	36,605	36,717
Net Income per share:			
Basic	\$ 1.79	\$ 2.09	\$ 2.34
Diluted	\$ 1.77	\$ 2.08	\$ 2.33

**Note 4: Goodwill and Intangible Assets**

Amortization expense for intangible assets for the years ended December 31, 2004, 2005 and 2006 was \$18.2 million, \$18.7 million and \$21.0 million, respectively. Amortization expense for the succeeding five years is expected to be as follows: 2007 \$20.3 million, 2008 \$18.4 million, 2009 \$13.2 million, 2010 \$12.5 million and 2011 \$12.2 million. The total gross carrying value and accumulated amortization of the Company's intangible assets by major intangible asset class is as follows:

	<b>Weighted Average Amortization Lives</b>	<b>As of December 31, 2005</b>		<b>As of December 31, 2006</b>	
		<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Cost</b>	<b>Accumulated Amortization</b>
<b>(in thousands)</b>					
Amortized intangible assets:					
Telecommunications service contracts	10 years	\$ 99,366	\$ (32,009)	\$ 119,433	\$ (49,450)
	5 years	36,849	(18,241)	42,104	(28,578)

Contract-based customer relationships					
Licenses	10 years	7,176	(3,182)	26,948	(4,295)
Other intangible assets	6 years	11,137	(7,216)	18,374	(7,991)
Total		\$ 154,528	\$ (60,648)	\$ 206,859	\$ (90,314)

The changes on the carrying amount of goodwill for the years ended December 31, 2005 and 2006, respectively, are as follows:

	<b>Business &amp; Corporate Segment</b>	<b>Carrier &amp; Operator Segment</b>	<b>Consumer Internet Segment</b>	<b>Total</b>
	(in thousands)			
Balance as of December 31, 2004	\$ 86,824	\$ 59,430		\$ 146,254
Goodwill related to acquisitions	1,563	302	1,130	2,995
Balance as of December 31, 2005	\$ 88,387	\$ 59,732	\$ 1,130	\$ 149,249
Goodwill related to acquisitions	6,215	420	1,456	8,091
Other	(133)	(35)	(717)	(885)
Foreign currency translation adjustment (see Note 2)	12,983	11,011	90	24,084
Balance as of December 31, 2006	\$ 107,452	\$ 71,128	\$ 1,959	\$ 180,539

**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 5: Business Combinations*****Acquisitions in 2004***

In February 2004, the Company completed the acquisition of 100% ownership interest in ST-HOLDING s.r.o. ( ST-HOLDINGS ), a Czech company that owns 50% plus one share in ZAO Samara Telecom, a telecommunications service provider in Samara, Russia from ZAO SMARTS and individual owners. In April 2004, the Company completed the acquisition of 100% of the common stock in OAO Balticom Mobile ( Balticom ) that owns 62% of ZAO WestBalt Telecom, an alternative telecommunications operator in Kaliningrad, Russia. In April 2004, the Company completed the acquisition of the remaining 49% ownership interest in OOO Uralrelcom that the Company did not already own. In May 2004, the Company completed the acquisition of a 54% ownership interest in SP Buzton ( Buzton ), an alternative telecommunications operator in Uzbekistan. These acquisitions were purchased for approximately \$16.0 million in cash. The results of ST-HOLDINGS have been included in the Company s consolidated operations since February 1, 2004. The results of Balticom have been included in the Company s consolidated operations since April 30, 2004. The results of Buzton have been included in the Company s consolidated operations since May 31, 2004.

The Company s consolidated financial statements reflect the allocation of the purchase price based on a fair value assessment of the assets acquired and liabilities assumed, and as such, the Company has assigned approximately \$7.4 million to telecommunications services contracts intangible assets which are amortized over a weighted average period of approximately 10 years. The excess of the purchase price over the fair value of the net assets acquired of approximately \$2.2 million has been assigned to goodwill and is not deductible for tax purposes. Approximately \$1.9 million of this goodwill has been assigned to Business and Corporate Services reportable segment and approximately \$0.3 million has been assigned to Carrier and Operator Services reportable segment. In accordance with SFAS No. 141, Business Combinations , and SFAS No. 142, Goodwill and Other Intangible Assets , the Company does not amortize the goodwill recorded in connection with the above acquisitions. The goodwill is tested for impairment at least annually.

***Acquisitions in 2005***

In March 2005, the Company completed the acquisition of 75% ownership interest in OOO Dicom ( Dicom ), an early-stage wireless broadband enterprise, for approximately \$0.5 million in cash. In conjunction with the acquisition, the Company entered into a participants agreement which provided the seller with a put option that, if exercised, would require the Company to purchase the seller s remaining 25% interest at fair market value. In addition, the participants agreement provided the Company with a call option that, if exercised, would require the seller to sell after February 1, 2008 the seller s 25% interest in Dicom at any time beginning after February 1, 2008, if Dicom s valuation exceeds targeted levels by February 1, 2008. The results of Dicom have been included in the Company s consolidated operations since March 31, 2005.

In September 2005, the Company completed the acquisition of 60% of OOO Joint Venture Sakhalin Telecom Limited ( Sakhalin Telecom ), a fixed line alternative operator in the Far East region of Russia for \$5.0 million in cash. As a result of this acquisition and combined with the Company s previous ownership in Sakhalin Telecom, the Company now owns 83% of Sakhalin Telecom. In October 2005, the Company acquired 100% of Sochitelecom, a fixed line alternative operator in the Krasnodar region of Russia, for approximately \$2.1 million in cash. The results of Sakhalin Telecom have been included in the Company s consolidated operations since September 30, 2005. The results of Sochitelecom have been included in the Company s consolidated operations since October 31, 2005.

The Company s consolidated financial statements reflect the allocation of the purchase price based on a fair value assessment of the assets acquired and liabilities assumed, and as such, the Company has assigned approximately \$2.1 million to telecommunications services contracts intangible assets which will be amortized over a weighted average period of approximately 10 years. The excess of the purchase price over the fair value of the net assets acquired of approximately \$2.1 million has been assigned to goodwill and is not deductible for tax purposes. Approximately \$1.5 million of this goodwill has been assigned to Business and Corporate Services reportable segment, approximately \$0.3 million has been assigned to Carrier and Operator Services reportable segment and

approximately \$6.3 million has been assigned to Consumer Internet Services reportable segment. In accordance with SFAS No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets, the Company will not amortize the goodwill recorded in connection with the above acquisitions. The goodwill will be tested for impairment at least annually.

**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In October 2005, the Company acquired 100% of Antel Rascom, Ltd., a British Virgin Islands company that owns 49% of ZAO Rascom ( Rascom ), an infrastructure and facilities company in northwest region of Russia, for approximately \$10.0 million in cash. In December 2005, the Company acquired an additional 5% of Rascom for approximately \$1.1 million in cash. The Company has concluded that its 54% investment in Rascom does not qualify for accounting under the consolidation method of accounting because the rights of the minority shareholder represent substantive participating rights, and as result, such rights overcome the presumption that the Company controls Rascom. Therefore, the Company accounts for this investment under the equity method.

In March 2005, the Company expensed approximately \$1.0 million in external legal, financial and consulting fees related to an acquisition opportunity the Company decided not to pursue, including advisory fees of approximately \$0.1 million paid to Alfa, a related party. In September 2005, the Company expensed approximately \$0.8 million in external legal, financial and consulting fees related to another acquisition, which the Company decided not to pursue.

***Acquisitions in 2006***

In March 2006, the Company completed the acquisition of 70% ownership interest in ZAO Tatar Intellectual Communications ( Tatintelcom ), an Internet service provider ( ISP ) in the Russian Republic of Tatarstan, for approximately \$4.0 million of cash consideration. The Company has consolidated the financial position of Tatintelcom as of March 31, 2006 and the results of operations of Tatintelcom from April 1, 2006.

The Company's consolidated financial statements reflect the allocation of the purchase price based on a fair value assessment of the assets acquired and liabilities assumed, and as such, the Company has assigned approximately \$4.8 million to right of way intangible assets which will be amortized over a weighted average period of approximately 10 years.

In April 2006, the Company completed the acquisition of 100% ownership interest in TTK LLC ( TTK ), a fixed line alternative operator in the Ivano-Frankovsk region of Ukraine, for approximately \$3.8 million consisting of cash consideration of \$3.4 million and \$0.4 recorded as a liability. The Company has consolidated the financial position of TTK from April 30, 2006 and the results of operations of TTK from May 1, 2006.

The Company's consolidated financial statements reflect the allocation of the purchase price based on a fair value assessment of the assets acquired and liabilities assumed, and as such, the Company has assigned approximately \$0.4 million to telecommunications services contracts intangible assets which will be amortized over a weighted average period of approximately 10 years. The excess of the purchase price over the fair value of the net assets acquired of approximately \$2.0 million has been assigned to goodwill and is not deductible for tax purposes. This goodwill has been assigned to Business and Corporate Services reportable segment. In accordance with SFAS No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*, the Company will not amortize the goodwill recorded in connection with the above acquisitions. The goodwill will be tested for impairment at least annually.

In June 2006, the Company completed the acquisition of 74% ownership interest in Kubtelecom LLC ( Kubtelecom ), a fixed line alternative operator in the Krasnodar region of Russia, for approximately \$10.1 million of cash consideration, plus the assumption of \$3.9 million of debt and other liabilities. The Company has consolidated the financial position of Kubtelecom from June 30, 2006. However, given the proximity of the acquisition to the Company's quarter end, consolidation of Kubtelecom's results of operations commenced from July 1, 2006. See Note 12 concerning litigation in association with the acquisition of Kubtelecom.

**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company's consolidated financial statements reflect the preliminary allocation of the purchase price based on a fair value assessment of the assets acquired and liabilities assumed, and as such, the Company has assigned approximately \$0.5 million to contract based customer relationship intangible assets which will be amortized over a weighted average period of approximately 10 years and \$0.6 million to other intangible assets which will be amortized over a weighted average period of approximately 10 years. The excess of the purchase price over the fair value of the net assets acquired of approximately \$3.7 million has been assigned to goodwill and is not deductible for tax purposes. The purchase price allocation will be finalized upon completion of the valuation of the acquired fixed and intangible assets. Approximately \$3.0 million of this goodwill has been assigned to Business and Corporate Services reportable segment, approximately \$0.4 million has been assigned to Carrier and Operator Services reportable segment, and approximately \$0.3 million has been assigned to Consumer Internet Services reportable segment. In accordance with SFAS No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*, the Company will not amortize the goodwill recorded in connection with the above acquisitions. The goodwill will be tested for impairment at least annually.

In August 2006, the Company completed the acquisition of 100% ownership interest in Telcom LLC (Telcom), a fixed line alternative operator in Nizhny Novgorod, Russia, for approximately \$1.7 million of cash consideration. The Company has consolidated the results of operations and financial position of Telcom from August 1, 2006.

The Company's consolidated financial statements reflect the allocation of the purchase price based on a fair value assessment of the assets acquired and liabilities assumed, and as such, the Company has assigned approximately \$0.1 million to telecommunications services contracts intangible assets which will be amortized over a weighted average period of approximately 10 years. The excess of the purchase price over the fair value of the net assets acquired of approximately \$0.8 million has been assigned to goodwill and is not deductible for tax purposes. This goodwill has been assigned to Business and Corporate Services reportable segment. In accordance with SFAS No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*, the Company will not amortize the goodwill recorded in connection with the above acquisitions. The goodwill will be tested for impairment at least annually.

In July 2006, the Company paid \$7.5 million in cash for the acquisition of 75% ownership interest in S-Line LLC (S-Line), an early-stage wireless broadband enterprise in Kiev, Ukraine, which closed in October 2006. The acquisition of S-Line was accounted for as an asset purchase of telecommunication licenses through a VIE. In conjunction with this transaction, the Company also entered into an agreement whereby the Company provided a secured loan of \$2.5 million to the seller with interest at 10% per annum. The loan is secured by the pledge of the remaining 25% interest in S-Line and matures in November 2010 and is recorded in other non-current assets. See Note 12 concerning a regulatory dispute in association with the acquisition of S-Line.

In October 2006, the Company completed the acquisition of 100% ownership interest in ZAO Corus ISP (Corus), an ISP in Ekaterinburg, Russia, for approximately \$1.2 million of cash consideration.

The Company's financial statements reflect the allocation of the purchase price, and as such, the Company has assigned approximately \$1.2 million to goodwill which is not deductible for the tax purpose. This goodwill has been assigned to Consumer Internet Services reportable segment. In accordance with SFAS No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*, the Company will not amortize the goodwill recorded in connection with the above acquisition. The goodwill will be tested for impairment at least annually.

Pro-forma operating results assuming all of the above business combinations had occurred as of the beginning of 2004 would not be materially different from the results of operations as presented in the accompanying consolidated financial statements.

**Note 6: Investments in and Advances to Ventures**

The Company has various investments in ventures that are accounted for by the equity method. The Company's ownership percentages in its equity method investments range from approximately 50% to 54%. Refer to Note 5 for further discussion on the accounting for the Company's 54% investment in Rascom.



**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The components of the Company's investments in and advances to ventures are as follows:

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
	<b>(in thousands)</b>	
Equity in net assets acquired	\$ 11,565	\$ 13,448
Goodwill as part of investment	1,313	1,313
Difference between fair value and historical value of assets acquired	(1,095)	(1,355)
Cash advances and other	(894)	(1,520)
<b>Total investments in and advances to ventures</b>	<b>\$ 10,889</b>	<b>\$ 11,886</b>

The Company has financed the operating and investing cash flow requirements of several of the Company's ventures in the form of cash advances. The Company aggregates all of the receivable and payable balances with the ventures in the Company's investments in and cash advances to the ventures.

The Company's approximately 23% in MCT Corp. ( MCT ) no longer qualifies for accounting under the equity method because the majority ownership of MCT is concentrated among a small group of shareholders who operate MCT without regard to the views of the Company and because the Company has attempted to obtain more financial information than is currently available to MCT's other shareholders and is unable to obtain such information.

**Note 7: Supplemental Balance Sheet Information**

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
	<b>(in thousands)</b>	
Other current assets consist of:		
Inventory	\$ 5,310	\$ 7,682
Notes receivable	1,494	379
Interest receivable	4	120
Due from related parties	703	1,227
Taxes receivable	549	6,466
Other current assets	4,949	5,444
<b>Total other current assets</b>	<b>\$ 13,009</b>	<b>\$ 21,318</b>
Other non-current assets consist of:		
Notes receivable	\$	\$ 2,500
Investments in and advances to ventures	10,889	11,886
Deferred tax asset	2	1,139
Other non-current assets	8,761	10,602
<b>Total other non-current assets</b>	<b>\$ 19,652</b>	<b>\$ 26,127</b>
Accounts payable and accrued expenses consists of:		
Accounts payable	\$ 60,043	\$ 78,799
Accrued compensation	11,322	33,367



Accrued other taxes	3,132	3,717
Accrued access and network services	12,196	27,734
Other accrued expenses	2,711	2,441
Total accounts payable and accrued expenses	\$ 89,404	\$ 146,058

**Note 8: Debt Obligations and Capital Leases**

The Company paid interest of \$0.6 million, \$0.6 million and \$0.5 million in 2004, 2005 and 2006, respectively.

Some of the Company's operating companies have received debt financing through direct loans from affiliated companies. In addition, certain operating companies have borrowed funds under a \$22.7 million back-to-back, seven-year credit facility from a ZAO Citibank ( Citibank ). Under this facility, the Company provides full cash collateral, held in London and recorded on our balance sheet as restricted cash, for onshore loans made by the bank to the Company's Russian registered ventures. In a second, similar facility, the Company provides full cash collateral for a \$10.0 million short term back-to-back, revolving, credit facility from the same bank for the Company's larger Russian operating companies. The funding level as of December 31, 2006 for all these facilities totaled \$0.2 million, of which none was funded to the Company's consolidated subsidiaries and \$0.2 million was funded to the Company's affiliates. The loan facilities carry interest at a rate equal to the three-month London Inter-Bank Offering Rate ( LIBOR ) plus 1.0 percent per annum (equivalent to approximately 6.9%, on average for loans outstanding, at December 31, 2006) and mature in July 2007.

**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In September 2006, Sovintel entered into a 90 day short term revolving credit facility for up to \$15.0 million with Citibank. As of December 31, 2006, Sovintel has borrowed \$6.6 million under this credit facility. The credit facility carries interest at a rate equal to the LIBOR plus 1.0% per annum (equivalent to approximately 6.4% at December 31, 2006). The credit facility requires Sovintel to maintain accounts with Citibank in the currencies of the loan and ensure that the aggregate amount of incoming payments credited to Sovintel's accounts with Citibank in any calendar month is equal to, or greater than 30% of the aggregate amount of the loans outstanding as of the last day of such month.

In October 2006, Sovintel entered into short-term revolving credit facility for up to 518,000,000 RUR, equivalent to \$19.7 million, with ZAO International Moscow Bank (IMB), a related party. As of December 31, 2006, Sovintel has not borrowed funds under this facility. The credit facility carries interest at a rate equal to the Moscow Prime Offered Rate plus 3% (equivalent to approximately 8.8% at December 31, 2006). The credit facility requires Sovintel to maintain accounts with IMB in the currencies of the loan and ensure that the aggregate amount of deposits credited to Sovintel's accounts with IMB is at least 150,000,000 RUR, equivalent to \$5.7 million, for each interest period during the term of the credit facility.

In July 2006, Golden Telecom (Ukraine) (GTU), the Company's subsidiary in Ukraine entered into one-year revolving, credit facility for up to \$3.5 million plus a cash coverage facility of up to \$2.0 million with Calyon Bank Ukraine (Calyon). As of December 31, 2006, GTU had borrowed \$3.9 million under this credit facility. The credit facility carries interest at a rate equal to LIBOR plus 2% for the loans denominated in USD and at prevailing bank's offered rate plus a margin of 2% for the loans denominated in Ukrainian hryvna (equivalent to approximately 15.6%, on average for loans outstanding, at December 31, 2006). The credit facility requires GTU to maintain accounts with Calyon in the currency of the loan and ensure that the aggregate amount of incoming payments credited to GTU's accounts with Calyon in any calendar month is equal to, or greater than 50% of the aggregate amount of monthly sales at least within the terms of credit facility agreement.

In August 2005, the Company entered into a lease for fiber optic capacity, including facilities and maintenance, on major routes within Ukraine. The lease has a term of five years with total payments of \$4.1 million over the term of the lease. The lease is classified as a capital lease in the balance sheet.

The following table presents minimum lease payments under capital leases:

	<b>Lease payments (in thousands)</b>
2007	\$ 876
2008	742
2009	631
2010	334
	2,583
Less: amount representing interest	239
Total principal payments	\$ 2,344

**Note 9: Shareholders' Equity***Common Stock*

In August 2005, the Company issued 27,000 restricted shares of the Company's common stock, par value \$0.01 per share, to senior management of the Company. These restricted shares gradually vest over three years.

At December 31, 2006, there were 10,286 unvested restricted shares of the Company's common stock. Unvested restricted shares of 1,907 relate to restricted shares issued to senior management of the Company in August 2005. The remaining 8,379 unvested restricted shares relate to restricted shares issued to certain members of the Board of

Directors of the Company in May 2006 and vest after one year.

The Company's outstanding shares of common stock increased by 109,000 shares and 215,097 shares in the years ended December 31, 2005 and 2006, respectively, issued in connection with the exercise of employee stock options. The Company has reserved 1,008,019 shares of common stock for issuance to certain employees and directors in connection with the 1999 Equity Participation Plan.

**Table of Contents**

**GOLDEN TELECOM, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Preferred Stock*

On May 17, 2000, the Company's shareholders authorized 10 million shares of preferred stock, none of which have been issued.

*Deferred Equity Compensation*

As required in accordance with the adoption of SFAS No. 123R, during 2006 the Company reversed \$0.5 million of unearned compensation.

*Dividends*

During 2005, the Company paid four quarterly dividends of \$0.20 per common share, for a total of \$0.80 per common share for the year. The total amount paid by the Company was \$29.1 million.

During 2006, the Company paid three quarterly dividends of \$0.20 per common share, for a total of \$0.60 per common share for the year. The total amount paid by the Company was \$22.0 million.

**Note 10: Stock Option and Stock Appreciation Rights Plans**

The Company has established the 1999 Equity Participation Plan of Golden Telecom, Inc. (the "Option Plan"). The Company has granted and intends to offer stock options to key employees and members of the Board of Directors of the Company. Under the Option Plan not more than 4,320,000 shares of common stock (subject to anti-dilution and other adjustment provisions) are authorized for issuance upon exercise of options or upon vesting of restricted or deferred stock awards. Options granted to key employees of the Company under the Option Plan vest over a three-year term from the date of grant with one-third vesting after one year and one thirty-sixth vesting each month thereafter and expire ten years from the date of grant. Options granted to members of the Board of Directors of the Company under the Option Plan vest over a one-year term from the date of grant and expire five years from the date of grant.

The fair value of options granted under the Option Plan in 2004 are estimated to be \$14.59 per common share and in 2005 are estimated to be \$13.44 per common share on the date of grant using the Black Scholes option pricing model with the following assumptions:

	<b>Year Ended December 31,</b>	
	<b>2004</b>	<b>2005</b>
Risk free interest rate	4.39%	3.86%
Dividend yield	3.0%	3.0%
Expected life (years)	3.0	3.0
Volatility	95%	88%

There were no options granted under the Option Plan in 2006.

Additional information with respect to stock options activity is summarized as follows:

	<b>Year Ended December 31,</b>					
	<b>2004</b>		<b>2005</b>		<b>2006</b>	
	<b>Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Shares</b>	<b>Weighted Average Exercise Price</b>
Outstanding at beginning of year	904,272	\$ 13.48	517,013	\$ 14.18	373,012	\$ 14.31
Options granted	5,000	26.61	2,500	26.32		
Options exercised	(374,396)	12.76	(109,000)	13.31	(215,097)	14.66
Options expired			(12,500)	20.88		
Options forfeited	(17,863)	12.00	(25,001)	14.00		

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Outstanding at end of year	517,013	14.18	373,012	14.31	157,915	13.82
Options exercisable at end of year	448,818	\$14.07	369,817	\$14.22	157,915	\$13.82

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95

**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

All stock options outstanding at December 31, 2006 were exercisable. The following table summarizes information about stock options outstanding and exercisable at December 31, 2006:

<b>Options Outstanding and Exercisable</b>			
<b>Exercise Prices at December 31, 2006:</b>	<b>Number Outstanding and Exercisable</b>	<b>Weighted Average Remaining Contractual Life (In Years)</b>	<b>Intrinsic Value (In thousands)</b>
\$ 12.00	103,997	4.5	\$ 3,623
15.63	38,918	2.8	1,215
19.45	10,000	1.4	274
26.32	2,500	3.4	51
26.61	2,500	2.4	51
	157,915		\$ 5,214

In September 2005, the Company granted SARs to the Company's Chief Executive Officer ( CEO ) with respect to 200,000 shares of the Company's common stock, at a share price which was the closing price of the Company's common stock on the NASDAQ Global Select Market on July 19, 2005 ( CEO Granting Share Price ), which was \$29.83, one-third of which shall be and become vested and nonforfeitable on each of the first three anniversary dates from September 1, 2005, provided the CEO remains continuously employed by the Company until each such relevant date. The SARs shall be fully vested if there is a change in control. If, prior to February 28, 2009 and during the CEO's period of employment with the Company, the average closing stock price of one share of the Company's common stock on the NASDAQ Global Select Market exceeded \$50.00 during any thirty day consecutive period, the CEO would be granted SARs for an additional 200,000 shares of the Company's common stock at the CEO Granting Share Price, which SARs should be fully vested upon issuance. On February 3, 2007, the Company's common stock achieved the \$50.00 threshold and CEO was granted additional fully vested SARs in respect of 200,000 shares of the Company's common stock. The SARs granted do not have a contractual term. However, all SARs shall be cancelled, and the Company shall make a payment to the CEO upon the termination of employment for any reason with respect of the SARs vested. The SARs provide for a cash only settlement and the related obligation is recorded as a liability in the consolidated financial statements.

The Golden Telecom, Inc. 2005 Stock Appreciation Rights Plan ( 2005 SAR Plan ) and the EDN Sovintel 2005 Stock Appreciation Rights Bonus Plan ( Sovintel SAR Plan ), which are approved by the Company's Board of Directors, permit the grant of SARs to the Company's senior management and employees. SAR awards are granted at a share price which is the lower of: (i) the average between the high and low sales price per share of the Company's common stock on the grant date, or in case no such sale takes place on the grant date, the last date on which a sale occurred or (ii) the average closing sales price per share of the Company common stock for the fourteen trading days immediately preceding such date ( Granting Share Price ). Seventy-five percent of the SAR grant shall be subject to time vesting, one-third of which shall be and become vested and nonforfeitable on each of the first three anniversary dates from the grant date, provided that the employee remains continuously employed by the Company until each such relevant date. The Granting Share Price shall increase by five percent on each anniversary date after the grant date in association with the SARs that shall be and become vested and nonforfeitable on each such anniversary date. Twenty-five percent of the SARs granted were subject to performance vesting upon the Company's common stock achieving a closing trading price of at least \$50.00 per share for thirty consecutive days as determined in the sole discretion of the Company. On February 22, 2007, the Company's common stock achieved the \$50.00 threshold and

the performance vesting SARs became fully vested. The SARs have a contractual term of 5 years. The aggregate number of shares of common stock which may be issued pursuant to the 2005 SAR Plan at the discretion of the grantees, shall be 200,000 shares. The SARs issued pursuant to the Sovintel SAR Plan provide for a cash only settlement. The related obligation is recorded as a liability in the consolidated financial statements.

The fair value of each SAR award is estimated at the end of each reporting period using the Monte Carlo simulation-based valuation model that uses the assumptions described in the table below. Estimated volatilities are based on historical volatility of the Company's stock for the period matching the awards' expected term. The Company uses historical data to estimate SAR exercise and employee termination within the valuation model; separate groups of employees that have similar historical exercise behavior are considered together for valuation purposes. The expected term of SARs granted is derived from the output of the SAR valuation model and represents the period of time that SARs granted are expected to be outstanding. The risk-free rate for periods within the expected term of the SAR is based on the US Treasury yield curve in effect at the end of the reporting period.

**Table of Contents**

**GOLDEN TELECOM, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	<b>Year Ended December 31, 2006</b>
Weighted-average volatility	42.5%
Expected dividend yield	1.7%
Expected term	0.12 4.75 years
Risk-free rate	4.7%

A summary of activity under the SAR Plans, including the CEO SARs, as of December 31, 2006, and changes during the year then ended is presented below:

	<b>SARs</b>	<b>Weighted Average Exercise Price</b>	<b>Aggregate Intrinsic Value (in thousands)</b>
Outstanding at January 1, 2006	1,251,800	\$29.19	
SARs granted	177,000	27.94	
SARs exercised	(20,200)	28.15	
SARs expired			
SARs forfeited	(114,800)	28.91	
Outstanding at December 31, 2006	1,293,800	29.05	\$ 23,007
Exercisable at December 31, 2006	233,217	\$28.63	\$ 4,247

The weighted-average fair value of SARs outstanding as of December 31, 2006 was \$21.50 per SAR. As of December 31, 2006, there was \$8.3 million of total unrecognized compensation cost related to non-vested SARs awards. That cost is expected to be recognized over a weighted-average requisite service period of 0.7 years.

**Note 11: Income Taxes**

The components of income before income taxes and minority interest were as follows:

	<b>Year Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
	<b>(in thousands)</b>		
Pretax income (loss):			
Domestic	\$ (4,853)	\$ (8,405)	\$ (11,176)
Foreign	101,886	125,272	142,582
	\$ 97,033	\$ 116,867	\$ 131,406

The following is the Company's significant components of the provision for income taxes attributable to continuing operations:

	<b>Year Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>



	<b>(in thousands)</b>		
Domestic current	\$	\$	\$
Domestic deferred	(373)	2,234	
Foreign current	35,350	41,630	44,242
Foreign deferred	(4,233)	(6,048)	(3,825)
	\$ 30,744	\$ 37,816	\$ 40,417

The Company paid income taxes of \$36.1 million, \$41.4 million and \$43.4 million in 2004, 2005 and 2006, respectively.

**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

US taxable income or losses recorded are reported on the Company's consolidated US income tax return. The Company was allocated its proportionate share, \$23.6 million, of GTS US net operating loss carry-forwards ( NOLs ) in 1999. As of December 31, 2006, the Company has NOLs for US federal income tax purposes of approximately \$15.4 million expiring in fiscal years between 2019 through 2026. In 2005, the Company recorded a full valuation allowance for NOLs for US federal income tax purposes of \$4.7 million. The Company also has NOLs for Cyprus tax purposes of approximately \$22.9 million that do not expire. However, the Company has also recorded a full valuation allowance for Cyprus NOLs since it does not anticipate recognizing taxable income in Cyprus.

The reconciliation of the US statutory federal tax rate of 35.0% to the Company's effective tax rate is as follows:

	<b>Year Ended December 31,</b>		
	<b>2004</b>	<b>2005</b>	<b>2006</b>
Tax expense at US statutory rates	(35.0)%	(35.0)%	(35.0)%
Non-deductible expenses	(7.3)	(4.8)	(4.7)
Foreign exchange differences	0.2	(0.3)	0.2
Different foreign tax rates	11.4	11.9	11.9
Change in valuation allowance	0.0	(4.2)	(2.4)
Other permanent differences	(1.0)	0.0	(0.8)
 Tax expense	 (31.7)%	 (32.4)%	 (30.8)%

Deferred tax assets and liabilities are recorded based on temporary differences between book bases of assets and liabilities and their bases for income tax purposes. The following table summarizes major components of the Company's deferred tax assets and liabilities:

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
	<b>(in thousands)</b>	
<b>Deferred Tax Assets:</b>		
Net operating loss carry-forwards	\$ 5,581	\$ 6,242
Accrued expenses	3,314	10,034
Deferred revenue	11,056	13,940
Intangible assets	2,595	2,359
Fixed assets	761	294
Other deferred tax assets	1,789	3,046
Valuation allowance	(8,441)	(11,550)
 Total deferred tax asset	 \$ 16,655	 \$ 24,365
 <b>Deferred Tax Liabilities:</b>		
Accrued revenue	\$	\$ 693
Deferred expenses	2,812	3,129
Intangible assets	21,337	26,606
Fixed assets	5,500	9,172
Other deferred tax liabilities	299	1,817
 Total deferred tax liability	 \$ 29,948	 \$ 41,417

Net deferred tax liability	\$ (13,293)	\$ (17,052)
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The following table presents the Company's deferred tax assets and liabilities as of December 31, 2005 and 2006 attributable to different tax paying components in different tax jurisdictions:

	<b>December 31,</b>	
	<b>2005</b>	<b>2006</b>
	<b>(in thousands)</b>	
Deferred Tax Assets:		
US tax component	\$	\$
Foreign tax component	16,655	24,365
Total deferred tax asset	\$ 16,655	\$ 24,365
Deferred Tax Liability:		
US tax component	\$	\$
Foreign tax component	29,948	41,417
Total deferred tax liability	\$ 29,948	\$ 41,417
Net deferred tax liability	\$ (13,293)	\$ (17,052)

**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 12: Commitments and Contingencies***Leases*

The Company has various cancelable and non-cancelable operating lease agreements for equipment and office space with terms ranging from one to eight years. Rental expense for operating leases aggregated \$6.5 million, \$9.8 million, and \$12.3 million for the years ended December 31, 2004, 2005 and 2006, respectively.

Future minimum lease payments under non-cancelable operating leases with terms of one year or more, as of December 31, 2006, are as follows: 2007 \$9.9 million, 2008 \$5.9 million, 2009 \$5.4 million, 2010 \$3.2 million, 2011 \$2.6 million, and thereafter \$1.6 million.

*Other Commitments and Contingencies*

The Company has future purchase commitments of \$75.5 million as of December 31, 2006, which primarily includes equipment, interconnect and satellite transponder capacity.

In the ordinary course of business, the Company has issued financial guarantees on debt for the benefit of certain of its non-consolidated ventures, which is all collateralized by cash as described in Note 8. The Company expects that all the collateralized debt will be repaid by the ventures.

*Tax Matters*

The Company's policy is to accrue for contingencies in the accounting period in which a liability is deemed probable and the amount is reasonably determinable. In this regard, because of the uncertainties associated with the Commonwealth of Independent States Taxes ( CIS Taxes ), the Company's final CIS Taxes may be in excess of the estimated amount expensed to date and accrued at December 31, 2005 and 2006. It is the opinion of management that the ultimate resolution of the Company's CIS Tax liability, to the extent not previously provided for, will not have a material effect on the financial condition of the Company. However, depending on the amount and timing of an unfavorable resolution of any contingencies associated with CIS Taxes, it is possible that the Company's future results of operations or cash flows could be materially affected in a particular period.

Sovintel is engaged in litigation with the Russian tax inspectorate in regard to claims issued by the tax inspectorate on February 1, 2006. The Russian tax inspectorate claimed that Sovintel owes taxes, fines and penalties in the amount of \$1.9 million for the years ended December 31, 2002 and 2003. On February 16, 2006, Sovintel filed a lawsuit against the tax inspectorate disputing the claims. The court ruled in favor of the Company by dismissing the tax inspectorate's claim in three instances. The tax inspectorate did not appeal this decision. The Company considers it probable that it will receive a refund in the amount of \$1.6 million previously paid to the tax inspectorate in regard to this claim.

Sovintel is engaged in litigation with the Russian tax inspectorate in regard to claims issued by the tax inspectorate on September 25, 2006. The Russian tax inspectorate claimed that Sovintel owes taxes, fines and penalties in the amount of \$21.9 million for the years ended December 31, 2004 and 2005. On October 4, 2006, Sovintel filed a lawsuit against the tax inspectorate disputing the claims. The preliminary court hearing was held on November 8, 2006. The Company expects that the first instance court decision will take place in April 2007. Currently, the Company does not consider an unfavorable outcome probable for this claim. In October 2006, IMB, a related party, provided a bank guarantee for up to 518,000,000 RUR, equivalent to \$19.7 million, for Sovintel's obligation in connection with this claim.

Starting in 2006, the Russian tax inspectorate, in the course of tax audits of Russian long-distance telecom operators, started to challenge the offset of VAT relating to the cost of international telecommunication services. Therefore, there is a risk that the Company may be assessed additional VAT, fines and penalties on similar issues. The amount of such risk relating to the years ended December 31, 2004 and 2005 is included in the \$21.9 million tax claim currently disputed, as disclosed above. The amount of similar risk relating to the year ended December 31, 2006 is assessed as being up to \$13.0 million. Should the Russian tax inspectorate assert such claim, the Company believes it has meritorious defenses to successfully dispute such claim and defend its position in court. However, due to the fact that court cases on such matters are appearing for the first time, the expected outcome of such cases is currently unclear.



**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In March 2005, the Company reversed a \$2.0 million accrued liability related to estimated taxes, including \$0.6 million related to income taxes. This accrued liability was recorded upon the acquisition of one of the Company's Russian subsidiaries. Management has concluded that the probability of this accrued liability arising in the future is remote due to the expiry of Russian regulatory statutes of limitations for any potential tax claims from the Russian tax inspectorate. The net effect of the reversal of this accrued liability was \$1.4 million reduction in selling, general and administrative expenses in the year ended December 31, 2005, and \$0.6 million reduction in intangible assets for the portion associated with income tax at December 31, 2005.

*Russian Environment and Current Economic Situation*

The Russian economy, while deemed to be of market status beginning in 2002, continues to display certain traits consistent with that of a market in transition. These characteristics have in the past included higher than normal historic inflation, lack of liquidity in the capital markets, and the existence of currency controls which cause the national currency to be illiquid outside of Russia. The continued success and stability of the Russian economy will be significantly impacted by the government's continued actions with regard to supervisory, legal, and economic reforms.

On January 1, 2004, a new Law on Communications (the Telecommunications Law) came into effect in Russia. While some of the supporting regulations to implement the Telecommunications Law have not been enacted, the Russian government approved in March 2005 new rules for interconnection (the Interconnection Rules) that became effective on January 1, 2006. These Interconnection Rules contemplate a new three-layer interconnection system consisting of domestic long distance / international long distance ( DLD/ILD ), zonal, and local operators. Under this new structure, end-users will have the right to choose a long-distance operator and DLD/ILD operators will be required to have interconnection points in each of the 88 constituent territories of the Russian Federation. In addition, the Telecommunications Law created a universal service fund ( USF ) charge, which became effective May 3, 2005, calculated as 1.2% of revenue from services provided to customers, excluding interconnection and other operators traffic routing revenue. The Company incurred approximately \$2.6 million in Russian Federation USF charges for May through December 2005 and approximately \$4.7 million in Russian Federation USF charges for the year ended December 31, 2006 which is recorded in cost of revenue.

On May 31, 2005, the Company received a DLD/ILD license in Russia valid until May 31, 2012. The Company is required under the license to begin providing services and fulfil the network requirements specified in the Interconnection Rules not later than May 31, 2007. The Company has constructed a Federal Transit Network ( FTN ) in compliance with the Telecommunications Law and the DLD/ILD license. On December 15, 2006, the Ministry of Information Technologies and Communications of the Russian Federation granted the Company access codes to operate the Company's FTN.

In a letter dated December 20, 2006, several deputies of the State Duma, wrote to the Russian General Prosecutor alleging that Sovintel was illegally providing domestic and international services prior to receipt of access codes. The letter states that because Sovintel had not yet received access codes to offer such services in the first, second and third quarter of 2006, then Sovintel was operating illegally in this respect. Further, the letter requests that the Prosecutor General's office conduct an investigation of Sovintel's activities and, if appropriate, charge those Sovintel officials responsible for the activities. Sovintel received the access codes in December 2006 and prior to construction of its FTN was operating under its previous licenses. The Company believes that it was acting in accordance with Russian regulations and legislation and its licenses.

*Other Matters*

In the ordinary course of business, the Company may be party to various legal and tax proceedings, and subject to claims, certain of which relate to the developing markets and evolving fiscal and regulatory environments in which the Company operates. In the opinion of management, the Company'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 Company.

The Company is currently engaged in litigation with a minority shareholder of Kubtelecom in regard to the shareholder's claim that the shareholder's pre-emptive right to acquire 74% ownership in Kubtelecom was breached.

The Company does not consider an unfavorable outcome probable for this claim. However, in case of an unfavorable outcome of this litigation, the Company may be forced to unwind the Kubtelecom acquisition.

The Company is currently engaged in a regulatory dispute with the NCCR over the license, recorded at \$13.3 million, for broadband radio frequencies. The Company considers the reissuance of this license probable.

**Note 13: Related Party Transactions**

Revenue and cost of revenue with the Company's equity investees, Alfa, OAO Rostelecom ( Rostelecom ), and Telenor, significant shareholders of the Company, were as follows, for the years ended December 31:

100

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**Table of Contents**

**GOLDEN TELECOM, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

	<b>2004</b>	<b>2005</b>	<b>2006</b>
		<b>(in thousands)</b>	
Revenue from equity investees	\$ 116	\$ 363	\$ 779
Revenue from Rostelecom	404	646	1,953
Revenue from Telenor	139	470	593
Revenue from Alfa	1,798	3,158	4,552
	\$ 2,457	\$ 4,637	\$ 7,877
Cost of revenue from equity investees	4,798	3,038	7,867
Cost of revenue from Rostelecom	25,809	23,979	33,721
Cost of revenue from Telenor	332	605	367
Cost of revenue from Alfa	56		
	\$ 30,995	\$ 27,622	\$ 41,955

Accounts receivable and accounts payable with the Company's Alfa, Rostelecom, and Telenor, significant shareholders of the Company, were as follows, at December 31:

	<b>2005</b>	<b>2006</b>
	<b>(in thousands)</b>	
Accounts receivable from Rostelecom	\$ 35	\$ 440
Accounts receivable from Telenor	195	107
Accounts receivable from Alfa	473	681
	\$ 703	\$ 1,228
Accounts payable from Rostelecom	2,402	4,441
Accounts payable from Telenor	68	57
Accounts payable from Alfa		7
	\$ 2,470	\$ 4,505

The Company maintains bank accounts with Alfa, which acts as one of the clearing agents for the payroll of the Russian staff of the Company. The balances at these bank accounts were minimal at December 31, 2005 and 2006. In addition, certain of the Company's Russian subsidiaries maintain current accounts with Alfa. The amounts on deposit were \$0.2 million at December 31, 2005 and \$0.3 million at December 31, 2006.

The Company maintains bank accounts with IMB. The spouse of the Company's President is a member of the Executive Board of Directors of IMB. The amounts on deposit were approximately \$2.6 million at December 31, 2005 and \$1.1 million at December 31, 2006.

In 2003, the Company incurred approximately \$0.3 million in advisory fees from Alfa in relation to the acquisition of Sibchallenge. In addition, in 2003 the Company incurred approximately \$0.1 million in advisory fees from Alfa in relation to a potential acquisition that was subsequently withdrawn from the market. In 2005, the Company expensed approximately \$0.1 million in advisory fees from Alfa in relation to a potential acquisition opportunity the Company



decided not to pursue.

The Company purchased consulting services from Alfa in the amount of \$0.7 million and \$0.5 million in the years ended December 31, 2005 and 2006, respectively.

In December 2003, the Company entered into a one year agreement with Alfa to provide the Company with property and equipment liability insurance. The amount payable under this agreement was approximately \$0.2 million. The Company extended this agreement until February 2005 and in February 2005, the Company entered into a one year agreement with Alfa, to provide the Company with property and equipment liability insurance. The amount payable under this agreement is approximately \$0.4 million. In 2006, the Company has entered into various agreements with Alfa to provide the Company with property and equipment liability insurance expiring in 2007. The amount payable under these agreements is approximately \$0.4 million.

A member of the Company's Board of Directors is a relative of the general director of two Russian based telecommunications services providers. The Company received revenue from these two telecommunications services providers in the amount of \$5.3 million, \$5.1 million and \$6.9 million for the years ended December 31, 2004, 2005 and December 31, 2006, respectively and incurred costs to these two telecommunications services providers in the amount of approximately \$1.9 million, \$1.3 million and \$1.3 million in the years ended December 31, 2004, 2005 and December 31, 2006, respectively. At December 31, 2005, the Company had accounts receivable of approximately \$0.9 million and zero accounts payable with these two telecommunications services providers. At December 31, 2006, the Company had accounts receivable of approximately \$3.4 million and accounts payable of \$0.3 million with these two telecommunications services providers.

Table of Contents**GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 14: Segment Information****Line Of Business Data**

The Company operates in four segments within the telecommunications industry. The four segments are: (1) Business and Corporate Services; (2) Carrier and Operator Services; (3) Consumer Internet Services; and (4) Mobile Services. The following tables present financial information for both consolidated subsidiaries and equity investee ventures, segmented by the Company's lines of business for the years ended December 31, 2004, 2005 and 2006, respectively. Transfers between lines of businesses are included in the adjustments to reconcile segment to consolidated results. The Company evaluates performance based on the operating income (loss) of each strategic business unit, among other performance measures.

	Business and Corporate	Carrier and Operator	Consumer Internet	Mobile Services	Corporate & Eliminations (in thousands)	Business Segment Total	Consolidated Results	Adjustments to Reconcile Business Segment to Consolidated Results Equity	Method Venture	Affiliate Adjustments
<b>Year Ended December 31, 2004</b>										
Revenue from external customers	\$324,814	\$198,027	\$45,515	\$15,808	\$	\$584,164	\$583,978	\$(4,710)	\$4,524	
Intersegment revenue		1,016			(1,016)					
Operating income (loss)	72,345	28,637	2,159	4,729	(11,756)	96,114	95,536	(578)		
Identifiable assets	435,276	261,424	57,732	5,693	49,562	809,687	805,768	(3,919)		
Capital expenditures	80,107	33,223	4,920	1,025	178	119,453	118,101	(1,352)		



**Table of Contents**

**GOLDEN TELECOM, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Geographic Data**

Revenues from external customers are based on the location of the operating company providing the service.

The Company operated within two main geographic regions of the CIS: Russia and Ukraine. Geographic information as of December 31, 2004, 2005 and 2006 is as follows:

	Russia	Ukraine	Corporate, Other Countries & Eliminations (in thousands)	Consolidated Results
<b>Year ended December 31, 2004</b>				
Revenue	\$522,018	\$64,455	\$ (2,495)	\$583,978
Long-lived assets	563,856	27,995	11,116	602,967
<b>Year ended December 31, 2005</b>				
Revenue	\$593,640	\$73,816	\$ (77)	\$667,379
Long-lived assets	611,788	44,801	14,092	670,681
<b>Year ended December 31, 2006</b>				
Revenue	\$766,169	\$81,819	\$ 6,629	\$854,617
Long-lived assets	780,737	78,381	16,434	875,552

**Note 15: Supplemental Cash Flow Information**

The following table summarizes significant non-cash investing and financing activities for the Company.

	Year Ended December 31, (in thousands)		
	2004	2005	2006
Amounts payable in connection with business acquisitions	\$400	\$ 885	\$378
Capitalized leased assets		3,580	

**Note 16: Long Term Incentive Bonus Program**

In July 2004, the Board of Directors of the Company adopted a Long Term Incentive Bonus Program ( LTIBP ) for senior management of the Company, effective as of January 1, 2004. In February 2006, the Board of Directors of the Company discontinued the LTIBP effective January 1, 2005. Accordingly, in the fourth quarter of 2005 the Company recorded a reduction in compensation expense of \$1.8 million. During the year ended December 31, 2005 the Company did not record any expense associated with the LTIBP. The Company has not granted any shares under the LTIBP.

**Note 17: Sale of Minority Interest in Subsidiary**

Recognizing that many of the markets in which the Company operates are complex, in particular as it relates to business, regulatory, political and cultural matters, the Company occasionally seeks experienced local partners to assist in markets where the Company is likely to encounter operational difficulties. GTI has been cooperating with local partners in Ukraine to resolve commercial and regulatory disputes with monopoly operators and regulatory authorities in Ukraine but had not previously finalized the compensation arrangement for the services. In addition to or in lieu of cash compensation, the Board of Directors approved the sale of a non-controlling interest in GTU to such parties.

**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Upon approval of GTI's Board of Directors, in August 2004 the Company entered into a compensation arrangement for services provided to assist the Company in addressing commercial and regulatory disputes with monopoly operators and regulatory authorities in Ukraine. The Company's local partners have provided services on a success fee basis. The Company's Board of Directors approved an arrangement that effectively transferred 20% of the shares in GTU owned by the Company to the local partners as compensation for the services already provided and certain additional services to be provided. Under this arrangement, the Company paid the local partners \$0.5 million in cash and granted the local partners an option to purchase 20% of GTU for \$0.5 million in cash, in a transaction where the cash and the value of the services were approximately \$3.6 million. This transaction closed in the third quarter of 2004, when the performance was completed and the option was exercised and resulted in a charge to operating income of approximately \$3.6 million. The excess of the fair value of consideration exchanged for services over the book value of 20% of net assets of GTU was recorded as a credit to the consolidated equity. Fair value of the option approximated the fair value of shares transferred to the local partner due to the short exercise period of the option and was determined using the discounted cash flow valuation method.

In December 2005, in connection with an increase of GTU registered capital, the Company received a \$3.8 million cash contribution from the minority partner of GTU.

**Note 18: Quarterly Financial Data (Unaudited)**

Summarized quarterly financial data is as follows:

	<b>For the Three Months Ended</b>			
	<b>March 31,</b>	<b>June 30,</b>	<b>September</b>	<b>December</b>
	<b>2005</b>	<b>2005</b>	<b>30,</b>	<b>31,</b>
	<b>2005</b>			
	<b>(in thousands, except per share data)</b>			
Revenues	\$ 156,465	\$ 165,509	\$ 169,930	\$ 175,475
Access and network services (excluding depreciation and amortization)	79,997	86,191	88,345	92,999
Gross Margin	76,468	79,318	81,585	82,476
Selling, general and administrative (excluding depreciation and amortization)	27,586	28,828	30,967	32,509
Net income	20,027	19,767	18,395	17,884
Net income per share(1)- basic	0.55	0.54	0.51	0.49
Net income per share(1)- diluted	0.55	0.54	0.50	0.49
	<b>For the Three Months Ended</b>			
	<b>March 31,</b>	<b>June 30,</b>	<b>September</b>	<b>December 31,</b>
	<b>2006</b>	<b>2006</b>	<b>30,</b>	<b>2006 (2)(3)</b>
	<b>2006</b>			
	<b>(in thousands, except per share data)</b>			
Revenues	\$ 178,140	\$ 196,968	\$ 228,717	\$ 250,792
Access and network services (excluding depreciation and amortization)	93,393	105,608	128,153	147,235
Gross Margin	84,747	91,360	100,564	103,557
Selling, general and administrative (excluding depreciation and amortization)	33,881	33,569	37,505	47,853(4)
Net income	18,785	22,645	24,229	19,841
Net income per share(1)-basic	0.52	0.62	0.66	0.54
Net income per share(1)- diluted	0.51	0.62	0.66	0.54

- (1) The sum of the earnings per share for the four quarters will generally not equal earnings per share for the total year due to changes in the average number of common shares outstanding.
- (2) The operating results for the fourth quarter of 2006 include the impact of a \$3.1 million change in estimate with respect to the Company's allowance for doubtful accounts.
- (3) The operating results for the fourth quarter of 2006 include the impact of \$2.6 million due to the reversal of liabilities to a former shareholder because of the expiration of the statute of limitations.
- (4) Includes SARs expense of \$13.8 million.

**Table of Contents****GOLDEN TELECOM, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 19: Subsequent Events**

In January 2007, GTI and two wholly-owned subsidiaries, GTS Finance, Inc. ( GFI ) and Sovintel entered into a five-year term Facility Agreement (the Facility Agreement ) with banks, financial institutions and other institutional lenders, Citibank, N.A. London Branch and ING Bank N.V. as mandated lead arrangers, and Citibank International plc as agent. The Facility Agreement establishes an unsecured credit facility under which the Company, GFI, and Sovintel may borrow up to an aggregate of \$275.0 million. Funds borrowed may be used for general corporate purposes, including acquisitions, the payment of dividends and capital expenditures. The Facility Agreement carries interest at LIBOR plus 1.5% per annum for the first twenty-four months and LIBOR plus 2.0% per annum thereafter.

In February 2007, the Company completed the acquisition of 65% ownership interest in Fortland Limited ( Fortland ), which owns Kolangon-Optim LLC, an early-stage digital video broadcast enterprise in Russia, for approximately \$49.7 million consisting of cash consideration of \$38.6 million and \$11.1 million to be settled in cash upon satisfactory achievement of certain conditions plus the assumption of up to \$1.6 million debt. In conjunction with this transaction, the Company also entered into an agreement whereby the Company agreed to provide a secured loan of \$12.1 million to the seller. The loan is secured by a pledge of the 15% interest in Fortland and matures in April 2011. In conjunction with this transaction, the Company also entered into a put option agreement that, if exercised, would require the Company to purchase the seller's remaining 35% interest in Fortland at fair market value. In conjunction with this transaction, the Company also entered into a call option agreement that, if exercised, would require the seller to sell the seller's remaining 35% interest in Fortland at fair market value. The put and call options are exercisable on and after September 30, 2010.

In February 2007, Sovintel and GTI entered into a Stock Purchase Agreement ( SPA ) with Inure Enterprises Ltd. ( Inure ) and Rambert Management Limited ( Rambert ) to acquire the 51% ownership interest in ZAO Cortec and its subsidiaries (together Corbina ). Inure owns 99% of the issued and outstanding shares Corbina. As of the closing date, Rambert shall be the owner of 1% of Corbina. Upon closing Inure will receive \$10.0 million in cash and will be issued GTI common stock such that Inure will hold 8% of the outstanding common shares of GTI immediately following the closing. GTI and Inure have also entered into a Registration Rights Agreement. The transaction is conditioned upon, among other things, the receipt of all necessary regulatory approvals in Russia. Additionally, prior to the closing, Sovintel shall refinance up to \$45.0 million of debt out of the approximately \$90.0 million of debt that Inure owes to JSC Vneshtorgbank. The refinancing will be effected through a loan to Corbina from the Company. The Company expects to close this acquisition in the second half of 2007.

In March 2007, Sovintel responded by letter to Rossvyaznadzor concerning allegations by Rossvyaznadzor of improper routing of traffic by Sovintel. Rossvyaznadzor is the Russian government agency responsible for the control and supervision of information technology and communications. Rossvyaznadzor had warned Sovintel that it should remedy certain alleged violations in traffic routing, following an inspection by Rossvyaznadzor of certain telephone calls of an independent operator. Following the warning, Sovintel conducted its own investigation of the calls and determined that many of the calls were not made through its network and, of those calls that did go through its network, all were routed in accordance with existing regulations and Sovintel's license.

**Table of Contents**

**ITEM 9. *Changes In and Disagreements with Accountants on Accounting and Financial Disclosure***

None

**ITEM 9A. *Controls and Procedures***

**Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of December 31, 2006, the Company's disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms.

**Management's Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2006 based on the framework in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on that evaluation, our management concluded that our internal control over financial reporting was effective as of December 31, 2006.

Management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006 has been audited by Ernst & Young LLC, an independent registered public accounting firm, as stated in their report which is included elsewhere herein.

**Changes in Internal Control over Financial Reporting**

There were no changes in our internal control over financial reporting during the fourth quarter of 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Shareholders of Golden Telecom, Inc.

We have audited management's assessment, included in the accompanying Management Report on Internal Control Over Financial Reporting, that Golden Telecom, Inc. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Golden Telecom, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of the internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

In our opinion, management's assessment that Golden Telecom, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Golden Telecom, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Golden Telecom, Inc. as of December 31, 2005 and 2006, and the related consolidated statements of operations, cash flows, and shareholders' equity for each of the three years in the period ended December 31, 2006, and our report dated March 15, 2007 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLC

Moscow, Russia

March 15, 2007

**Table of Contents**

**ITEM 9B. *Other Information***

108

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**Table of Contents****PART III****ITEM 10. Directors and Executive Officers of the Registrant**

The information required by Item 10 (other than the information required by Item 406 of Regulation S-K) is incorporated herein by reference to the section entitled "Election of Directors", "Executive Officers" and "Section 16(a) Beneficial Ownership Reporting Compliance" of our proxy statement for our 2007 Annual Meeting of Shareholders that we will file by April 30, 2007.

The Company has adopted its "Conduct Guidelines", a code of ethics that applies to all employees, including its executive officers. A copy of the Conduct Guidelines is posted on the Company's Internet site at <http://www.goldentelecom.com>. In the event that the Company makes any amendment to, or grants any waivers of, a provision of the Conduct Guidelines that applies to the principal executive officer, principal financial officer, or principal accounting officer that requires disclosure under applicable SEC rules, the Company intends to disclose such amendment or waiver and the reasons therefore on its Internet site.

**ITEM 11. Executive Compensation**

The information required by Item 11 is incorporated herein by reference to the section entitled "Executive Compensation" of our proxy statement for our 2007 Annual Meeting of Shareholders that we will file by April 30, 2007.

**ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The information required by Item 12 (other than the information required by Item 201(d) of Regulation S-K) is incorporated herein by reference to the section entitled "Common Stock Ownership of Certain Beneficial Owners and Management" of our proxy statement for our 2007 Annual Meeting of Shareholders that we will file by April 30, 2007.

The information with respect to Item 201(d) of Regulation S-K as of December 31, 2006 is as follows:

**Equity Compensation Plan Information**

The following table provides information on securities that were authorized for issuance under equity compensation plans as of December 31, 2006:

	(a)	(b)	(c)
<b>Plan category</b>	<b>Number of securities to be issued upon exercise of outstanding options, warrants and rights</b>	<b>Weighted-average exercise price of outstanding options, warrants and rights</b>	<b>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)).</b>
Equity compensation plan approved by security holders	357,915	\$ 22.19	853,271
Total	357,915		853,271

Please refer to Note 10 "Stock Option and Stock Appreciation Rights Plans" of the Audited Financial Statements contained within this document, for a description of our equity compensation plans.

**ITEM 13. Certain Relationships and Related Transactions**

The information required by Item 13 is incorporated herein by reference to the section entitled "Certain Relationships and Related Transactions" of our proxy statement for our 2007 Annual Meeting of Shareholders that we will file by April 30, 2007.

**ITEM 14. *Principal Accountant Fees and Services***

The information required by Item 14 is incorporated herein by reference to the section entitled *Ratification of Appointment of Auditors* of our proxy statement for our 2007 Annual Meeting of Shareholders that we will file by April 30, 2007.

**Table of Contents**

**PART IV**

**ITEM 15. Exhibits and Financial Statement Schedules**

a) The following documents are filed as part of this report:

*1. Financial Statements*

The following consolidated financial statements of the Company are included as part of this document:

- § Report of Independent Registered Public Accounting Firm
- § Consolidated Balance Sheets as of December 31, 2005 and 2006
- § Consolidated Statements of Operations for the years ended December 31, 2004, 2005 and 2006
- § Consolidated Statements of Cash Flows for the years ended December 31, 2004, 2005 and 2006
- § Consolidated Statements of Changes in Shareholders' Equity for the years ended December 31, 2004, 2005 and 2006
- § Notes to Consolidated Financial Statements

*2. Consolidated Financial Statement Schedules*

We have furnished Schedule II - Valuation and Qualifying Accounts on Page 114.

All other schedules are omitted because they are not applicable or not required, or because the required information is either incorporated herein by reference or included in the financial statements or notes thereto included in this report.

b) Exhibits

Exhibit Number	Description of Exhibit
3.1	Amended and Restated Certificate of Incorporation of Golden Telecom, Inc. (Incorporated herein by reference to Exhibit 3.1 to the Company's registration statement on Form S-1 dated July 14, 1999 and amendments (Commission File No. 333-82791)).
3.2	Amended and Restated By-laws of Golden Telecom, Inc. (Incorporated by reference to Exhibit 3.1 to the Company's current report on Form 8-K dated December 12, 2005).
4.1	Specimen certificate representing shares of Common Stock. (Incorporated by reference to Exhibit 4.1 to the Company's registration statement on Form S-1 dated July 14, 1999 (Commission File No. 333-82791)).
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110

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\* Filed herewith.

**Table of Contents****SIGNATURES**

Pursuant to the requirements of the Section 13 or 15(d) of the Securities Exchange Act 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Moscow, Russian Federation, on this 16th day of March 2007.

GOLDEN TELECOM, INC.  
(Registrant)

By: /s/ BORIS SVETLICHNY

Name: Boris Svetlichny  
Title: Senior Vice President, Chief Financial  
Officer and Treasurer  
(Principal Financial Officer)

By: /s/ MICHAEL D. WILSON

Name: Michael D. Wilson  
Title: Vice President and Corporate  
Controller  
(Principal Accounting Officer)

We, the undersigned officers and directors of Golden Telecom, Inc. hereby severally constitute and appoint, Boris Svetlichny, Ilya Smirnov and Michael Wilson and each of them singly, as his true and lawful attorney-in-fact and agents with full power of substitution and resubstitution, for him, and in his name, place and stead, in any and all capacities to sign any and all amendments and supplements to this annual report on Form 10-K and all amendments thereto, and to file the same, with all exhibits thereto, and all other documents in connection therewith, in each case, with our names and on our behalf in our capacities as officers and directors to enable Golden Telecom, Inc. to comply with the provisions of the Securities Exchange Act of 1934, as amended, and all requirements of the Securities and Exchange Commission, hereby ratifying and confirming our signatures as they may be signed by our said attorney to said annual report on Form 10-K and any and all amendments thereto.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons in the capacities indicated

<b>Signature</b>	<b>Title</b>	<b>Date</b>
/s/ JEAN-PIERRE VANDROMME Jean-Pierre Vandromme	Chief Executive Officer and Director (Principal Executive Officer)	March 16, 2007
/s/ PETER AVEN Peter Aven	Chairman of the Board of Directors	March 16, 2007
/s/ VLADIMIR BULGAK Vladimir Bulgak	Director	March 16, 2007
/s/ PATRICK GALLAGHER	Director	March 16, 2007

Patrick Gallagher

/s/ DAVID HERMAN                      Director                                      March 16, 2007

David Herman

/s/ KJELL JOHNSEN                      Director                                      March 16, 2007

Kjell Johnsen

/s/ ALEXEY KHUDYAKOV                      Director                                      March 16, 2007

Alexey Khudyakov

/s/ OLEG MALIS                              Director                                      March 16, 2007

Oleg Malis

/s/ RONNY NAEVDAL                      Director                                      March 16, 2007

Ronny Naevdal

/s/ DAVID SMYTH                              Director                                      March 16, 2007

David Smyth

/s/ BORIS SVETLICHNY                      Senior Vice President, Chief  
Financial Officer and Treasurer  
(Principal Financial Officer)                      March 16, 2007

Boris Svetlichny

/s/ MICHAEL D. WILSON                      Vice President and Corporate  
Controller (Principal Accounting  
Officer)                                      March 16, 2007

Michael D. Wilson

**Table of Contents**

**SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS**  
**Golden Telecom, Inc.**  
(In Thousands)

COL. A	COL. B	COL. C		COL. D	COL. E
<b>Description</b>	<b>Balance at Beginning of Period</b>	<b>Charged to Costs and Expenses</b>	<b>Additions Reserves From Acquisitions</b>	<b>Deductions</b>	<b>Balance at End of Period</b>
Allowance for doubtful accounts at 12/31/06	\$27,327	\$ 4,128	\$	\$(6,231)	\$25,224
Allowance for doubtful accounts at 12/31/05	23,205	7,967	53	(3,898)	27,327
Allowance for doubtful accounts at 12/31/04	13,896	10,065	117	(873)	23,205

114

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