GOLDEN TELECOM INC
Form 10-Q
November 08, 2005

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2005
(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.)

Representative Office Golden TeleServices, Inc.
1 Kozhevnichesky Proezd
Moscow, Russia 115114
(Address of principal executive office)
(011-7-501) 797-9300
(Registrant s telephone number, including area code)

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 þ No o

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes þ No o

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

At November 8, 2005, there were 36,425,990 outstanding shares of common stock of the registrant.

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* Please refer to the special note regarding forward-looking statements in this section.

PART I. FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements of Golden Telecom, Inc.

GOLDEN TELECOM, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands of US$, Except Share Data)

	December 31, 2004 (audited)	September 30, 2005 (unaudited)
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 53,699	$ 85,950
Accounts receivable, net of allowance for doubtful accounts of $23,205 and $28,290 at December 31, 2004 and September 30, 2005, respectively	89,177	98,718
VAT receivable	19,022	19,384
Prepaid expenses and advances to suppliers	13,793	11,171
Deferred tax asset	7,863	8,827
Other current assets	16,738	14,607
TOTAL CURRENT ASSETS	200,292	238,657
Property and equipment, net of accumulated depreciation of $185,781 and $229,866 at December 31, 2004 and September 30, 2005, respectively	347,891	374,212
Goodwill and intangible assets:		
Goodwill	146,254	148,507
Intangible assets, net of accumulated amortization of $41,999 and $55,422 at December 31, 2004 and September 30, 2005, respectively	101,316	93,743
Net goodwill and intangible assets	247,570	242,250
Restricted cash	1,012	563
Other non-current assets	9,003	9,197
TOTAL ASSETS	$ 805,768	$ 864,879

See notes to condensed consolidated financial statements.

GOLDEN TELECOM, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In Thousands of US$, Except Share Data)

	December 31, 2004 (audited)	September 30, 2005 (unaudited)
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES		
Accounts payable and accrued expenses	$ 81,474	$ 89,778
VAT payable	14,235	18,557
Current capital lease obligations	2,301	2,429
Deferred revenue	11,761	15,103
Due to affiliates and related parties	3,199	1,981
Other current liabilities	3,572	3,174
TOTAL CURRENT LIABILITIES	116,542	131,022
Long-term debt, less current portion	200	253
Long-term deferred tax liability	24,244	23,551
Long-term deferred revenue	23,124	28,928
Long-term capital lease obligations	1,538	2,812
Other non-current liabilities	2,001	
TOTAL LIABILITIES	167,649	186,566
Minority interest	11,738	14,329
SHAREHOLDERS EQUITY		
Preferred stock, $0.01 par value (10,000,000 shares authorized; none issued and outstanding at December 31, 2004 and September 30, 2005)		
Common stock, $0.01 par value (100,000,000 shares authorized; 36,322,490 and 36,425,990 shares issued and outstanding at December 31, 2004 and September 30, 2005, respectively)	363	364
Additional paid-in capital	669,777	671,018
Accumulated deficit	(43,759)	(7,398)
TOTAL SHAREHOLDERS EQUITY	626,381	663,984
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$ 805,768	$ 864,879

See notes to condensed consolidated financial statements.

GOLDEN TELECOM, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In Thousands of US$, Except Per Share Data)
(unaudited)

	Three Months Ended September 30, 2004	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2005
REVENUE:				
Telecommunication services	$ 152,213	$ 168,716	$ 423,129	$ 488,706
Revenue from affiliates and related parties	500	1,214	1,631	3,198
TOTAL REVENUE	152,713	169,930	424,760	491,904
OPERATING COSTS AND EXPENSES:				
Access and network services (excluding depreciation and amortization)	77,953	88,345	216,447	254,533
Selling, general and administrative (excluding depreciation and amortization)	29,518	30,967	81,029	87,381
Depreciation and amortization	19,504	20,594	55,184	60,465
TOTAL OPERATING COSTS AND EXPENSES	126,975	139,906	352,660	402,379
INCOME FROM OPERATIONS	25,738	30,024	72,100	89,525
OTHER INCOME (EXPENSE):				
Equity in earnings of ventures	7	669	250	501
Interest income	241	772	781	1,672
Interest expense	(123)	(94)	(473)	(531)
Foreign currency losses	(443)	(125)	(667)	(364)
TOTAL OTHER INCOME (EXPENSE)	(318)	1,222	(109)	1,278
Income before minority interest and income taxes	25,420	31,246	71,991	90,803
Minority interest	245	837	784	2,102
Income taxes	9,064	12,014	23,536	30,512
NET INCOME	$ 16,111	$ 18,395	$ 47,671	$ 58,189
Basic earnings per share of common stock:				

Net income per share basic	$	0.44	$	0.51	$	1.32	$	1.60
Weighted average common shares basic		36,278		36,411		36,200		36,356
Diluted earnings per share of common stock:								
Net income per share diluted	$	0.44	$	0.50	$	1.30	$	1.59
Weighted average common shares diluted		36,551		36,637		36,544		36,595
Cash dividends per common share	$		$	0.20	$	0.40	$	0.60

See notes to condensed consolidated financial statements.

GOLDEN TELECOM, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands of US$)
(unaudited)

	Nine Months Ended September 30,	
	2004	**2005**
OPERATING ACTIVITIES		
Net income	$ 47,671	$ 58,189
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Depreciation	41,606	47,021
Amortization	13,578	13,444
Equity in earnings of ventures	(250)	(501)
Foreign currency losses	667	364
Other	(67)	232
Changes in assets and liabilities:		
Accounts receivable	(15,535)	(8,602)
Accounts payable and accrued expenses	22,079	10,071
VAT, net	2,984	3,849
Other changes in assets and liabilities	(2,895)	4,235
NET CASH PROVIDED BY OPERATING ACTIVITIES	109,838	128,302
INVESTING ACTIVITIES		
Purchases of property and equipment and intangible assets	(86,062)	(70,330)
Acquisitions, net of cash acquired	(15,022)	(4,791)
Restricted cash	(5)	449
Other investing	932	2,243
NET CASH USED IN INVESTING ACTIVITIES	(100,157)	(72,429)
FINANCING ACTIVITIES		
Repayments of debt	(525)	
Proceeds from exercise of employee stock options	4,220	1,003
Cash dividends paid	(14,478)	(21,828)
Other financing	(2,540)	(2,660)
NET CASH USED IN FINANCING ACTIVITIES	(13,323)	(23,485)
Effect of exchange rate changes on cash and cash equivalents	(249)	(137)
Net increase (decrease) in cash and cash equivalents	(3,891)	32,251
Cash and cash equivalents at beginning of period	65,180	53,699

CASH AND CASH EQUIVALENTS AT END OF PERIOD	$	61,289	$	85,950

See notes to condensed consolidated financial statements.

GOLDEN TELECOM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Basis of Presentation

Golden Telecom, Inc. (the Company) is a provider of a broad range of telecommunications services to businesses, other telecommunications service providers and consumers. The Company provides these services through its operation of voice, Internet and data networks, international gateways, local access and various value-added services in the Commonwealth of Independent States (CIS), primarily in Russia, and through its fixed line and mobile operations in Ukraine.

The financial statements included herein are unaudited and have been prepared in accordance with generally accepted accounting principles in the United States of America (US GAAP) for interim financial reporting and United States Securities and Exchange Commission (SEC) regulations. Certain information and footnote disclosures normally included in complete financial statements prepared in accordance with US GAAP and SEC rules and regulations have been condensed or omitted pursuant to such US GAAP and SEC rules and regulations. In the opinion of management, the financial statements reflect all adjustments of a normal and recurring nature necessary to present fairly the Company s financial position, results of operations and cash flows for the interim periods. These financial statements should be read in conjunction with the Company s 2004 audited consolidated financial statements and the notes related thereto. The results of operations for the three and nine months ended September 30, 2005, may not be indicative of the operating results for the full year.

Note 2: Summary of Significant Accounting Policies and New Accounting Pronouncements

Summary of Significant Accounting Policies

Goodwill and Intangible Assets

The total gross carrying value and accumulated amortization of the Company s intangible assets by major intangible asset class is as follows:

	As of December 31, 2004		As of September 30, 2005	
	(in thousands)			
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Amortized intangible assets:				
Telecommunications service contracts	$ 92,250	$ (21,917)	$ 96,164	$ (28,949)
Contract-based customer relationships	36,849	(10,883)	36,849	(16,478)
Licenses	4,358	(2,515)	5,348	(2,997)
Other intangible assets	9,858	(6,684)	10,804	(6,998)
Total	$ 143,315	$ (41,999)	$ 149,165	$ (55,422)

Other intangible assets include software, Internet software and related content, as well as other intangible assets.

Comprehensive Income

Comprehensive income is defined as the change in equity of a business enterprise during a period from non-owner sources. For the three and nine months ended September 30, 2004, and 2005, respectively, comprehensive income for the Company is equal to net income.

GOLDEN TELECOM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock-Based Compensation

The Company follows the provisions of Statement of Financial Accounting Standard (SFAS) No. 123, Accounting for Stock-Based Compensation, for its Equity Participation Plan. SFAS No. 123 establishes a fair value method of accounting for employee stock options and similar equity instruments. The fair value method requires compensation cost to be measured at the grant date based on the value of the award and to be recognized over the service period. SFAS No. 123 generally allows 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 Company has elected to account for its stock-based compensation in accordance with the provisions of APB No. 25 and to present pro forma disclosures of results of operations as if the fair value method had been adopted.

The effect of applying SFAS No. 123 on the reported net income, as disclosed below is not representative of the effect on net income in future periods due to the vesting period of the stock options and the fair value of additional stock options in future periods.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	**2005**	**2004**	**2005**
		(in thousands, except per share data)		
Net income, as reported	$ 16,111	$ 18,395	$ 47,671	$ 58,189
Deduct: total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	454	145	1,357	475
Pro forma net income	$ 15,657	$ 18,250	$ 46,314	$ 57,714
Net income per share:				
Basic as reported	$ 0.44	$ 0.51	$ 1.32	$ 1.60
Basic pro forma	0.43	0.50	1.28	1.59
Diluted as reported	0.44	0.50	1.30	1.59
Diluted pro forma	0.43	0.50	1.27	1.58

Income Taxes

The Company accounts for income taxes using the liability method required by SFAS No. 109, Accounting for Income Taxes. For interim reporting purposes, the Company also follows the provisions of APB No. 28, Interim Financial Reporting, which requires the Company to account for income taxes based on the Company s best estimate of the effective tax rate expected to be applicable for the full fiscal year on a current year-to-date basis. The rate so determined is based on the tax rates currently applicable to the Company in the United States and to the Company s subsidiaries in Russia and other CIS countries and includes the Company s best estimate of the annual tax effect of non-deductible expenses, primarily related to amortization of intangible assets, foreign exchange and other permanent differences as well as estimates as to the realization of certain deferred tax assets. 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. The Company does not provide for deferred taxes on the undistributed earnings of its foreign subsidiaries, as such earnings are generally intended to be reinvested in those operations permanently. In the case of non-consolidated entities, where our 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.

Use of Estimates in Preparation of Financial Statements

The preparation of these consolidated financial statements, in conformity with US GAAP, requires management to make estimates and assumptions that affect amounts in the financial statements and accompanying notes and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

GOLDEN TELECOM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Comparative Figures

Certain 2004 amounts have been reclassified to conform to the presentation adopted in the current year.

Recent Accounting Pronouncements

In December 2004, Financial Accounting Standards Board (FASB) issued SFAS No. 123R, Share Based Payment , which is a revision of SFAS No. 123, Accounting for Stock-Based Compensation 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 (with certain exceptions) and is required to be recognized over the period during which the employees are required to provide services in exchange for the equity instruments. SFAS No. 123R is effective in the first annual reporting period beginning after June 15, 2005.

SFAS No. 123R provides two alternatives for adoption: (1) a modified prospective method in which compensation cost is recognized for all awards granted subsequent to the effective date of this statement as well as for the unvested portion of awards outstanding as of the effective date and (2) a modified retrospective method which follows the approach in the modified prospective method, but also permits entities to restate prior periods to reflect compensation cost calculated under SFAS No. 123 for pro forma amounts disclosure. The Company plans to adopt SFAS No. 123R using the modified prospective method. As the Company currently accounts for share based payments to employees in accordance with the intrinsic value method permitted under APB No. 25, no compensation expense is recognized. On March 30, 2005, the SEC released Staff Accounting Bulletin No. 107, Share Based Payments, (SAB 107), which expresses the views of the SEC staff regarding the application of SFAS No. 123R. The impact of adopting SFAS No. 123R and SAB 107 cannot be accurately estimated at this time, as it will depend on the amount of share based awards granted in future periods. However, had the Company adopted SFAS No. 123R and SAB 107 in a prior period, the impact would approximate the impact of SFAS No. 123 as described in the disclosure of pro forma net income and earnings per share. SFAS No. 123R also requires that tax benefits received in excess of compensation cost be reclassified from an operating cash flow to a financing cash flow in the Consolidated Statement of Cash Flows. This change in classification will reduce net operating cash flows and increase net financing cash flows in the periods after adoption.

In March 2005, the FASB issued FASB Interpretation No. 47 (FIN No. 47), Accounting for Conditional Assets Retirement Obligations . FIN No. 47 clarifies that an entity must record a liability for a conditional asset retirement obligation if the fair value of the obligation can be reasonably estimated. FIN No. 47 is effective no later than the end of the fiscal year ending after December 15, 2005. The Company does not expect that the adoption of FIN No. 47 will have a material effect on the financial position, results of operations, or cash flow.

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. The Company does not expect that the adoption of SFAS No. 154 will have a material effect on the financial position, results of operations, or cash flow.

GOLDEN TELECOM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3: Net Earnings Per Share

Basic earnings per share at September 30, 2004, and 2005 are computed on the basis of the weighted average number of common shares outstanding. Diluted earnings per share at September 30, 2004, and 2005 are 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 three and nine months ended September 30, 2004, and 2005, was 10,000 stock options.

The components of basic and diluted earnings per share were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
	(in thousands, except per share data)			
Net income	$ 16,111	$ 18,395	$ 47,671	$ 58,189
Weighted average outstanding of:				
Common stock shares	36,278	36,411	36,200	36,356
Dilutive effect of:				
Employee stock options	273	226	344	239
Common stock and common stock equivalents	36,551	36,637	36,544	36,595
Earnings per share:				
Basic	$ 0.44	$ 0.51	$ 1.32	$ 1.60
Diluted	$ 0.44	$ 0.50	$ 1.30	$ 1.59

Note 4: Business Combinations

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 from Open Joint Stock Company Vimpel Communications. 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. The results of Sakhalin Telecom have been included in the Company s consolidated operations since September 30, 2005.

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 an affiliate of Alfa Telecom Limited, a significant shareholder of the Company. In September 2005, the Company expensed approximately $0.8 million in external legal, financial and consulting fees related to the acquisition of Hudson Telecom, Inc., which the Company decided not to pursue.

GOLDEN TELECOM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 5: Shareholders Equity

Common Stock

The Company s outstanding shares of common stock increased by 331,835 shares and 76,500 shares in the nine months ended September 30, 2004, and 2005, respectively, which were issued in connection with the exercise of employee stock options.

In August 2005, the Company awarded 27,000 restricted shares of the Company s common stock, par value $0.01, to senior management. These restricted shares gradually vest over three years.

Dividends

In February 2005, the Board of Directors of the Company declared a cash dividend of $0.20 per common share to shareholders of record as of March 17, 2005. The Company paid the total amount payable of approximately $7.3 million to shareholders on March 31, 2005.

In May 2005, the Board of Directors of the Company declared a cash dividend of $0.20 per common share to shareholders of record as of June 16, 2005. The Company paid the total amount payable of approximately $7.3 million to shareholders on June 30, 2005.

In September 2005, the Board of Directors of the Company declared a cash dividend of $0.20 per common share to shareholders of record as of September 16, 2005. The Company paid the total amount payable of approximately $7.3 million to shareholders on September 30, 2005.

Note 6: Commitments, Contingencies and Other Matters

Tax Matters

The Company s wholly-owned subsidiary, EDN Sovintel, is engaged in litigation with the Russian tax inspectorate in regard to a claim against OAO Comincom (Comincom), which merged into Sovintel on December 1, 2004, issued by the tax inspectorate on July 8, 2004. The Russian tax inspectorate claimed that Sovintel owes taxes, fines and penalties in connection with Comincom in the amounts of $0.8 million for the years ended December 31, 2001 and 2002. Comincom filed a lawsuit against the tax inspectorate disputing the claims, and the court ruled in favor of the Company by dismissing the tax inspectorate s claim on January 21, 2005. On July 11, 2005, the third instance court decided that the case against Comincom shall be reverted to the first instance court for new consideration. The first instance court ruled in favor of the Company by dismissing the tax inspectorate s claim on October 24, 2005. The Company expects that the tax inspectorate will appeal this decision. The term for last appeal expires in December 2005. The Company does not consider an unfavorable outcome probable for this claim. Since the tax claim relates to the period before the Company acquired 100% of shares of Comincom, they are covered by the indemnification provisions of the Share Exchange Agreement between the Company and Nye Telenor East Invest (Telenor). Therefore, in case of an unfavorable outcome of this litigation, the Company intends to seek indemnification from Telenor.

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 nine months ended September 30, 2005, and $0.6 million reduction in intangible assets for the portion associated with income tax.

GOLDEN TELECOM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In the third quarter of 2005, the Company recorded a deferred tax asset valuation allowance for net operating loss carry-forwards for United States federal income tax purposes of $1.7 million due to the reassement of sources of future taxable income in the United States.

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 uncertainties associated with 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 September 30, 2005. 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.

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, the new law On Telecommunications (the New Law) came into effect in Russia. While some of the supporting regulations to implement the New Law have not been enacted, the Russian government approved in March 2005 new rules for interconnection (Interconnection Rules) that will take effect on January 1, 2006. The Company believes that the Interconnection Rules will impact the Company s operations in the areas of numbering capacity, licenses for international long distance traffic, voice over Internet Protocol traffic, and interconnect pricing. In addition, the New Law creates a universal service 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 has incurred $1.5 million in universal service fund expense for the period of May through September 2005.

The comprehensive interpretation and implementation of the Interconnection Rules are subject to and dependent upon pending regulations yet to be released by the Russian government. These include Rules of Non-Discriminatory Access to Infrastructure and Calling Party Pays Regulations Until these regulations are finalized, the Company cannot predict with any certainty how the New Law will affect the Company.

On May 31, 2005, the Company received a national intercity and international telephone license in Russia valid until May 31, 2012. The Company must begin providing services and fulfil certain network requirements specified in the Interconnection Rules not later than May 31, 2007. The Company is currently on schedule to rollout its federal transit network and provide long distance services in compliance with the Russian long distance license at the beginning of 2006. The effective utilization and implementation of the Russian long distance license is subject to and dependant upon the pending regulations yet to be released by the Russian government.

On September 20, 2005, the National Commission of Communication s Regulation in Ukraine issued an international license (Ukrainian international license) to Golden Telecom Ukraine (GTU). The Ukrainian international license will allow GTU to provide international telecommunications services throughout all of Ukraine, allow the leasing of channels to third parties, and increase GTU s potential as an international telecommunications carrier.

Other Commitments and Contingencies

In the ordinary course of business, the Company has issued financial guarantees of debt for the benefit of certain of the Company s equity investees, which are all collateralized by cash. The Company expects that all the collateralized debt will be repaid by the equity investees.

GOLDEN TELECOM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In September 2005, the Company issued stock appreciation rights (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 National Market on July 19, 2005 (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 or one of its subsidiaries or business units until each such relevant date. If, prior to August 31, 2008 and during the CEO s period of employment with the Company or one of its subsidiaries or business units, the average closing stock price of one share of the Company s common stock on the NASDAQ National Market, or any such other exchange on which the Company s common stock may then be traded, exceeds $50.00 during any thirty day consecutive period, the CEO will be granted SARs for an additional 200,000 shares of the Company s common stock at the Granting Share Price, which SARs shall be fully vested upon issuance. The SARs provide for a cash only settlement and the related obligation is recorded as a liability in the consolidated financial statements.

The Company has future purchase commitments of $81.4 million as of September 30, 2005. These purchase commitments primarily include the Company s contractual legal obligations for the future purchase of equipment, interconnect, and satellite transponder capacity.

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.

Change in Accounting Estimate

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 obligation for unused vacation. The change in accounting estimate decreased net income for the nine months ended September 30, 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) for the nine months ended September 30, 2005.

Capital Lease Obligation

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 and total payments of $4.1 million. The lease is classified as a capital lease in the balance sheet.

Other Matters

The Company confirmed in March 2005, that its 22.8% investment 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.

GOLDEN TELECOM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 7: 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 businesses for the three and nine months ended September 30, 2004, and 2005, 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. In accordance with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information , the Company has presented the following four segments consistent with the information used by the chief operating decision maker to manage the operations for purposes of making operating decisions and allocating resources.

	Business and Corporate	Carrier and Operator	Consumer Internet	Mobile Services	Corporate & Eliminations	Business Segment Total	Consolidated Results	Adjustments to Reconcile Business Segment to Consolidated Results: Equity Method Ventures	Affiliate Adjustments
					(in thousands)				
Three Months Ended September 30, 2004									
Revenue from external customers	$ 84,491	$ 53,152	$10,878	$4,173	$	$152,694	$152,713	$(1,175)	$1,194
Intersegment revenue		277			(277)				
Operating income (loss)	19,554	7,061	497	1,324	(2,635)	25,801	25,738	(63)	
Identifiable assets	449,752	267,709	59,796	5,351	26,322	808,930	805,001	(3,929)	
Capital expenditures	18,579	6,883	1,250	186	38	26,936	26,579	(357)	

	Business and Corporate	Carrier and Operator	Consumer Internet	Mobile Services	Corporate & Eliminations	Business Segment Total	Consolidated Results	Adjustments to Reconcile Business Segment to Consolidated Results: Equity Method Ventures	Affiliate Adjustments
					(in thousands)				
Three Months Ended September 30, 2005									

Revenue from external customers	$ 99,544	$ 56,736	$10,093	$3,558	$	$169,931	$169,930	$ (603)	$602
Intersegment revenue		12			(12)				
Operating income (loss)	27,811	8,000	(1,240)	857	(5,314)	30,114	30,024	(90)	
Identifiable assets	473,149	295,295	61,762	3,724	33,909	867,839	864,879	(2,960)	
Capital expenditures	21,406	7,933	3,690	79	17	33,125	32,995	(130)	

GOLDEN TELECOM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Business and Corporate	Carrier and Operator	Consumer Internet	Mobile Services	Corporate & Eliminations	Business Segment Total	Consolidated Results	Adjustments to Reconcile Business Segment to Consolidated Results: Equity Method Ventures	Adjustments to Reconcile Business Segment to Consolidated Results: Affiliate Adjustments
					(in thousands)				
Nine Months Ended September 30, 2004									
Revenue from external customers	$236,375	$143,249	$33,448	$11,780	$	$424,852	$424,760	$(3,905)	$3,813
Intersegment revenue		640			(640)				
Operating income (loss)	54,731	21,193	2,077	3,366	(8,759)	72,608	72,100	(508)	
Identifiable assets	449,752	267,709	59,796	5,351	26,322	808,930	805,001	(3,929)	
Capital expenditures	60,276	24,295	3,640	720	59	88,990	88,013	(977)	

	Business and Corporate	Carrier and Operator	Consumer Internet	Mobile Services	Corporate & Eliminations	Business Segment Total	Consolidated Results	Adjustments to Reconcile Business Segment to Consolidated Results: Equity Method Ventures	Adjustments to Reconcile Business Segment to Consolidated Results: Affiliate Adjustments
					(in thousands)				
Nine Months Ended September 30, 2005									
Revenue from external customers	$284,063	$164,170	$32,605	$11,086	$	$491,924	$491,904	$(1,769)	$1,749
Intersegment revenue		34			(34)				
Operating income (loss)	77,153	22,861	(77)	2,967	(13,286)	89,618	89,525	(93)	
Identifiable assets	473,149	295,295	61,762	3,724	33,909	867,839	864,879	(2,960)	
Capital expenditures	50,509	19,303	5,991	259	124	76,186	75,958	(228)	

Included in Consumer Internet operating income is the impact of the reversal of an accrued liability related to estimated taxes, as discussed in note 6.

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 September 30, 2004, and 2005 is as follows:

GOLDEN TELECOM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Russia	Ukraine	Corporate, Other Countries And Eliminations	Consolidated Results
		(in thousands)		
Three Months Ended September 30, 2004				
Revenue	$135,506	$17,367	$ (160)	$152,713
Long-lived assets	555,292	27,422	10,340	593,054

	Russia	Ukraine	Corporate, Other Countries And Eliminations	Consolidated Results
		(in thousands)		
Three Months Ended September 30, 2005				
Revenue	$151,334	$18,324	$ 272	$169,930
Long-lived assets	578,583	34,800	11,847	625,230

	Russia	Ukraine	Corporate, Other Countries And Eliminations	Consolidated Results
		(in thousands)		
Nine Months Ended September 30, 2004				
Revenue	$380,236	$46,252	$ (1,728)	$424,760
Long-lived assets	555,292	27,422	10,340	593,054

	Russia	Ukraine	Corporate, Other Countries And Eliminations	Consolidated Results
		(in thousands)		
Nine Months Ended September 30, 2005				
Revenue	$437,748	$54,910	$ (754)	$491,904
Long-lived assets	578,583	34,800	11,847	625,230

Note 8: Subsequent Events

In October 2005, the Company acquired 100% of ZAO Sochitelecom, a fixed line alternative operator in the Krasnodar region of Russia, for approximately $3.0 million consisting of cash consideration of $2.1 million and $0.9 million to be settled in cash upon the satisfactory achievement of certain conditions.

In October 2005, the Company acquired 100% of Antel Rascom, Ltd., a British Virgin Islands company that owns 49% of ZAO Rascom, an infrastructure and facilities company in northwest region of Russia, for approximately $10.0 million in cash.

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ITEM 2. ***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 three and nine months ended September 30, 2005, and 2004. This discussion should be read in conjunction with our Condensed 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 including Moscow, Kiev, St. Petersburg, Nizhny Novgorod, Samara, Kaliningrad, Krasnoyarsk, Almaty, and Tashkent, and via leased channels and intercity fiber optic and satellite-based networks, including approximately 252 access points in Russia and other countries of the CIS. In addition, we offer mobile services in Kiev and Odessa.

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

> ***Business and Corporate Services (BCS).*** Using leased channels and 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 leased channels and 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.*** We provide dial-up 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 name, although, some services still carry local brand names because of recent acquisitions. Our dial-up Internet services are distributed under the ROL brand name in Russia, Kazakhstan and Uzbekistan and under the Svit-On-Line brand name 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 believe that the carriers, including mobile operators, which contribute a substantial portion of our revenues, in turn 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. In 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 affects our revenues. In addition, some of our competitors do not link their prices to the United States dollar (USD) to ruble exchange rate, so when the ruble devalues, their prices effectively become lower in relation to our prices. The ruble exchange rate with the USD has become relatively stable since early 2000, appreciated in 2004 and slightly depreciated during the nine months ended September 30, 2005, so price pressures associated with devaluation have eased considerably. We cannot be certain that the exchange rate will remain stable in the future and therefore we may experience additional price pressures.

Recent Acquisitions

In March 2005, we 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 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% remaining 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 OOO Joint Venture Sakhalin Telecom Limited (Sakhalin Telecom), a fixed line alternative operator in the Far East region of Russia for approximately $5.0 million in cash from Open Joint Stock Company Vimpel-Communications (Vimpelcom). 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 ZAO Sochitelecom, a fixed line alternative operator in the Krasnodar region of Russia for approximately $3.0 million consisting of cash consideration of $2.1 million and $0.9 million to be settled in cash upon the satisfactory achievement of certain conditions.

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 $10 million in cash. Rascom is an infrastructure and facilities company in the Moscow and St. Petersburg regions.

We continue to take advantage of consolidation opportunities through selective acquisitions and expect to pursue selective acquisitions in the future which we expect to contribute to our revenue growth. In March 2005, we expensed approximately $1.0 million in external legal, financial and consulting fees related to an acquisition opportunity that we decided not to pursue, including advisory fees of approximately $0.1 million paid to an affiliate of Alfa Telecom Limited, one of our significant shareholders. In September 2005, we expensed approximately $0.8 million in external legal, financial and consulting fees related to the previously announced acquisition of Hudson Telecom, Inc. and its subsidiaries, which we decided not to pursue.

Other Developments

On January 1, 2004, the new law On Telecommunications (the New Law) came into effect in Russia. While some of the supporting regulations to implement the New Law have not been enacted, the Russian government approved in March 2005 new rules for interconnection (Interconnection Rules) that will take effect on January 1, 2006. We believe that the Interconnection Rules will impact our operations in the areas of numbering capacity, licenses for international long distance traffic, voice over Internet Protocol (VoIP) traffic, and interconnect pricing. In addition, the New Law created a universal service 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. We have incurred approximately $1.5 million in universal service fund expense for May through September 2005.

The comprehensive interpretation and implementation of the Interconnection Rules are subject to and dependent upon pending regulations yet to be released by the Russian government. These include Rules of Non-Discriminatory Access to Infrastructure and Calling Party Pays Regulations. Until these regulations are finalized, it is difficult to predict how the New Law will affect us. We continue to have regular dialogue about these current regulatory issues with the Russian Ministry of Telecommunications.

On May 31, 2005, we received a national intercity and international telephone license in Russia valid until May 31, 2012. We must begin providing services and fulfil certain network requirements specified in the Interconnection Rules not later than May 31, 2007. We are currently on schedule to rollout our federal transit network and provide long distance services in compliance with the Russian long distance license at the beginning of 2006. The effective utilization and implementation of the Russian long distance license is subject to and dependant upon the pending regulations yet to be released by the Russian government.

On September 20, 2005, the National Commission of Communication s Regulation in Ukraine issued an international license (Ukrainian international license) to Golden Telecom Ukraine (GTU). The Ukrainian international license will allow GTU to provide international telecommunications services throughout all of Ukraine, allow the leasing of channels to third parties, and increase

GTU s potential as an international telecommunications carrier.

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 recently 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 June 2005, another carrier expressed its intentions to divert a portion of its traffic from our network. This diversion of traffic resulted in a decrease of average monthly revenues of approximately $0.9 million when comparing the third quarter of 2005 with the second quarter of 2005. We don t expect this carrier to reduce their traffic volumes further in the foreseeable future. However, revenues from carriers and operators are by nature volatile and can fluctuate significantly between periods.

Prior to the second quarter of 2005, we recorded estimates for unused vacation based on the average salary levels of our employees and total days of unused vacation of employees. During the second quarter of 2005, we 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 our obligation for unused vacation. The change in accounting estimate decreased net income for the nine months ended September 30, 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 shares-diluted) for the nine months ended September 30, 2005.

During the third quarter of 2005, we incurred approximately $1.0 million in employee termination costs in connection with the overall streamlining of our operations. We expect to continue to incur such costs in the remainder of 2005 and in 2006.

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 2004 and during 2005, 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 2004 and during 2005. 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.

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 inter-city fiber optic link which we launched in the middle of 2004 continues in 2005. At present, we are constructing an inter-city fiber optic link from Moscow to Ufa through Nizhny Novgorod and Kazan. Subject to weather conditions, we expect that this inter-city fiber optic link will be operational in early 2006. To date, this inter-city fiber optic link has been completed from Moscow to Noginsk and from Ufa to Almetyevsk. Completion of the next stage of the project, from Noginsk to Nizhny Novgorod, is scheduled for November 15, 2005. At present we have laid approximately 1,255 kilometers of cable for this project; we anticipate that the entire Moscow to Ufa inter-city fiber optic link will require us to lay approximately 1,575 kilometers of cable. We intend to connect our operations in the European part of Russia to this backbone network and plan to invest a total of approximately $40.0 million to $50.0 million in this and related backbone projects through 2007. In addition, we started construction of the Oktyabrsky to Samara inter-city fiber optic link, which we plan to complete by the end of 2006. To date, we have invested approximately $11.8 million in these projects.

A significant portion of our carrier revenue in Ukraine is generated from the Ukrainian cellular operators large volumes of international and long distance traffic. Price and quality of services are the primary factors in their purchase decision. In 2004, several Ukrainian cellular operators, including Ukrainian Mobile Communications

(UMC), received international telecommunications licenses. Nevertheless, UMC, one of our largest customers, continued sending a large volume of outgoing international traffic through our network in 2004 and during the first quarter of 2005. However, in April 2005, UMC significantly decreased the volume of such traffic it routes through our network and began directly terminating such traffic with international carriers. This change in routing resulted in our quarterly UMC international outgoing traffic revenues decreasing from $1.5 million in the first quarter of 2005 to approximately $0.2 million in the third quarter of 2005. We do not anticipate that this UMC traffic will be restored in future periods.

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 other new technologies. We are responding to these customer demands by testing and implementing new technologies such as 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. Our customers are willing to pay a premium for this type of technology and customer service.

In 2005, we continue to see growth opportunities organically, through select 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 the key regions of Nizhny Novgorod, Samara, Ufa, Krasnoyarsk, Vladivostok, Khabarovsk, and Ekaterinburg.

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 business or (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.

In Carrier and Operator Services, our strategy focuses on partnering with more operators in the regions. 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 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. In response to a 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. We currently offer consumer broadband in selected cities such as St. Petersburg, Nizhny Novgorod, Ekaterinburg, Krasnoyarsk, and Sochi. However, our expansion in this area is currently limited by restrictions on our access to unbundled local loop. Therefore, we are currently looking at alternatives to deliver quality broadband Internet services at competitive pricing in our major markets. As part of this process, we have evaluated various broadband and related Wi-Fi technologies in order to penetrate the broadband market in Moscow and elsewhere in Russia. To further this strategy, we have also signed a supplier agreement for the provision of certain infrastructure and broadband equipment. Additionally, to enhance our overall consumer Internet strategy, we have combined both the consumer broadband and dial-up Internet businesses into one business unit.

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.

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 2004, 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 designed around customer characteristics: 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; We have determined in accordance with the functional currency criteria of SFAS No. 52, Foreign Currency Translation , that the USD should be considered the functional currency of all foreign subsidiaries. There are subjective elements in this determination, including a weight given to each specific criteria established by SFAS No. 52. Changes in the underlying business transactions could lead to different functional currency determination for a particular subsidiary, which would have an impact on its reported financial position and results of operations.

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 United States generally accepted accounting principles, 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 estimabl