



Consolidated Financial Statements

JOINT STOCK COMPANY “CONCERN GALNAFTOGAZ”

Year ended 31 December 2004

With Report of Independent Auditors

These consolidated financial statements contain 28 pages

**Joint Stock Company “Concern Galnaftogaz”
Consolidated Financial Statements
Year ended 31 December 2004**

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Report of Independent Auditors

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Report of Independent Auditors

To the Board of Directors and Shareholders of
Joint Stock Company “Concern Galnaftogaz”:

We have audited the accompanying consolidated balance sheet of Joint Stock Company “Concern Galnaftogaz” (hereinafter referred to as the “Company”) and its subsidiaries as of 31 December 2004, and the related consolidated statements of income, changes in shareholders’ equity and cash flows for the year then ended. These consolidated financial statements on pages 2 to 28 are the responsibility of the management of the Company. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Joint Stock Company “Concern Galnaftogaz” and its subsidiaries as of 31 December 2004 and the results of their operations and their cash flows for the year then ended in accordance with International Financial Reporting Standards.

21 June 2005

Joint Stock Company “Concern Galnaftogaz”
Consolidated income statement
For the year ended 31 December 2004
(In thousands of Ukrainian hryvnia, unless otherwise noted)

	Note	2004	2003
Revenues	5	1,283,605	942,375
Cost of sales	6	(1,222,630)	(897,692)
Gross profit		60,975	44,683
General and administrative expenses	7	(30,979)	(22,449)
Other operating income/(expenses), net	8	357	(2,832)
Profit from operations		30,353	19,402
Income from associates		3,307	989
Net financing loss	9	(5,708)	(7,768)
Profit before income tax and minority interest		27,952	12,623
Income tax	10	(5,704)	(1,536)
Profit before minority interest		22,248	11,087
Minority interest		(26)	(1)
Net profit		22,222	11,086

These consolidated financial statements are authorised for issue on 21 June 2005 and signed on behalf of the Board of Directors of JSC “Concern Galnaftogaz” by:

General director
Y.L. Kuchabskiy

Financial Director
N.I. Kupybida

The consolidated income statement is to be read in conjunction with the notes to and forming part of the consolidated financial statements set out on pages 6 to 28.

Joint Stock Company “Concern Galnaftogaz”**Consolidated balance sheet**

As of 31 December 2004

(In thousands of Ukrainian hryvnia, unless otherwise noted)

	Note	2004	2003
ASSETS			
Non-current assets			
Property, plant and equipment	11	239,895	179,194
Intangible assets	12	7,777	8,930
Investments	13	41,986	35,249
Deferred tax assets	14	7,085	5,775
Other non-current assets		125	917
		<u>296,868</u>	<u>230,065</u>
Current assets			
Inventories	15	30,210	15,156
Prepaid income tax		1,107	270
Trade and other receivables	16	89,929	60,569
Prepayments and other current assets	17	44,570	20,723
Cash and cash equivalents	18	13,348	9,308
		<u>179,164</u>	<u>106,026</u>
Total assets		<u>476,032</u>	<u>336,091</u>
LIABILITIES AND SHAREHOLDERS' EQUITY			
Shareholders' equity			
Share capital	19	130,000	120,000
Additional paid-in capital		20,720	17,420
Land revaluation reserve		8,321	9,324
Retained earnings		44,371	21,146
Total shareholders' equity		<u>203,412</u>	<u>167,890</u>
Minority interest		494	48
Non-current liabilities			
Loans and borrowings	20	125,327	81,674
Deferred tax liabilities	14	9,608	4,787
		<u>134,935</u>	<u>86,461</u>
Current liabilities			
Loans and borrowings	20	20,049	11,461
Income tax payable		-	82
Trade and other payables	21	113,092	62,984
Other current liabilities		4,050	7,165
		<u>137,191</u>	<u>81,692</u>
Total liabilities and shareholders' equity		<u>476,032</u>	<u>336,091</u>

The consolidated balance sheet is to be read in conjunction with the notes to and forming part of the consolidated financial statements set out on pages 6 to 28.

Joint Stock Company “Concern Galnaftogaz”**Consolidated cash flow statement**

For the year ended 31 December 2004

(In thousands of Ukrainian hryvnia, unless otherwise noted)

	2004	2003
Cash flows from operating activities		
Profit before income tax and minority interest	27,952	12,623
Adjustments for:		
Depreciation, amortisation and impairment	14,499	9,665
(Gain)/loss on disposal of property, plant and equipment	(4,315)	1,331
Impairment on property, plant and equipment	473	267
Impairment on trade and other receivables	1,373	-
Income from associates	(3,307)	(989)
Bonds amortisation	-	162
Interest expense, net	5,908	4,998
Foreign currency exchange (gain)/loss	(335)	4
Operating profit before changes in working capital	42,248	28,061
Increase in inventories	(12,667)	(2,793)
Increase in trade and other receivables	(25,885)	(17,548)
Increase in prepayments and other current assets	(23,829)	(10,801)
Increase in trade and other payables	45,407	20,875
(Decrease)/increase in other current liabilities	(6,474)	3,269
Cash flows generated from operations	18,800	21,063
Income taxes paid	(2,977)	(913)
<i>Net cash from operating activities</i>	15,823	20,150
Cash flows from investing activities		
Acquisition of subsidiaries, net of cash acquired (Note 23)	(4,113)	(8,875)
Purchases of property, plant and equipment	(61,735)	(102,852)
Purchases of intangible assets	(100)	(6,608)
Proceeds from sale of equipment	4,776	3,621
Proceeds from sale of investments	42,852	46,015
Purchase of investments	(44,236)	(62,539)
Interest received	30	-
<i>Net cash used in investing activities</i>	(62,526)	(131,238)
Cash flows from financing activities		
Proceeds from issue of shares and additional paid-in capital	13,300	60,563
Proceeds from long-term borrowings	88,407	102,302
Proceeds from short-term borrowings	30,210	26,640
Repayments of long-term borrowings	(36,109)	(45,669)
Repayments of short-term borrowings	(30,267)	(23,836)
Issued loan	-	(19,196)
Proceeds from repayment of loan	-	19,196
Interest paid	(14,798)	(4,942)
<i>Net cash provided by financing activities</i>	50,743	115,058
Net increase in cash and cash equivalents	4,040	3,970
Cash and cash equivalents at the beginning of the year	9,308	5,338
Cash and cash equivalents at the end of the year (Note 18)	13,348	9,308

SUPPLEMENTARY CASH FLOWS INFORMATION (Note 22)

The consolidated cash flows statement is to be read in conjunction with the notes to and forming part of the consolidated financial statements set out on pages 6 to 28.

Joint Stock Company “Concern Galnaftogaz”
Consolidated statement of changes in shareholders’ equity
For the year ended 31 December 2004
(In thousands of Ukrainian hryvnia, unless otherwise noted)

	Share capital	Additional paid-in capital	Land revaluation reserve	Retained earnings	Total
Balance at 1 January 2003	74,183	-	952	10,060	85,195
Share capital paid-in	45,817	11,661	-	-	57,478
Contributions by shareholders, net of tax	-	5,759	-	-	5,759
Revaluation of land, net of tax	-	-	8,372	-	8,372
Net profit	-	-	-	11,086	11,086
Balance at 31 December 2003	120,000	17,420	9,324	21,146	167,890
Share capital paid-in	10,000	3,300	-	-	13,300
Disposal of revalued land	-	-	(1,003)	1,003	-
Net profit	-	-	-	22,222	22,222
Balance at 31 December 2004	130,000	20,720	8,321	44,371	203,412

The consolidated statement of changes in shareholders’ equity is to be read in conjunction with the notes to and forming part of the consolidated financial statements set out on pages 6 to 28.

Joint Stock Company “Concern Galnaftogaz”
Notes to the consolidated financial statements
(In thousands of Ukrainian hryvnia, unless otherwise noted)

1. Organization and operations

JSC “Concern Galnaftogaz” (the “Company”) and its subsidiaries (together referred to as the “Group”) comprise Ukrainian joint stock companies as defined in the Civil Code of Ukraine. JSC “Concern Galnaftogaz” was established on 30 October 2001. The Company is the ultimate parent entity of this group of companies.

The Group’s principal activity is marketing of petroleum products in Ukraine. The Group operates network of 10 petroleum depots and about 160 petrol stations, 94 of which are under the Group’s registered trademark “OKKO”.

From formation, the Group has expanded substantially through acquisitions of new companies and establishment of new businesses.

The Company’s registered office is 1 Plastova Str., Lviv, Ukraine.

The average number of employees of the Group was 2,648 during 2004 (2003: 2,009).

2. Ukrainian business conditions

Operating environment

While there have been improvements in the economic situation in Ukraine in recent years, it continues to display emerging market characteristics. These characteristics include the lack of a well-developed business and regulatory infrastructure, limited convertibility of the national currency along with various currency controls and low levels of liquidity in the capital market. The reforms necessary to create banking, judicial and regulatory systems that usually exist in more developed markets have not yet been fully implemented.

The consolidated financial statements reflect management’s assessment of the impact of the Ukrainian economic environment on the operations and the financial position of the Group. The future business environment may differ from management’s assessment.

Foreign currency risk

In common with many other businesses in Ukraine, foreign currencies, in particular the US dollar (“USD”), play a significant role in the underlying economics of the business transactions of the Group. As of 31 December 2004, the exchange rate of Ukrainian hryvnia as established by the National Bank of Ukraine was 5.31 to the US dollar. The rate at the date of issue of these consolidated financial statements was 5.06 to the US dollar.

Concentration risk

During 2004, the majority of purchases of petroleum products were made by the Group from one supplier. Management believes that in case the supplier fails to perform or partly performs its contractual obligations the Group would be able to shift its purchases to another supplier without entailing significant business interruption or financial losses.

In addition, as of 31 December 2004 the Group pledged certain property, plant and equipment with a carrying amount of UAH 22,674 to secure bank loans received by this supplier.

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As of 31 December 2004, the Group’s outstanding custody commitment to this supplier approximates UAH 22,938.

3. Basis of preparation

Statement of compliance

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”) promulgated by the International Accounting Standards Board (“IASB”) and interpretations issued by the International Financial Reporting Interpretations Committee of the IASB.

The Company and its subsidiaries maintain their statutory accounting records and prepare separate statutory financial statements in accordance with Ukrainian Accounting Standards and regulations (“UAS”). These consolidated financial statements differ from the financial statements issued for statutory purposes in Ukraine in that they reflect certain adjustments, not recorded in the Company’s and subsidiaries books, which are appropriate to present the consolidated financial position, results of operations, and cash flows of the Group in accordance with IFRS.

Basis of measurement

The consolidated financial statements are prepared on the historical cost basis except that investments available-for-sale are stated at fair value and certain classes of property, plant and equipment are revalued.

Measurement and presentation currency

The national currency of Ukraine is the Ukrainian hryvnia (“UAH”), which is the Group’s measurement currency and the currency in which these consolidated financial statements are presented. All financial information presented in UAH has been rounded to the nearest thousand.

Use of estimates

Management has made a number of estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these consolidated financial statements in conformity with IFRS. Actual results could differ from those estimates.

4. Summary of significant accounting policies

The following significant accounting policies have been applied in the preparation of the consolidated financial statements.

Basis of consolidation

The consolidated financial statements comprise the financial statements of the Company and its subsidiaries drawn up to 31 December 2004.

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Notes to the consolidated financial statements
(In thousands of Ukrainian hryvnia, unless otherwise noted)

Subsidiaries

Subsidiaries are those enterprises controlled by the Group. Control exists when the Group has the power, directly or indirectly, to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control effectively commences until the date the control effectively ceases.

Associates

Associates are those enterprises in which the Group has significant influence, but not control, over the financial and operating policies. The consolidated financial statements include the Group's share of the total recognised gains and losses of associates accounted on an equity basis, from the date that significant influence effectively commences until the date that significant influence effectively ceases. When the Group's share of losses exceeds the carrying amount of the associate, the carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred obligations in respect of the associate.

Transactions eliminated on consolidation

Intragroup balances and transactions, and any unrealised gains arising from intragroup transactions, are eliminated in preparing the consolidated financial statements. Unrealised gains arising from transactions with associates are eliminated against the investment in the associate to the extent of the Group's interest in the enterprise.

Changes in accounting policies

The accounting policies adopted are consistent with those of the previous financial year except that the Group has adopted those standards designed to form the 'stable platform' intended to be mandatory for financial years beginning on or after 1 January 2005. The principal effects of this decision are discussed below.

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

The adoption of IFRS 3 and IAS 36 has resulted in the Group ceasing annual goodwill amortisation and to test for impairment annually at the cash generating unit level (unless an event occurs during the year which requires the goodwill to be tested more frequently) from 1 January 2004.

Also, the Group decided to change its accounting policy for the capitalisation of the borrowing costs as it will provide more relevant and reliable information about the carrying amount of the assets.

As at 1 January 2004 the Group elected to prospectively change its accounting policy for capitalisation of the borrowing costs attributable to the acquisition or construction of the qualifying assets. In previous periods the Group expensed such costs and has now decided to capitalise borrowing costs to conform to the allowed alternative treatment of IAS 23.

Foreign currencies

Transactions in foreign currencies are translated to UAH at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated to UAH at the foreign exchange rate ruling at that date. Foreign exchange differences arising on translation are recognised in the income statement. Non-monetary assets and liabilities denominated in foreign currencies, which are stated at historical cost, are translated to UAH at the foreign exchange rate ruling at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated to UAH at the foreign exchange rate ruling at the dates the fair values were determined.

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Property, plant and equipment

Land is stated at revalued amounts less impairment losses. Other items of property, plant and equipment are stated at cost less accumulated depreciation and impairment losses. The cost of self-constructed assets includes the cost of materials, direct labour and an appropriate proportion of production overheads.

Construction in progress represents plant and properties under construction and is stated at cost. This includes cost of construction, property, plant and equipment and other direct costs. Construction in progress is not depreciated until such time as the relevant assets are completed and put into operational use.

Where an item of property, plant and equipment comprises major components having different useful lives, they are accounted for as separate items of property, plant and equipment.

Subsequent expenditure

Expenditure incurred to replace a component of an item of property, plant and equipment that is accounted for separately, is capitalised with the carrying amount of the component being written off. Other subsequent expenditure is capitalised only when it increases the future economic benefits embodied in the item of property, plant and equipment. All other expenditure is recognised in the income statement as an expense as incurred.

Revaluation

A revaluation surplus on land is recognised directly in equity except to the extent that it reverses a previous revaluation deficit recognised in the income statement, in which case it is recognised in the income statement. A revaluation deficit on land is recognised in the income statement except to the extent that it reverses a previous revaluation surplus recognised directly in equity, in which case it is recognised directly in equity.

Depreciation

Depreciation is charged to the income statement on a straight-line basis over the estimated useful lives of the individual assets. Depreciation commences on the date of acquisition or, in respect of internally constructed assets, from the time an asset is completed and ready for use. Land is not depreciated.

The estimated useful lives are as follows:

Buildings	- 40 years
Equipment	- 10 years
Office equipment	- 4 years
Vehicles	- 5 years

Intangible assets

Goodwill

Goodwill arising on an acquisition represents the excess of the cost of the acquisition over the fair value of the net identifiable assets acquired. Goodwill is stated at cost less accumulated amortisation and impairment losses. In respect of associates, the carrying amount of goodwill is included in the carrying amount of the investment in the associate.

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Goodwill relating to acquisitions from 1 January 2004 is not amortised. Goodwill is reviewed for impairment, annually or more frequently if events or changes in circumstances indicate that the carrying value may be impaired.

Other intangible assets

Other intangible assets, which are acquired by the Group, are stated at cost less accumulated amortisation and impairment losses.

Amortisation

Amortisation is charged to the income statement on a straight-line basis over the estimated useful lives of intangible assets.

The estimated useful lives are as follows:

Patents and licences	- 5 to 10 years
Software licences	- 3 years

Investments

All investments are initially recognised at cost, being the fair value of the consideration given and including acquisition charges associated with the investment. After initial recognition, investments, which are classified as available-for-sale, are measured at fair value.

Gains or losses on available-for-sale investments are recognized as a separate component of equity until the investment is sold, collected or otherwise disposed of, or until the investment is determined to be impaired, at which time the cumulative gain or loss previously reported in equity is included in income.

The fair value of investments available-for-sale is their quoted bid price at the balance sheet date. Investments in equity securities that are not quoted on a stock exchange, and where fair value cannot be estimated on a reasonable basis by other means, are stated at cost less impairment losses.

Inventories

Inventories are valued at the lower of cost or net realisable value. Net realisable value is the estimated selling price in the ordinary course of business, less the estimated costs necessary to make the sale.

The cost of inventories is based on the first-in first-out principle and includes expenditure incurred in acquiring the inventories and bringing them to their existing location and condition.

Trade and other receivables

Trade receivables, which generally have 30-90 day terms, are recognized and carried at original invoice amount less an impairment provision. An estimate for doubtful debts is made when collection of the full amount is no longer probable. Bad debts are written off when identified.

Cash and cash equivalents

Cash and cash equivalents comprise cash at bank and in hand and short-term deposits with an original maturity of three months or less.

Joint Stock Company “Concern Galnaftogaz”
Notes to the consolidated financial statements
(In thousands of Ukrainian hryvnia, unless otherwise noted)

Impairment

The carrying amounts of the Group’s assets, other than inventories and the deferred tax asset, are reviewed at each balance sheet date to determine whether there is any indication of impairment. If any such indication exists, the assets’ recoverable amounts are estimated. An impairment loss is recognised when the carrying amount of an asset exceeds its recoverable amount. Impairment losses in respect of revalued property, plant and equipment are recognised in the same way as revaluations; other impairment losses are recognised in the income statement.

Calculation of recoverable amount

The recoverable amount of the Group’s investments stated at cost and non-current receivables is calculated as the present value of expected future cash flows, discounted at the effective interest rate inherent in the asset.

The recoverable amount of other assets is the greater of their net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

Reversal of impairment

An impairment loss in respect of an investment stated at cost or receivable is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

In respect of other assets, an impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount.

An impairment loss is reversed only to the extent that the asset’s carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

Loans and borrowings

Loans and borrowings are recognised initially at cost. Subsequent to initial recognition, loans and borrowings are stated at amortised cost with any difference between cost and redemption value being recognised in the income statement over the period of the borrowings on an effective interest basis.

Trade and other payables

Liabilities for trade and other amounts payable which are normally settled on 30-90 day terms, are carried at cost which is the fair value of the consideration to be paid in the future for goods and services received, whether or not billed to the Group.

Employee benefits

The Group does not have any pension arrangements separate from the state pension system of Ukraine, which requires current contributions by the employer to be calculated as a percentage of current gross salary payments; such expense is charged to the income statement in the period the related compensation is earned by the employee. The Group has no post-retirement benefits or significant other compensated benefits requiring accrual.

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(In thousands of Ukrainian hryvnia, unless otherwise noted)

Provisions

A provision is recognised in the balance sheet when the Group has a legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation. If the effect is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability.

Income tax

Income tax for the year comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax expense is the expected tax payable on the taxable income determined in accordance with Ukrainian tax regulations for the year, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of the previous years.

Deferred income tax is provided, using the liability method, on all temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred income tax liabilities are recognised for all taxable temporary differences:

- § except where the deferred income tax liability arises from goodwill amortisation or the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- § in respect of taxable temporary differences associated with investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference can be controlled and it is probable that the temporary difference will not reverse in the foreseeable future.

Deferred income tax assets are recognised for all deductible temporary differences, carry-forward of unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences and carry-forward of unused tax losses can be utilised:

- § except where the deferred income tax asset relating to the deductible temporary difference arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss; and
- § in respect of deductible temporary differences associated with investments in subsidiaries and associates, deferred tax assets are only recognised to the extent that it is probable that the temporary differences will reverse in the foreseeable future and taxable profit will be available against which the temporary difference can be utilised.

The carrying amount of deferred income tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilised.

Joint Stock Company “Concern Galnaftogaz”

Notes to the consolidated financial statements

(In thousands of Ukrainian hryvnia, unless otherwise noted)

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

Revenue recognition

Revenue from the sale of goods is recognised in the income statement when the significant risks and rewards of ownership have been transferred to the buyer.

Revenue from the sale of goods on consignment basis is recognised on the gross amount billed to a customer to the extent the Group has the following indicators:

- § the Group is the primary obligor in the sales arrangements;
- § the Group has general and physical loss inventory risks;
- § the Group has credit risk and discretion in supplier selection;
- § the Group has latitude in establishing prices

Revenue from transportation services is recognised in the income statement when services are rendered, i.e. when destination point is reached.

Operating leases

Leases of assets under which the lesser effectively retains all the risks and rewards of ownership are classified as operating leases. Payments made under operating leases are recognised in the income statement on a straight-line basis over the term of the lease.

Net financing loss

Net financing loss comprises interest expense on borrowings, the accretion of interest on provisions, interest income on funds invested, dividend income, foreign exchange gains and losses, gains and losses on the revaluation and disposal of investments held for trading, and impairment losses and gains and losses on the disposal of available-for-sale investments.

All interest and other costs incurred in connection with borrowings are expensed as incurred as part of net financing costs.

Interest income is recognised as it accrues, taking into account the effective yield on the asset. For investments in associates, dividend income is included in the determination of the equity income from the associate. For investments in other companies, dividend income is recognised on the date that the dividend is declared.

Borrowing costs

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of that asset.

Other borrowing costs are recognised as expenses in the period in which they are incurred.

Reclassifications

During 2004, the Group modified the classification of its cost of sales in the income statement, by netting off the gain from trading investments in the amount of UAH 14,083 (2003: UAH 12,723) with the cost of petroleum and consumer products. Comparatives were reclassified for consistency.

Joint Stock Company “Concern Galnaftogaz”
Notes to the consolidated financial statements
(In thousands of Ukrainian hryvnia, unless otherwise noted)

5. Revenues

Revenues are as follows:

	2004	2003
Retail sales of petroleum products	808,138	586,743
Big consignment wholesale of petroleum products	370,524	269,729
Sales of consumer products and other services	50,512	41,310
Small consignment wholesale of petroleum products	47,204	43,548
Sales of transportation services	7,227	1,045
	<u>1,283,605</u>	<u>942,375</u>

Small consignment represents parcels of up to 10 tons in average while big consignment parcels are more than 10 tons.

6. Cost of sales

Cost of sales is as follows:

	2004	2003
Petroleum and consumer products	1,174,634	862,969
Salary, wages and related charges	17,042	10,351
Depreciation	7,268	4,218
Rent	5,287	10,976
Repair and maintenance	5,150	2,223
Transportation	3,675	1,885
Security	2,444	1,203
Utilities	2,246	1,682
Other	4,884	2,185
	<u>1,222,630</u>	<u>897,692</u>

7. General and administrative expenses

General and administrative expenses are as follows:

	2004	2003
Salary and related charges	6,401	5,567
Depreciation	5,616	4,361
Professional services	3,250	1,405
Bank charges	2,933	1,177
Insurance	2,903	2,164
Commission fees	2,569	1,230
Taxes other than income tax	2,485	1,695
Communication	2,049	1,238
Advertisement	1,167	1,287
Security	514	720
Rent	405	455
Other	687	1,150
	<u>30,979</u>	<u>22,449</u>

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(In thousands of Ukrainian hryvnia, unless otherwise noted)

8. Other operating (income)/expenses, net

Other operating (income)/expenses are as follows:

	2004	2003
(Gain)/loss on disposal of property, plant and equipment	(4,315)	1,331
Impairment of trade and other receivables	1,373	-
Amortisation and impairment of intangible assets	1,615	1,086
Impairment of property, plant and equipment	473	267
Other	497	148
	<u>(357)</u>	<u>2,832</u>

9. Net financing loss

Net financing loss is as follows:

	2004	2003
Foreign currency exchange gain	335	-
Interest income	30	18
	<u>365</u>	<u>18</u>
Interest expense	(5,938)	(5,016)
Other financing expense	(135)	(2,604)
Amortisation of bonds	-	(162)
Foreign currency exchange loss	-	(4)
	<u>(6,073)</u>	<u>(7,786)</u>
	<u>(5,708)</u>	<u>(7,768)</u>

As of 1 January 2004, the Group changed its accounting policy as to the capitalisation of the borrowing costs attributable to the acquisition or construction of the property, plant and equipment (Note 4).

10. Income tax

Income tax expense reported in the consolidated income statement is as follows:

	2004	2003
<i>Current tax expense:</i>		
Current year	2,193	652
Under provided in prior years	-	5
	<u>2,193</u>	<u>657</u>
<i>Deferred tax expense:</i>		
Origination and reversal of temporary differences	3,511	1,216
Reduction in tax rate	-	(337)
	<u>3,511</u>	<u>879</u>
	<u>5,704</u>	<u>1,536</u>

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Ukraine was the only tax jurisdiction in which the Group’s income was subject to income tax in 2003-2004. In 2003 the Group’s applicable income tax rate was 30%. In early 2003, new amendments to the income tax law were approved, which introduce a new tax rate of 25% applicable to corporate profits. The new tax rate was applied after 1 January 2004.

Reconciliation of effective tax rate is as follows:

	2004	%	2003	%
Profit before income tax and minority interest	27,952	100%	12,623	100%
Computed income tax at applicable tax rate	6,988	25%	3,787	30%
Non-taxable income	(3,857)	(14%)	(3,828)	(30%)
Tax effect of expenses that are not deductible in determining taxable profit:				
50% of fuel and lease restriction	861	3%	486	4%
Charitable donations	569	2%	106	1%
Employees benefits	457	2%	234	2%
Taxes not deductible	343	1%	136	1%
Fines and penalties	165	1%	16	-
Impairment provisions and write-offs	72	-	224	1%
Notaries and other non deductible services	70	-	127	1%
Losses on disposal of property, plant and equipment	36	-	357	3%
Reduction in tax rate	-	-	(337)	(3%)
Other	-	-	228	2%
	<u>5,704</u>	<u>20%</u>	<u>1,536</u>	<u>12%</u>

11. Property, plant and equipment

Property, plant and equipment is as follows:

	2004	2003
Property, plant and equipment, net	228,482	166,185
Construction in progress and uninstalled equipment	10,678	7,958
Prepayments for property, plant and equipment	735	5,051
	<u>239,895</u>	<u>179,194</u>

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Changes in property, plant and equipment are as follows:

	Land & buildings	Equipment	Office equipment	Vehicles	Total
<i>At cost/ revalued amount</i>					
At 1 January 2003	51,446	10,257	8,140	4,875	74,718
Additions through acquisition	2,299	-	260	22	2,581
Revaluation	11,163	-	-	-	11,163
Additions	81,104	12,457	7,032	6,410	107,003
Disposals	(1,414)	(2,428)	(9)	(1,410)	(5,261)
At 31 December 2003	144,598	20,286	15,423	9,897	190,204
Additions through acquisition	525	109	45	965	1,644
Additions	50,514	17,893	3,752	3,782	75,941
Disposals	(1,251)	(115)	(116)	(934)	(2,416)
Impairment	(858)	(57)	-	-	(915)
At 31 December 2004	193,528	38,116	19,104	13,710	264,458
<i>Accumulated depreciation</i>					
At 1 January 2003	10,360	1,636	2,272	1,481	15,749
Depreciation charge	2,269	1,670	3,218	1,422	8,579
Disposals	(8)	(181)	-	(120)	(309)
At 31 December 2003	12,621	3,125	5,490	2,783	24,019
Depreciation charge	3,583	2,954	3,230	3,117	12,884
Impairment	(411)	(31)	-	-	(442)
Disposals	(160)	(42)	(70)	(213)	(485)
At 31 December 2004	15,633	6,006	8,650	5,687	35,976
<i>Net book value</i>					
At 31 December 2003	131,977	17,161	9,933	7,114	166,185
At 31 December 2004	177,895	32,110	10,454	8,023	228,482

Property, plant and equipment with a carrying amount of UAH 79,491 is subject to a registered debenture to secure bank loans (Note 20). Furthermore, as of 31 December 2004, the Group pledged certain property, plant and equipment with a carrying amount of UAH 19,567 to secure bank loans received by related parties (Note 25) and UAH 25,522 to secure bank loans received by third parties.

As of 31 December 2004, property, plant and equipment with a cost of UAH 4,580 was fully depreciated but still in active use.

The amount of borrowing costs capitalised during 2004 is UAH 8,997 (Note 22).

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12. Intangible assets

Intangible assets are as follows:

	Patents and licences	Software licences	Goodwill	Total
<i>Cost</i>				
At 1 January 2003	260	99	89	448
Additions through acquisition	-	36	3,189	3,225
Additions	6,006	602	-	6,608
Disposal	(160)	(65)	-	(225)
At 31 December 2003	<u>6,106</u>	<u>672</u>	<u>3,278</u>	<u>10,056</u>
Additions through acquisition	-	-	362	362
Additions	-	100	-	100
Disposal	-	(10)	-	(10)
At 31 December 2004	<u>6,106</u>	<u>762</u>	<u>3,640</u>	<u>10,508</u>
<i>Accumulated amortisation and impairment</i>				
At 1 January 2003	20	23	-	43
Amortisation/impairment charge	716	206	164	1,086
Disposal	-	(3)	-	(3)
At 31 December 2003	<u>736</u>	<u>226</u>	<u>164</u>	<u>1,126</u>
Amortisation/impairment charge	1,213	230	172	1,615
Disposal	-	(10)	-	(10)
At 31 December 2004	<u>1,949</u>	<u>446</u>	<u>336</u>	<u>2,731</u>
<i>Net book value</i>				
At 31 December 2003	<u>5,370</u>	<u>446</u>	<u>3,114</u>	<u>8,930</u>
At 31 December 2004	<u>4,157</u>	<u>316</u>	<u>3,304</u>	<u>7,777</u>

13. Investments

Investments are as follows:

	2004	2003
Investments in associates	34,811	28,488
Investments available-for-sale		
Stated at cost	6,557	5,921
Stated at fair value	618	840
	<u>7,175</u>	<u>6,761</u>
	<u>41,986</u>	<u>35,249</u>

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As of 31 December, the Group has the following investments in associates:

	Country	2004	Ownership	2003	Ownership
Bank Universalniy	Ukraine	31,921	49.6%	28,407	49.6%
JSC Technopark	Ukraine	2,792	24.9%	-	-
JSC Effort	Ukraine	84	25.0%	81	25.0%
Zaporizhnaftosbut Ltd.	Ukraine	14	24.0%	-	-
		34,811		28,488	

As of 31 December 2004, the Group’s share of post-acquisition total recognized gains in the above associated companies comprised UAH 4,774.

Investments available-for-sale stated at cost primarily comprise unquoted equity securities in the consumer products industry and services. There is no market for these investments and there have not been any recent transactions that provide evidence of fair value. In addition, discounted cash flow techniques yield a wide range of fair values due to the uncertainty of future cash flows in this industry. However, these investments were acquired recently and management believes it is unlikely that the fair value at the end of the year would differ significantly from that carrying amount.

14. Deferred tax assets and liabilities

Deferred tax assets and liabilities are as follows:

	2003	<i>Charged/ (credited) to consolidated income statement</i>	2004
<i>Deferred tax asset</i>			
Intangible assets	5,704	261	5,965
Trade and other receivables	30	158	188
Trade and other payables	-	660	660
Inventory	-	272	272
Bonds	41	(41)	-
Deferred tax asset	5,775	1,310	7,085
<i>Deferred tax liability</i>			
Property, plant and equipment	(3,457)	(3,639)	(7,096)
Prepayments and other current assets	(713)	(1,799)	(2,512)
Trade and other payables	(617)	617	-
Deferred tax liability	(4,787)	(4,821)	(9,608)
Net	988	(3,511)	(2,523)

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15. Inventories

Inventories are as follows:

	2004	2003
Petroleum products	21,754	7,798
Consumer products	5,841	5,360
Materials and spare parts	2,615	1,998
	<u>30,210</u>	<u>15,156</u>

16. Trade and other receivables

Trade and other receivables are as follows:

	2004	2003
Trade accounts receivable	55,732	16,208
Other receivables	23,804	20,033
Receivables from related parties (Note 25)	11,878	24,440
	<u>91,414</u>	<u>60,681</u>
Less: Impairment provision	(1,485)	(112)
	<u>89,929</u>	<u>60,569</u>

17. Prepayments and other current assets

Prepayments and other current assets are as follows:

	2004	2003
Prepayments for inventories (Note 25)	14,409	3,844
Prepayments for securities (Note 25)	10,728	-
Prepayments to related parties (Note 25)	10,221	3,859
Prepayments for taxes other than income tax	7,543	9,392
Other current assets	1,669	3,628
	<u>44,570</u>	<u>20,723</u>

Prepayments to related parties comprise prepaid inventories and securities.

Subsequent to 31 December 2004, part of the prepayments to related parties and third parties for securities and inventories were paid back to the Group (Note 29).

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18. Cash and cash equivalents

Cash and cash equivalents are as follows:

	2004	2003
Cash at bank	8,124	6,758
Cash in transit	3,932	1,503
Cash in hand	1,292	906
Call deposits	-	141
	<u>13,348</u>	<u>9,308</u>

Cash at bank earns interest at floating rates based on daily bank deposits rates.

Cash at bank as of 31 December 2004 and 2003 includes UAH 3,944 and UAH 5,273, respectively, placed at bank accounts in Bank Universalniy, which is the Group’s related party (Note 25).

19. Share capital

As of 31 December 2004, authorised, issued and paid share capital comprises 13,000,000 thousand ordinary shares with the par value of UAH 0.01.

During 2005, the Group increased its share capital up to 16,000,000 thousand ordinary shares with the par value of UAH 0.01. As of the date of these consolidated financial statements this increase was registered and paid in.

The holders of ordinary shares are entitled to receive dividends as declared unless imposed restrictions exist and are entitled to one vote per share at annual and general meetings of the Company.

In accordance with Ukrainian legislation the Company’s distributable reserves are limited to the balance of accumulated retained earnings as recorded in the Company’s statutory financial statements prepared in accordance with UAS.

During 2003-2004, the Company entered into the bank loan agreements with Raiffeisen Bank in the total amount of USD 10,000 thousand (equivalent of UAH 53,100) (Note 20). The loan agreement imposes covenants whereby the Company is not allowed to distribute declared dividends without the Raiffeisen Bank concord. This restriction expires on 25 July 2009 or at the date of the final loan settlement whichever is earlier.

The same negative covenants are stipulated by the loan agreement with Black Sea Trade and Development Bank dated 25 October 2004 for the amount of USD 23,000 thousand (equivalent of UAH 121,900). Under this agreement, the Company shall not declare or pay any dividends, purchase, redeem or otherwise acquire any shares of capital of the Company, unless the bank otherwise agrees. This restriction expires on 25 October 2011 or at the date of the final loan settlement whichever is earlier.

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20. Loans and borrowings

The Group’s loans and borrowings are as follows:

	2004	2003
<i>Non-current:</i>		
Secured bank loans	95,327	51,836
Unsecured bond issue	30,000	29,838
	<u>125,327</u>	<u>81,674</u>
<i>Current:</i>		
Current portion of long-term secured bank loans	12,949	4,142
Secured short-term bank loans	7,100	6,926
Unsecured loan from a shareholder	-	393
	<u>20,049</u>	<u>11,461</u>
	<u>145,376</u>	<u>93,135</u>

For more information about the Group’s exposure to interest rate and foreign currency risk refer to Note 24.

Terms and debt repayment schedule are as follows:

	Within one year	From one to five years	Over five years	Total
Secured bank loans:				
USD 5,000 thousand	2,763	23,764	-	26,527
UAH 8,000	7,100	-	-	7,100
USD 8,800 thousand	-	30,347	16,341	46,688
USD 1,214 thousand	1,804	1,576	-	3,380
USD 5,000 thousand	6,632	18,790	-	25,422
USD 1,297 thousand	1,750	4,509	-	6,259
Unsecured bond issue:				
UAH 30,000	-	30,000	-	30,000
	<u>20,049</u>	<u>108,986</u>	<u>16,341</u>	<u>145,376</u>

Total credit line on the loan agreement with Black Sea Trade and Development Bank dated 25 October 2004 is for the amount of USD 23,000 thousand (equivalent of UAH 121,900).

As of 31 December 2004 and 2003, the bank loans interest rates approximate effective rates. Interest rates on secured bank loans in USD range from LIBOR + 5.25 to LIBOR + 8.75. The only secured bank loan in UAH has annual interest rate at 19%.

The bonds that mature in 2006 have an effective interest rate of 17%.

The loans as of 31 December 2004 and 2003 were secured with property, plant and equipment with a carrying amount of UAH 79,491 and UAH 57,573, respectively (Note 11).

The Group has no subordinated debt and no debt convertible into equity.

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21. Trade and other payables

Trade and other payables as of 31 December are as follows:

	2004	2003
Trade payables for inventories	55,906	49,688
Payables to related parties for inventories and securities (Note 25)	39,903	7,705
Advances received	9,048	1,054
Payables for taxes other than income tax	4,647	2,125
Accrued salary	943	461
Other	2,645	1,951
	<u>113,092</u>	<u>62,984</u>

22. Supplementary cash flows information

Supplementary consolidated cash flows information for the years ended 31 December is as follows:

	2004	2003
Non-cash transactions		
Investment activities:		
Capitalisation of borrowing costs (Note 11)	8,997	-
Revaluation of land	-	11,163
Intangible assets written off, net	-	(222)
	<u>-</u>	<u>10,941</u>

As of 31 December 2004, the Group has UAH 76,237 thousand of undrawn short-term and long-term borrowing facilities that may be available for its future operating and investment activities.

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23. Acquisition of subsidiaries

In 2004 the Group acquired 90.72% of JSC Vinnytsa ATP 10554 and 100% of JSC Transport Communications, Naftoterminal Ltd. and Trade House Galnaftogaz Ltd. (2003: 99.33% of JSC Terra Petroleum), which had the following effect on the Group’s assets and liabilities:

	2004	2003
Property, plant and equipment	1,644	2,611
Intangible assets	-	36
Construction in progress	13	1,513
Inventories	2,387	340
Trade and other receivables	4,647	1,888
Prepayments and other current assets	855	855
Cash and cash equivalents	248	92
Investments	2,046	2,700
Long-term borrowings	-	3,008
Trade and other payables	4,482	1,195
Other current liabilities	3,359	54
Net identifiable assets and liabilities	3,999	5,778
Goodwill on acquisition	362	3,189
Consideration paid, satisfied in cash	(4,361)	(8,967)
Cash acquired	248	92
Net cash outflow	(4,113)	(8,875)

24. Financial instruments

Exposure to credit, interest rate and currency risk arises in the normal course of the Group’s business.

Credit risk

The Group does not require collateral in respect of financial assets. Credit evaluations are performed on all customers, other than related parties, requiring credit over a certain amount.

Concentration risk

At the balance sheet date there were no significant concentrations of credit risk. The maximum exposure to credit risk is represented by the carrying amount of each financial asset in the balance sheet.

Interest rate risk

Changes in interest rates impact primarily loans and borrowings by changing either their fair value or their future cash flows. The Group adopts a policy of ensuring that at least 60 percent of its exposure to changes in interest rates on secured bank loans is on a fixed rate basis. However, at the time of issuing new debt management uses its judgment to decide whether it believes that a fixed or variable rate would be more favourable to the Group over the expected period until maturity.

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Foreign currency risk

The Group incurs foreign currency risk on borrowings that are denominated in USD. Management believes that as of 31 December 2004 the Group’s exposure to foreign currency risk is remote.

Fair value

The estimated fair values of financial instruments are determined with reference to various market information and other valuation methodologies as considered appropriate, however considerable judgment is required in interpreting market data to develop these estimates. Accordingly, the estimates are not necessarily indicative of the amounts that the Group could realise in a current market situation.

The carrying values of cash and cash equivalents, trade and other receivables and payables, taxes payable and accrued liabilities approximate their fair values due to the short maturities of these instruments.

As discussed in Note 13, the Group has investments in certain Ukrainian companies. There are no quoted market prices for these instruments and a precise estimate of fair value could not be made without incurring excessive costs. However, management believes that the carrying value of these investments does not differ substantially from their fair value.

Borrowing arrangements on short-term and long-term debt have both fixed and variable interest rates that reflect the currently available terms for similar debt. The carrying value of this debt is a reasonable approximation of its fair value.

25. Related Parties

In the rapidly developing businesses environment in Ukraine, companies have frequently used nominees and other forms of intermediary companies in transactions. Management consider that the Group has appropriate procedures in place to identify and properly disclose transactions with related parties and has disclosed all of the relationship identified which it deemed to be significant.

Transactions with management

The members of the Supervisory Board, executive directors (president and vice-presidents) and the close family members control 6% of the voting shares of the Company. There are no share options granted to the directors and pensions paid to the former or existing members of the Supervisory Board.

In 2004 the amount of the total remuneration of the directors was UAH 3,759 (2003: UAH 1,650). Total remunerations are included in “General and administrative expenses”.

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Transactions with other related parties

Related parties comprise associated companies of the Group, the shareholders of the Company and all other companies in which those shareholders, either individually or together, have a controlling interest.

During 2004 and 2003, the Group had the following transactions and balances with related parties and companies acting in an interest of the Group:

	Note	2004	2003
<i>Balances with related parties:</i>			
Cash and cash equivalents	18	3,944	5,273
Trade and other receivables	16	11,878	24,440
Prepayments and other current assets	17	10,221	3,859
Loans and borrowings	20	-	393
Trade and other payables	21	39,903	7,705
Other current liabilities		-	2,311
<i>Balances with companies acting in the interest of the Group:</i>			
Prepayments for inventory	17	7,732	-
Prepayments for securities	17	10,728	-
<i>Transactions with related parties included in the consolidated income statement:</i>			
Purchases of inventories and petroleum products	6	38,335	57,014
Purchase of financial investments	9	10,209	40,378
Rent services received	6, 7	2,393	3,955
Transportation service received	6, 7	-	2,960
Insurance	7	2,903	2,164
Security services	6, 7	1,919	1,622
Other services received		1,285	5,454
Sales of financial investments	9	12,801	-
Sales of petroleum products	5	57,692	-
Sales of transportation services	5	2,093	-
<i>Other:</i>			
Pledged property, plant and equipment with various banks on behalf of related parties at the year end	11	19,567	19,567
Outstanding guarantees issued in favour of related parties	27	170	7,630

The Group conducted transactions with several companies acting in the interest of the Group. Ultimate purposes of such transactions were cash management, finance management and other.

26. Operating leases

As of 31 December 2004, non-cancellable operating lease rentals are payable as follows:

Within one year	2,983
Between one and five years	82
More than five years	-
	3,065

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The Group leases a number of buildings and vehicles under operating lease agreements as a lessee. The leases typically run on an initial period of one year, with an option to renew the lease after that date. Lease payments are usually increased annually to reflect market rentals. None of the leases include contingent rentals.

During 2004, UAH 5,692 (2003: UAH 11,431) was recognised as an expense in the consolidated income statement in respect of operating leases.

27. Commitments and contingencies

Taxation

The Group performs most of its operations in Ukraine and therefore falls within the jurisdiction of the Ukrainian tax authorities. The Ukrainian tax system can be characterized by numerous taxes and frequently changing legislation which may be applied retroactively, open to wide interpretation and in some cases are conflicting. Instances of inconsistent opinions between local, regional, and national tax authorities and between the National Bank of Ukraine and the Ministry of Finance are not unusual. Tax declarations are subject to review and investigation by a number of authorities that are enacted by law to impose fines and penalties and interest charges.

Management believes that it has adequately provided for tax liabilities based on its interpretation of tax legislation. However, there can be no assurance that the tax authorities may not have a different interpretation of the Company's and its subsidiaries compliance and assess fines and penalties.

No provisions for potential tax assessments have been made in these consolidated financial statements.

Insurance

The insurance industry in Ukraine is in a developing state and many forms of insurance protection common in other parts of the world are not yet generally available. The Group has insurance coverage for the majority of its property, plant and equipment as well as for third party liability in respect of property or environmental damage arising from accidents on the Group's property or relating to its operations.

From late 2004 the Group began counter-insurance of its proprietary interests with foreign insurers.

Guarantees

As of 31 December 2004, the Group provided loan guarantees of UAH 170 on behalf of the related parties and UAH 5,000 on behalf of the third parties. The guarantees expire in periods from one to two years. The Group would be required to perform under the guarantees in the event of default by the related and third parties. The maximum amount of potential payments is UAH 5,170. There are no amounts being recognised as liabilities for these guarantees as management does not believe that it is probable that the Group will be required to perform under these guarantees.

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Custody

During 2004, the Group provides various third parties with custody services on storage of petroleum products. As of 31 December 2004, the Group’s outstanding custody commitment approximates UAH 31,461 (2003: UAH 38,153).

Other commitments

The Group is committed to reimburse employees for all expenses incurred in case of injuries at work. These amounts are expensed when they are incurred.

28. Significant subsidiaries

The Company’s significant subsidiaries, all of which are incorporated in Ukraine, as of 31 December 2004 are as follows:

	Ownership
Subsidiary Company Lvivnaftoproduct	100%
Subsidiary Company Ivano-Frankivsknaftoproduct	100%
Subsidiary Company Uzhgorodnaftoproduct	100%
Subsidiary Company Khustnaftoproduct	100%
Subsidiary Company Vinnytsanaftoproduct	100%
Subsidiary Company Rivnenaftoproduct	100%
Subsidiary Company CRPP	100%
Resurs-2 Ltd	99.8%
CJSC Terra-Petroleum	99.3%
OJSC Vinnytsa ATP 10554	90.7%
CJSC Transport Communications	100%
Naftoterminal Ltd.	100%
Trade House Galnaftogaz Ltd.	100%

29. Subsequent events

Subsequent to 31 December 2004, certain agreements on purchase of securities and inventory were cancelled and prepayments made by the Group were reversed by cash received to bank accounts of the Group in the amount of UAH 7,700 paid back from related parties and UAH 4,625 from companies acting in the interest of the Group for the prepaid securities and UAH 7,696 paid back from companies acting in the interest of the Group for the prepaid inventory (Note 17).

In 2005 the subsidiary of the Group - Trade House Galnaftogaz Ltd. – is taking over the functions of the sole supplier of the petroleum products to the Group that reduces the risk of concentration (Note 2).