Baltika Group

Strategy Report 2006–2008

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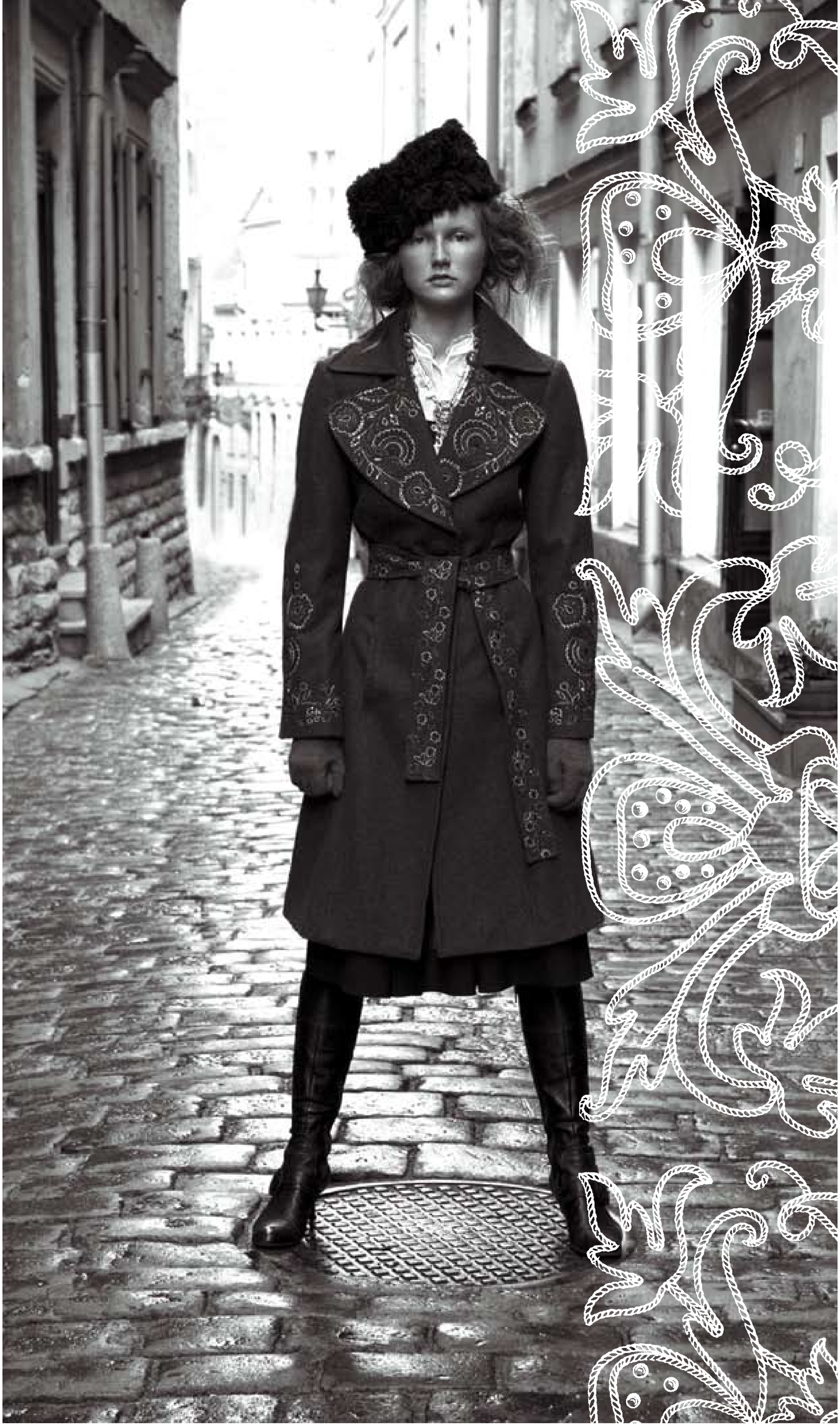
The Baltika Group is a rapidly growing fashion retailer in the Baltic States and Eastern Europe. As of the end of 2005 the Group had:

- three retail concepts
- 86 stores with sales space of 12,736 m²
- retail coverage of six countries

Financial highlights

	2005	2004	Change, %
Operating results, EUR '000			
Net sales	43,518	37,189	17.0%
Gross profit	22,438	17,796	26.1%
Operating profit	4,787	1,201	298.7%
Profit before taxes	4,535	896	406.3%
Net profit	4,644	1,067	335.1%
Balance sheet data, EUR '000			
Total assets	24,101	20,271	18.9%
Interest-bearing liabilities	5,933	7,697	-22.9%
Shareholders' equity	13,290	9,042	47.0%
Other data			
Number of directly managed stores	86	78	10.3%
Retail space, m²	12,736	11,668	9.2%
Number of employees (31 Dec)	1,678	1,704	-1.5%
Key ratios			
Share of retail sales in net sales	80%	72%	11.2%
Share of export in net sales	71%	75%	-4.4%
Gross margin	51.6%	47.9%	7.7%
Operating margin	11.0%	3.2%	240.7%
Net margin	10.7%	2.9%	271.8%
Debt to equity ratio	44.6%	85.1%	-47.6%
Net gearing ratio	31.3%	75.9%	-58.8%
Return on equity	44.1%	14.6%	202.1%
Return on assets	22.2%	5.1%	335.3%



Mission and goal

Baltika creates quality fashion that enables people to express themselves and feel good.

Our goal is to be the leading specialist fashion retailer in Central and Eastern Europe.

Key strategic strengths

- Learning organisation with high targets
- Flexible vertical integration and buying models
- Centralised management with a tailor-made approach to target markets
- Brand portfolio covering a broad customer base

Financial objectives 2006-2008

- To increase net sales at least two times in comparison with 2005
- Number of stores at the end of period 160-180
- Gross margin at least 52%
- Return on equity at least 30%

Highlights from history

1928 Gentleman established in Tallinn as producer of raincoats
1959 Company is restructured and renamed Baltika, producing formal menswear
1988 Production of ladieswear begins
1991 Baltika privatised, first menswear collection, Baltman, launched, first independent shop opened in Estonia
1993 First ladieswear collection, Christine Collection (CHR), launched, first shop opened in Lithuania
1994 First shop opened in Russia
1995 Evermen collection launched
1996 First shop opened in Latvia
1997 Baltika listed on the Tallinn Stock Exchange (OMX Exchanges)
2000 First shop opened in Ukraine and in Poland
2002 Strategic turnaround into vertically integrated fashion retailer begins
2002 Monton brand launched in five markets
2004 50.1% holding acquired in the Russian retail operations
2005 Exit of a long-term strategic shareholder, management becomes largest single shareholder
2005 Strategic turnaround completed
2006 CHR and Evermen concepts rebranded as Mosaic

Statement by the Chairman of the Council

It is a great pleasure to be able to present to our shareholders such an exciting set of results as Baltika had last year. In fact, the year 2005 represents a break-through year for the company, as significant progress was made in virtually all areas – in sales development, inventory management, profitability levels etc. Moreover, the overall profitability achieved in 2005 represents a return to levels that we wish to maintain in the future years.

The posted results throughout the year received a reception from investors that exceeded our expectations. During the past year, Baltika's market capitalisation increased over seven times, to nearly 76 million euros - a remarkable achievement that will be hard to repeat.

The retail growth strategy has proved to be the correct strategic decision. It began in 2002 with the launch of the new brand Monton. With just three years, Monton has established a solid position in the quality fast fashion sector as well as in the Group's revenues. Now our Monton stores enjoy steadily growing visitor trend and improving brand awareness. The other two brands, CHR/Evermen (rebranded as Mosaic in February 2006) and Baltman, were refurbished in 2003, and now witness significant growth in revenues.

During the turnaround years, Baltika has grown tremendously in terms of experience gained. Now, with the successful conclusion of the 2002-2005 strategy period, we have laid a strong foundation for future growth. In 2005, Baltika's management initiated a strategic planning process for the next three-year period. Capitalising on the experience gained, management has set challenging yet realistic strategies and targets to be achieved in the years 2006 through 2008. The Council remains fully supportive of and committed to meeting these challenges successfully. I encourage you to read more about our strategic objectives for the 2006-2008 period in this report.

On behalf of all Council members I would like to thank our Board of Directors led by Meelis Milder and all of the employees of Baltika, as none of these achievements would have been possible without their bold decisions, hard work and dedication. I would also like to thank our shareholders for their confidence in the company during the tough times. I remain very optimistic about the future of Baltika in our way to becoming one of the leading fashion retailers in Central and Eastern Europe, along with our hope to bring long-term value to our shareholders.

Miles Burger
Chairman of the Council

Successful conclusion of the turnaround

Solid foundation for future growth

Statement by the CEO

The year 2005 was a special year for the Baltika Group, because it was expected that it would show the results of the strategic change – the retail strategy – initiated four years ago. Thus we are now not only presenting for evaluation the last year separately, but also in comparison with the objectives set in 2002, and the extent and successfulness of the changes that have been implemented.

Baltika was already prepared for major changes in 2001, but was still a chiefly traditional clothing manufacturing company with the limited retail experience. Retail sales were then around 10 million euros and represented 37% of the Group's total turnover, and the Group's profits were roughly one million euros.

Four years later, retail sales represented 80% of the Baltika Group's total turnover, which is an increase of 3.6 times. In four years, the Baltika Group's net profit had increased 4.6 times, and the company's market value 7.8 times.

Baltika's strategic turnaround was not a simple matter. Nevertheless, even in what were outwardly the most complicated times we did not lose sight of our objective, and thanks to our employees' extraordinary efforts and the support of our shareholders, the results are before us today. The Baltika Group has become one of the leading specialist clothing retailers in Central and Eastern Europe, with markets in six of the region's countries and three successful retail concepts.

Meelis Milder
Chairman of the Board
Group CEO

In addition to high-quality fashion, our other objective is to offer our consumers an emotionally comfortable environment for their purchases and also professional service, and it appears that we have been successful in this.

Both significantly enhanced product selection and improved stock management have been of great importance in increasing the profitability of the retail system. More precise product selection, the continual renewal of collections and well-organised campaigns throughout the season have made it possible to reduce discounts and increase stockturn.

The growth in the retail system has gone hand in hand with our co-operation with suppliers. Here I would like to thank all of our co-operation partners who have supported our development plans.

The exit of our long-time major shareholder the Baltic Republics Fund (BRF) in connection with the closure of the fund was one of the more important events in 2005. We would like to express our warm thanks to the BRF and its representatives on our Council, Joakim Helenius and Claire Chabrier for their excellent co-operation and their support for our development plans.

The successfully organised exit of BRF also significantly changed the shareholders' structure of Baltika, increased the proportion of freely negotiable stocks, and as a result also the stocks' overall liquidity. The management controlled OÜ BMIG, which was until then the second-largest shareholder, acquired additional shares during the exit of BRF and became the largest single shareholder of Baltika.

Last year Baltika's management set out to develop a new strategy for the next three years, which could be described as a "profitable growth" strategy. The new strategy concentrates on using the business model implemented at Baltika for rapid growth with existing brands and primarily in existing markets. We also believe that the efficiency and profitability indicators that have been achieved can not only be maintained, but even improved upon.

In conclusion, I would like to thank all of the employees of the Baltika Group, not only for an excellent result in 2005, but also for supporting one another and believing in the achievement of the objective even in the most complicated times.

Baltika's turnaround in 2002-2005

For Baltika, 2005 was the final year in the 2002-2005 strategic period, which included a radical turnaround of the company into a vertically integrated fashion retailer. The process was challenging, but with the commitment of the management team and support from shareholders, the year 2005 represents the successful end of the turnaround process. The success is evidenced both in our daily operations by our professional teams in the well-structured organisation as well as by the Group's improving financial results.

The start of the turnaround process goes back to the end of the 1990s, when the economic slowdown in the region forced us to look for new growth options. It was necessary to find a way to increase the company's value and assure the long-term growth of the Group's revenues and profits. This is not an easy task for any company, left alone a clothing manufacturer, even though at that time Baltika already had its own brand collections and a small retail chain. The prevailing thinking at that time was to choose among two options – either to be a manufacturer or a retailer. Nevertheless, as a result of the analysis of the fashion business pyramid and case studies, Baltika's management reached the decision to combine the two and incorporate a vertically integrated business model.

In 2000-2001, the new strategy gradually started to take shape. This period can be regarded as a preparation for the impending turnaround. During this period, the company also prepared a new retail concept that was to help to break Baltika out of its traditional field of office suits and costumes and into more casual clothing segments, faster fashion and broader customer base. This brand is now known as our fast fashion brand Monton.

The launch of Monton in the fall of 2002 represented the start of the turnaround process and the strategic period of 2002-2005. Launched simultaneously in five countries, Monton received 80% of the Group's retail space. In 2003, which was designated as the year of changes, Baltika's other concepts, Baltman and CHR/Evermen, were refurbished, and the three concepts' store portfolio was readjusted. The whole organisation was restructured in accordance with the real profit centres, i.e. brands and markets. At present, Baltika incorporates centralised brand-based management with retail organisations in target markets.

The toughest year for Baltika was 2003, when procedures and systems were still being introduced and management teams developed. One of the hardest lessons learnt in 2003 included inventory management and ended with the one-time write-off of old stock at the end of the year and a red bottom line. This radical decision helped the company to start the year 2004 – the year of stabilisation - with a clean slate. The greatest effort made in 2004 involved inventory management. We now have in place efficient information systems that enable the daily monitoring and analysis of sales and inventory. Additionally, the retail organisations in our markets were restructured and own retail operations were introduced in Russia in 2004.

By the end of the strategic period, Baltika has achieved the ultimate goal - becoming a fully integrated specialist fashion retailer. The year 2005 was the year of results – we delivered the kind of financial results that we wanted to achieve and that we intend to maintain in the future in terms of profit margins. In the period from 2002 to 2005, the Baltika Group's retail sales grew 3.6 times, and net profit 4.6 times. Return on equity increased from 4.4% in 2001 to 44.1% in 2005.

In 2005, we also formulated our new strategy for the next three-year period, from 2006 to 2008, in which our goal is, in brief, to achieve profitable expansion. We are confident that the established business model enables continued rapid growth. Our confidence is further supported by the strong and committed management team that has been created in the past few years. The success of the current management in implementing the turnaround and shift from production to retail also assures the success of the future expansion plan.

Key strategic strengths

Learning organisation with high targets

The most important factor in our business in achieving our goals is people, both our customers and our employees.

We respect and value our teams and are committed to our common goals. We strive to maintain a highly motivating working environment that supports employees' professional development and the desire for learning. We operate in an open, interactive organisation where every individual is expected to use his or her initiative and produce results. We have high targets and we reward success.

Flexible vertical integration and buying models

Baltika employs a vertically integrated business model that establishes a flexible structure for our business. We believe that vertical integration is a system that promises the best result, by providing our customers with quality fashion clothing. Vertical integration means that Baltika controls all stages of the fashion process: design, manufacturing, supply chain management, distribution/logistics and retail sales:

- Our experienced brand teams have the capacity to interpret trends and create collections that inspire customers to buy. At the same time, the ideas that are realised have a clear connection to financial objectives.
- Part of production takes place in the Group's own factories, which are located close to our headquarters. Own factory capacity is reserved for products that need top quality and fast lead times. Worldwide sourcing is used for the rest of production. Consistently high quality is one of the fundamental characteristics of Baltika.
- The key channel to reach customers is through the retail network, which is currently divided between our three distinctively positioned concepts: Monton, Mosaic and Baltman. We also offer our products through a wholesale network.
- Our business model helps us react flexibly to fluctuations in demand. Fashion goods are delivered to stores every week, while high availability of basics is assured. Our goal is to improve lead times, enabling us to bring the product to the market faster, thus more efficiently meeting our customers' demands.

Centralised management with a tailor-made approach to target markets

The Baltika business model is effective because we combine centralised brand-based management and support resources with strong retail organizations in our markets. The key centrally managed functions include product design, supply chain and logistics. Our retail market organisations ensure a closer approach to the local customer and provide effective, locally relevant communication and marketing. They make sure that we consistently deliver a first class customer experience, and that our retail network in a specific market is developed properly. Our interactive culture and the sharing of experience is a basic characteristic of our day-to-day operations and a key reason for our success.

Our business model is supported by an integrated information system that provides daily operational data from all of our stores and distribution facilities, supporting better decision making throughout the Group.

Brand portfolio covering a broad customer base

A balanced portfolio of three retail concepts includes fast fashion (Monton), contemporary clothing with a family focus (Mosaic), and prestigious high quality upper-market clothing (Baltman). The operation of a portfolio of different brands serves a broad customer base and offers stability in the fast-moving fashion business. Nevertheless, we are looking for new opportunities every day - our collections are continuously evolving, as the design and sourcing teams are engaged in developing exciting new products that increase brand attractiveness and sales efficiency.

All of the concepts have a common characteristic: a quality product with fashionable design and unique style offered at competitive prices. Each collection is designed to meet the target customer's needs and personality. At the same time, every brand is focused to contribute positively to the Group's bottom line.

We see significant growth potential with the current portfolio of brands and markets, however, our portfolio is going to be extended to additional product areas, markets and customer groups.

Brands and the strategy for 2006-2008

Kaie Kaas
Monton Brand Manager

MONTON

Monton is a fast fashion brand with a unique handwriting and well-focused quality range. The brand is targeted to fashion-conscious men and women who are socially active and want to differ from the norm. Monton offers high-quality service in its stores, and communicates innovatively with its customers. A new collection is launched every month, and new goods are delivered to shops every week.

The brand was launched in 2002 and now generates 54% of the Group's retail sales. As of the end of 2005, Monton had 31 stores in six markets.

The Monton brand plans to grow in excitement, size and profit. The current collection range will be enlarged by adding more colour themes and increased range of accessories. We also plan to expand the brand into new product areas like underwear and swimwear, and consequently begin operating larger stores. Store size will grow from the current 200-300 square metres to 400-500 square metres.

Recognition to Monton

- Most Practical Men's Fashion Brand 2005 (magazine FHM, Lithuania)
- Best Domestic Clothing Brand 2005 (magazine FHM, Estonia)
- Best Domestic Clothing Brand 2004 (magazine FHM, Estonia)
- Choice of the Year 2004 in Womenswear (Ukraine)
- Most innovative brand 2004 (Latvia)

Essence of Mosaic

The term Mosaic comes from the decorative technique that uses many smaller multi-coloured pieces to create a larger eye-catching image. On an everyday level, a mosaic can exist in all possible fields. We can talk about the mosaic of feelings, sound, etc. What is important is that the essence is the same - different pieces will connect and harmonise to form a complete whole. Our Mosaic collection will help to create a wider mosaic of the wearer and enhance the person's own little mosaic pieces.

Brigitta Kippak
Mosaic Brand Manager

MOSAIC

Mosaic is quality clothing for women and men who want fashion at affordable prices. The predecessors of Mosaic – CHR and Evermen – were launched in 1993 and 1995, respectively. At the very beginning of 2006, the CHR and Evermen concepts were rebranded as Mosaic.

The name change was carried out in order to simplify the brand's name and thus enhance the concept's international competitiveness. It was undertaken before major expansion, as the company expects to benefit from the name change and the new international store concept, primarily in large markets where brand awareness is currently limited due to the small number of stores. Considering the active development of the Russian and Ukrainian markets, it is prudent and also cheaper to conduct the name change today, before opening more stores in these countries.

Mosaic will build on the heritage and success of CHR/Evermen, developing a clearer proposition to better serve our target customers. Mosaic shops are represented in all our retail markets. As of the end of 2005, there were a total of 32 Mosaic shops in our retail system. The collection is also sold through wholesale partners. Sales of Mosaic accounted for 28% of our retail sales revenue in 2005.

In addition to our business clothing collection, which has until now been our strongest, the selection of casual clothing in Mosaic will increase, and **the collection will become more uniform and integral. We also plan to create collections more often than we now do, and revitalise the brand.** In the long-term, we intend to add new product areas. The store size will increase from the present 100-130 square metres to 180-300 square metres.

Tarvo Jaansoo
Baltman Brand Manager

BALTMAN

Baltman is a prestigious lifestyle brand for men, offering high quality men's contemporary businesswear and personal service in a comfortable shopping environment. Baltman is the Baltika Group's oldest brand, dating back to 1991. Baltman strives to be the first-choice men's business brand, by tailoring the season's latest looks with a modern classic twist. This is achieved through high quality and attention to detail.

Baltman collections are launched twice a year – for the spring/summer and autumn/winter seasons. The collections are well balanced between formal and smart-casual ranges. With every new collection we aim to create a more interesting and innovative lifestyle collection for our target customer.

Baltman currently operates in all of our retail markets but Poland. Altogether there were 13 Baltman stores in our retail network as of the end of 2005. The Baltman collection is also sold through wholesale partners. Sales of Baltman comprised 11% of our 2005 retail sales.

In the case of Baltman we also wish to develop the casual clothing part of the collection, and if necessary supplement the collection by adding clothing designed specially for travel or formal events. **Baltman seeks to offer its customers first-class and personal service, and thereby further strengthen the reputation of its prestigious lifestyle brand.** The Baltman brand is positioned as an advisor in business clothing. The store size will increase from the present 80-100 square metres to 120-130 square metres.

Markets and the strategy for 2006-2008

Baltika's retail operations are currently present in six countries: Estonia, Latvia, Lithuania, Ukraine, Russia and Poland. In terms of population, this region covers 236 million people, offering perspective for substantial growth. Although smallest in terms of population, the Baltic countries together comprised around 65% of the Group's retail sales in 2005 versus the 27% sales generated in Russia and Ukraine. This relationship is expected to change in favour of the latter group, with Russia and Ukraine fuelling major growth in the coming years.

The Central and Eastern European region in which Baltika operates is currently one of the most dynamic regions in the world, posting solid economic growth. The Baltic countries are expected to maintain their position as the fastest-growing economies in the EU, with GDP growth rates of 6-8% p.a. in the next few years. The economic growth of Poland, which is also a member of the EU, is forecast to pick up to around 4% in 2006-2007, compared with the ca 2% growth level for the EU as a whole. Russia and Ukraine are also expected to post encouraging economic growth in the range of 5-6% in 2006-2007.

In addition, the region still boasts a relatively lower penetration of fashion brands in comparison with Western Europe, and consumption of fashion is not as fast as in the developed countries. However, booming retail markets, evolving purchasing power and Baltika's first-mover advantage gained by the early roll-out of retail facilities support the company's growth outlook in the region.

In the coming years the Baltika Group's rapid development in target markets will continue, although it will differ from country to country as a result of regional peculiarities.

Macroeconomic overview of Baltika's markets

	Population, mln	GDP 2005, EUR bln	GDP per capita 2005, EUR	GDP growth 2005	GDP growth 2006f	Inflation rate 2005
Estonia	1.3	11	7,842	9.8%	7.8%	4.1%
Latvia	2.3	13	5,523	10.2%	8.0%	7.0%
Lithuania	3.4	21	6,042	7.5%	6.5%	2.7%
Poland	38.6	241	6,227	3.2%	4.2%	2.1%
Ukraine	47.0	66	1,400	2.4%	5.0%	13.5%
Russia	143.5	616	4,292	6.4%	6.2%	10.9%
Total	**236.1**					

Source: State statistics departments, consensus estimates for 2006 GDP growth

Note: 2005 GDP figures are preliminary

The Baltic States

The three Baltic States are Baltika's home market. The company's headquarters and central functions, including product design and sourcing, are located in Estonia. Back in 1991, Baltika's first store was also opened in Estonia, and up to the present day, Estonia has been Baltika's largest market. In 2005, it had 24 stores and accounted for 28% of the Group's retail sales.

In 2006, Latvia will celebrate its 10th anniversary as a Baltika market. Latvia is currently characterised by a dominance of one city, the capital Riga, in which Baltika is well established, with 10 stores. The third Baltic country, Lithuania, was the first foreign venture for Baltika, starting in 1993 with the establishment of our own store. In 2005, Baltika undertook rapid expansion in Lithuania. During the year, eight stores were opened across the country, bringing the number of stores to 23.

Since the Baltic States is our home market, our brands are better known here, and we also have more stores in the region. By the end of 2005, the Baltika Group was represented in practically all of the most important and biggest cities in the Baltic States. In the coming years we see most growth coming from the development of brands – new product areas will be added and our stores will increase in size – and raised sales efficiency. As a result of the differing populations of the countries in which we operate, we expect the greatest growth to take place in Lithuania, where we will be able to further expand the Group's store chain. As concerns locations that are not yet covered, we have our sights set on a few larger and more promising cities in Latvia. In Estonia, new stores will be added when shopping centres with suitable concepts are established.

Maruta Ergle
Latvian Market Director

Sven Ohlau
Estonian Market Director

Daina Daubare
Lithuanian Market Director

At the end of 2005, Baltika had a total of 57 stores in Estonia, Latvia and Lithuania. **We plan to open another 20-22 new stores in these countries in the next three years.** As of the end of 2008, the share of the Baltic States should be above 40% in our store portfolio.

Ukraine and Russia

Baltika entered Ukraine in 2000 and now capitalises on its first-mover advantage that was gained by the early roll-out of our retail chain. In 2004, our fast fashion brand Monton received the “Choice of the year” award in the category of womenswear in Ukraine. In 2005, we refined our store portfolio, and by the end of the year had established 12 stores across the country. Despite the deficit of shopping centre developments and the lack of retail space, major expansion is planned for the next few years, with expansion already starting in the first half of 2006. In Ukraine we have our sights set on all cities that have more than 500,000 inhabitants.

Baltika has had a presence in Russia since 1994, however, own retail operations were only established in the market in May 2004 with the acquisition of a majority stake in the operations of its Russian wholesale partner. There are now nine stores in this huge market and a presence in three cities. We see great potential for growth in Russia in the coming years, bolstered by the accelerating development of shopping centres in the country. The main development of Baltika stores in Russia will take place in Moscow and St. Petersburg, although we are also concentrating on other Central Russian cities with populations over one million, such as Kazan, Nizhni Novgorod, Rostov and others.

Russia and Ukraine are exciting markets for Baltika due to their future expansion potential. We believe that in this region we will open the largest number of stores in 2006-2008. As of the end of 2005, there were 21 stores in these two countries. During the next three years we plan to open 60-75 new stores. After these openings Russia’s share should increase to more than 25% and Ukraine should represent 20-25% of our store portfolio.

Tatjana Karlova
Ukrainian Market Director

Olga Yakovleva
Russian Market Director

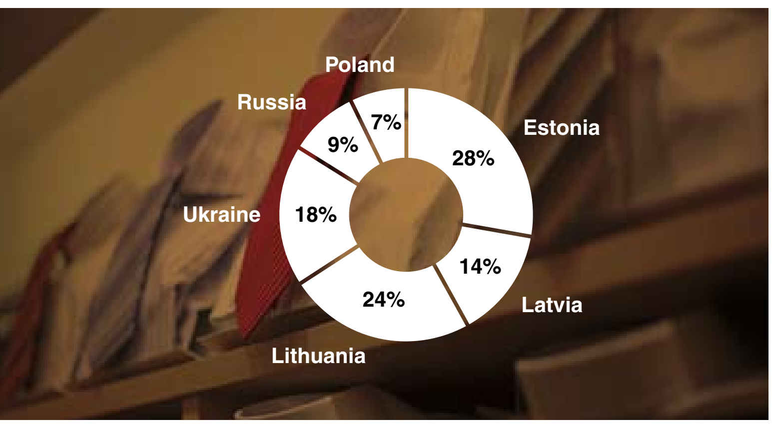
Aleksandra Makal-Młynarska
Polish Market Director

Poland

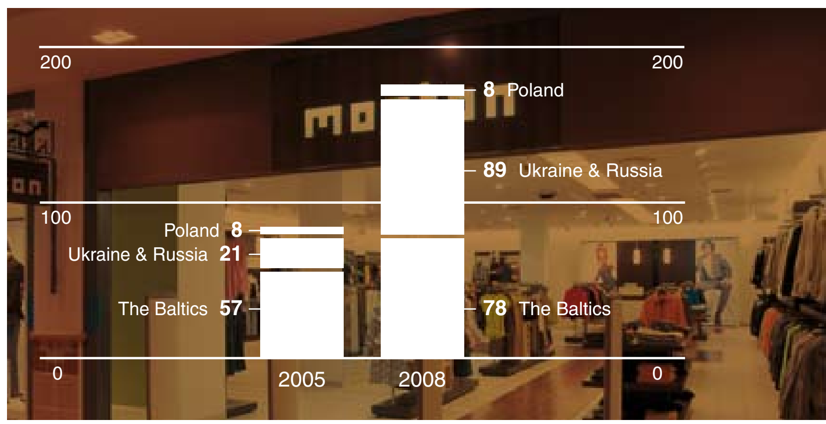
Poland is currently the smallest of Baltika's markets, with eight stores as of the end of 2005, and sales comprising around 7% of the Group's retail sales.

Baltika began retail operations in Poland in 2000, when the development of large shopping centres in the country was still in its infancy. As a result, some of the centres in which Baltika opened stores did not prove to be competitive in the long term, or the centres' concepts did not harmonise with the positioning of the Baltika brands. When the existing rental agreements come to an end, Baltika will consider closing those stores.

Our objective is to operate with our two brands – Monton and Mosaic – only in strong centres, and achieve average efficiency figures for those brands in the existing stores. In the coming years we will above all concentrate on the development of the store network in the capital Warsaw. Based on our previous experiences, we view developments in Poland carefully, and plan to have 6-9 stores there by the end of 2008 and thus Poland will comprise around 5% of the Group's store portfolio.



Share of markets in Baltika's retail sales, 2005



Estimated average growth of store portfolio 2005-2008

Expansion perspectives in summary

We believe that the CEE region as a whole offers great promise for the Baltika Group and thus we are following developments in other countries in the region with great interest. Our objective in the next three years is to select markets with the greatest potential for the Group, find new development partners and enter one or two new markets.

We believe that there is still a great deal of potential in the Baltika Group's target markets, and the next years will bring the Group a rapid increase in the number of stores and their size in square metres. Whereas Baltika had 86 stores as of the end of 2005, a further 80-100 new stores will be added to the sales network in the next three years.

Putting the vision into practice

Cyclical process in product development

Our brands - Monton, Mosaic and Baltman - have dedicated designers. Over the years, our main designers, Tarvo Jaansoo, Janika Sootna and Evelin Lill, have received a prominent Estonian designers' award, the Golden Needle. In 2006, our Monton ladieswear designer Iren Truuverk was nominated for the Golden Needle award.

Each brand uses the same management process but interprets feedback and trends in accordance with their individual customer profile. Every brand has a specialist product management team which operates as an individual profit centre. The brands are supported by shared resources in planning, sourcing, buying and technology to ensure the highest level of expertise in a cost-efficient manner. These teams work with our suppliers to ensure that we deliver the best possible product ranges for all of our customers and achieve the Group's financial objectives.

Building an efficient sourcing base

The Baltika Group's supply activity is structured in order to most effectively support the objectives of the Group's different brands, and thus the company as a whole. In the case of Monton, the fast fashion brand, this means flexible and rapid supply, for the Baltman brand it is the acquisition of high quality products, and for Mosaic it is above all the supply of products with the best price and quality.

Nearly half of all of the products sold under the Baltika Group trademarks are produced at the manufacturing companies that belong to the Group and by other Estonian sub-contractors. The material used for these products is centrally acquired from the best European materials suppliers. This manner of sourcing makes maximum use of the opportunities provided by vertical integration, in which the company controls the whole chain from product development to production. The possession of its own production base, which includes Baltika's three subsidiaries, gives the Group additional flexibility and speed in filling orders.

Another and continually growing group of products is acquired from the Group's long-term partners, primarily in the Far East and Turkey. Baltika's co-operation with some of these companies has lasted for over ten years. In addition to long-term partners, the Baltika Group co-operates with the world's largest supply chain management agency Li&Fung Ltd., which ensures access to new supply markets and significantly expanded opportunities to acquire products that comprehensively satisfy customer needs.

All supply operations are coordinated using systematic quality control procedures. The product development stages themselves are based on quality assurance requirements. In addition, every product in the production process undergoes repeated quality control in accordance with the established standards.

Penny Robinson
Product Division Director

Increasing focus on inventory management

Improving inventory management has been our key priority in the last two years. Our teams have continued to focus on maintaining appropriate levels of inventory, balancing our desire to deliver high availability for customers with the sound fiscal management of the business. Further enhancements to our business processes and our IT infrastructure continue to support this area, as demonstrated by the continued improvement in stock turnover, while delivering real sales growth.

As part of our overall location strategy and the plan to release the Veerenni Street site in Tallinn for redevelopment, we have commissioned a new warehouse facility at an industrial park in the suburbs of Tallinn, which will come on stream late in the summer of 2006. The purpose-built facility will enable further improvements in the efficiency of our logistics operations.

Becoming successful in retail

Baltika's key distribution channel is our retail network. Retail sales have gradually acquired a larger share in sales revenues since the shift from production to retail took place, and have now become the essence of Baltika's operations.

Maire Milder
Retail Division Director

Over the last four years, Baltika has continuously expanded its store portfolio. As of the end of 2001, Baltika's retail network had 36 directly managed stores with total sales area of 4,428 square metres. At the end of 2005, Baltika Group operated 86 stores with total sales area of 12,736 square metres.

In 2005, retail sales had posted annual growth of around 30% for two consecutive years, while same store sales posted an impressive growth of 23%. Our sales are supported by a favourable macroeconomic environment and booming retail sectors in the target markets. The economic growth in the region is accelerating and living standards are rising, which triggers higher expenditures on clothing. In addition, sales are positively impacted by higher store traffic in Baltika's shops in comparison with the previous year. Our brand awareness is increasing in the markets in which we operate, and we are continually recruiting a growing number of loyal customers.

During the year 2005, the management of retail activities has become more centrally coordinated and more efficient. The centralised management is supported by the expertise of retail organisations in our markets.

We have unified store concepts, marketing, human resources development, etc. Choosing the right personnel and providing continuous training to store personnel helps to improve service levels in our stores, thereby increasing customer satisfaction.

Inspiring stores in the best locations

Stores are everything for Baltika. This is where our customers make the purchase decision under the guidance of our professional staff. It is important to give customers ideas to choose things that suit their own style. Hence, we work to make our store environment comfortable, exciting, inspiring and to communicate fashion and style according to every brand's essence.

It is important to make the best out of every store location and shape. In recent years we have learned how to choose the best locations for our brands. There are many factors we look at when establishing a store - we evaluate local shopping streets and shopping centres, analyse potential traffic flows and accessibility, as well as the tenant mix in the centres and nearby areas. In the top centres we have all of our three brand stores, but in smaller centres in less favourable locations we choose the most suitable brands from our portfolio.

Our furniture is module-based, which makes it easier to adapt to different shapes of stores. We also adapt the merchandise mix for every store depending on the location, the size of the store and customer flow.

Customer hugging story (Odessa, Ukraine)

One weekday two young people walked into a store. One of them had suffered a serious calamity: he had just flown to his friend's wedding, but all of his baggage had been misplaced en route. The sales assistants found a suitable shirt, tie and suit. The pants were a little long, but the young man was nevertheless ready to rush off to the wedding. The sales assistants offered a compromise: the young men were sent to the neighbouring store to select a perfume, while the sales assistants set themselves to shortening the pants and ironing the shirt. When a few minutes later the young man was getting dressed in the clothes, he said among other words of thanks that he had never experienced such attention to the customer.

In recent years a lot has been done to harmonise personnel policy. Perhaps the greatest achievements in this area are the selection of employees in retail sales, the assessment of work results and the standardisation of the salary system. Uniform service standards have also been developed and implemented. We consider it very important to select sales assistants in a thorough and systematic manner, keeping in mind the values of both each brand and the company as a whole.

Sales structure 2005 vs 2001

Number of directly managed stores

Hugging culture increases customer satisfaction

The key component in all of our brands is customer satisfaction. We refer to our customer service concept as customer hugging, which does not mean every customer literally getting a bear hug, but devoting utmost attention to their wishes. In order to develop a culture of customer hugging, we have used a great deal of internal communication: we regularly gather stories of customer hugging, and share them both in stores and through an employee newspaper. We naturally recognise the best customer huggers, and instruct new employees based on their example.

In addition, we have also devoted attention to employees' continued training. In employees' occupational evaluation, we set the objective of individually evaluating each team member's performance, so as to increase employees' awareness and motivation. The results of the evaluation are closely connected with the further development of each employee, but also with the remuneration system and with the overall aim of increasing each store's profitability. Baltika has introduced a performance pay system that is based on a personal basic salary and team-based performance pay, and offers managers the opportunity to grant employees recognition for very good results.

Baltika's communication is aimed at building our brands

Baltika communicates in many different ways: through the print media, billboards, radio and television commercials, on the Internet - and above all in our stores and through our employees.

The store is our most important communication channel: more than ten million people visit our stores every year. We devote great effort to creating attractive store-windows, inspiring merchandise lay-out and visual communication tools. Above all, Baltika emphasises the importance of internal communication to our store employees.

A long-lasting relationship and regular communication with loyal customers is our next important marketing tool. We communicate directly via mail, e-mail, SMS and telephone with our more than 200,000 loyal customers in six markets.

PR and advertising in the media are important tools for brand building. Our brands' advertisements are produced centrally in our head-office by different agencies and freelancers. The advertisements are largely identical in all of our markets, but the media mix is adapted to local needs and conditions. We use different channels such as our stores, radio, TV, billboards, the daily, weekly and monthly press and the Internet.

We also use PR activities to reach our different target groups in a cost-efficient manner. Each season we hold meetings with the press to communicate the trends of our brands.

All of our brands have websites that give detailed information about the brands, ranges, trends, and where to find our stores. In addition to that, we have a website for the Baltika Group that is targeted to shareholders, potential employees and the media.

Boriss Loifenfeld
Wholesale and CIS Market
Projects Director

Wholesale complementing retail

In addition to its own retail chain, Baltika also sells its collections wholesale. One of Baltika's largest wholesale clients is a Russian company that operates stores in the Siberia and Ural region that sell Baltika's brands. The other wholesale partners are mainly department stores and the destination countries are the Baltics and Finland. Two brands – Baltman and Mosaic – are mostly distributed wholesale. Monton is sold wholesale only to Baltika's Russian partner. We are continuously looking for new partners, especially in markets where Baltika has not established and is not currently intending to establish its own retail operations, i.e. Western Europe and Scandinavia.

Compared with our much more aggressive expansion strategy in retail operations, expected growth in wholesale activities in the next three year period is much more modest. Wholesale is anticipated to grow at an average rate of 5% p.a. Nevertheless, by the end of the 2006-2008 strategy period we intend to develop our franchise concept and thereafter start rolling out our franchise business, which should provide a solid addition to wholesale revenues. In 2005, wholesale sales of our own products increased 4.4% in comparison with the previous year.

Stakeholders are important

During the last decade, Baltika has become a publicly traded company and also a truly international company – with international operations, personnel and shareholders. We understand that our sustainable development depends on a responsible attitude to all of our interest groups – employees, shareholders, customers and society as a whole.

Creating long-term value to shareholders

Baltika is a publicly traded company that has the objective of increasing the value of its owners' assets. It was in the interests of implementing that objective that the strategic turnaround from clothing manufacturer to retail enterprise has been undertaken in the last four years. The year 2005 demonstrated that the strategy we chose has borne fruit. In 2005, the value of the Baltika stock rose at record pace, from 1.86 euros to 13.00 euros and the Group's market value to 75.7 million euros. Although it is difficult to repeat such growth, our objective is to increase the company's value through further expansion, and thereby ensure long-term growth in the value of shareholders' investment. In this way we hope to be an attractive investment object in the CEE region.

Considering the Group's objectives in the coming years, the maximum dividend payout ratio is set at 25% of net profits for the financial year.

In 2005, a positive development also took place in the liquidity of the Baltika stock. In connection with the closure of the fund, long-term strategic investor, the Baltic Republics Fund, withdrew from Baltika's circle of shareholders. The fund's participation was sold through an international bid that created great interest and was oversubscribed severalfold. Institutional investors from eight different countries participated in the transaction, and as a result Baltika now has the largest percentage free float of all companies quoted on the Tallinn Stock Exchange. During the bidding, the management of Baltika increased its holding through the company OÜ BMIG, which is the largest shareholder after the bidding, with a 22.07% holding at the end of 2005. As of the same date, the members of the Management Board owned 26.44% of stocks, both directly and through companies controlled by them.

Dividend policy

In the long-term, Baltika's objective is to offer shareholders the maximum return through both the growth of the company's market value and the payment of dividends. Baltika is presently in a rapid growth phase, and in the coming years will need sufficient investments to be able to finance its expansion. At the same time, the company desires to pay out part of its profits to shareholders.

Commitment to investor relations

Since 2005, Baltika has devoted greater attention to investor relations bringing a specialist in this area into its team. At the moment, the priority of Baltika's investor relations is to improve the availability of the information presented to investors and other interest groups through various channels, and thus to raise the company's transparency and attractiveness among potential investors. Our objective is to develop efficient and open relations with investors, as a result of which we hope to diversify our investor base and raise share liquidity. In 2005, excluding the transaction for the sale of the Baltic Republics

Fund's stake, the stock exchange turnover involving Baltika shares increased by 16 times in comparison with 2004, reaching 16.5 million euros, and the number of Baltika stocks traded rose by more than three times to 2.3 million stocks.

In 2006, we plan to thoroughly renew the Baltika Group's webpage on the Internet, and also add an investor relations section. Our aim is to create a visually attractive and easily navigable homepage, where all of our interest groups will be able to find the up-to-date information that interests them. The homepage must become the primary and most high-quality source of information about the Baltika Group. Each of our brands already has attractive homepages for customers.

Baltika follows Corporate Governance Guidelines

In 2005, the Tallinn Stock Exchange and the Financial Supervision Authority jointly published a collection of rules entitled "Corporate Governance Guidelines", the observance of which offers investors and interested persons a sufficient opportunity for supervision over the company's governance, and helps guarantee investors and shareholders equal treatment. The Corporate Governance Guidelines establishes higher requirements for companies than those currently prescribed by Estonian legislation. In its everyday operations, Baltika already follows most of the rules contained in the Corporate Governance Guidelines, and in 2006 we will further improve our compliance with the set recommendations. As of 2006, a "comply or explain" recommendation applies to publicly traded companies, in accordance with which a company is required to prepare a separate report about its compliance with the respective guidelines, in addition to the financial statement.

Responsibility to the community

Over the years, Baltika has contributed to the community as much as it could, but today we are able to direct our profits more actively back into the community, whose recognition has made us stronger and helped us to become an influential clothing retailer in the Baltic States and beyond. Baltika supports the community in those areas that we consider most important – sport, education, children and young people. However, being one of the biggest employers locally, our most important role is to be a good employer both in Estonia and beyond. The Group currently employs more than 1,600 people. This figure will increase in conjunction with our expansion plans.

One of our largest co-operation partners is the Estonian Olympic Committee. In 2004, Monton designed the uniforms for the Estonian Olympians for the Athens summer games. In 2005, an agreement was concluded that appointed Monton to provide the parade and casual clothing for Estonia's Olympians during the Torino and Beijing Olympic Games.

In addition to Estonia's Olympic athletes, Monton clothes the Latvian hockey team, and Baltman the Latvian national football team. In Lithuania we supported the holding of an ice hockey competition. Among other things, Baltika has supported mentally disabled young people and donated clothes to children living in orphanages.

In co-operation with the Estonian Academy of Arts, Baltika has traditionally supported the training of new fashion designers. For nearly ten years, Baltika has awarded an annual stipend to one young and promising fashion designer at the Estonian Academy of Arts. The ultimate goal is to support education and entrepreneurship that involves fashion design.

Estonian Olympians marching towards the most victorious Olympics ever (Torino, February 2006)

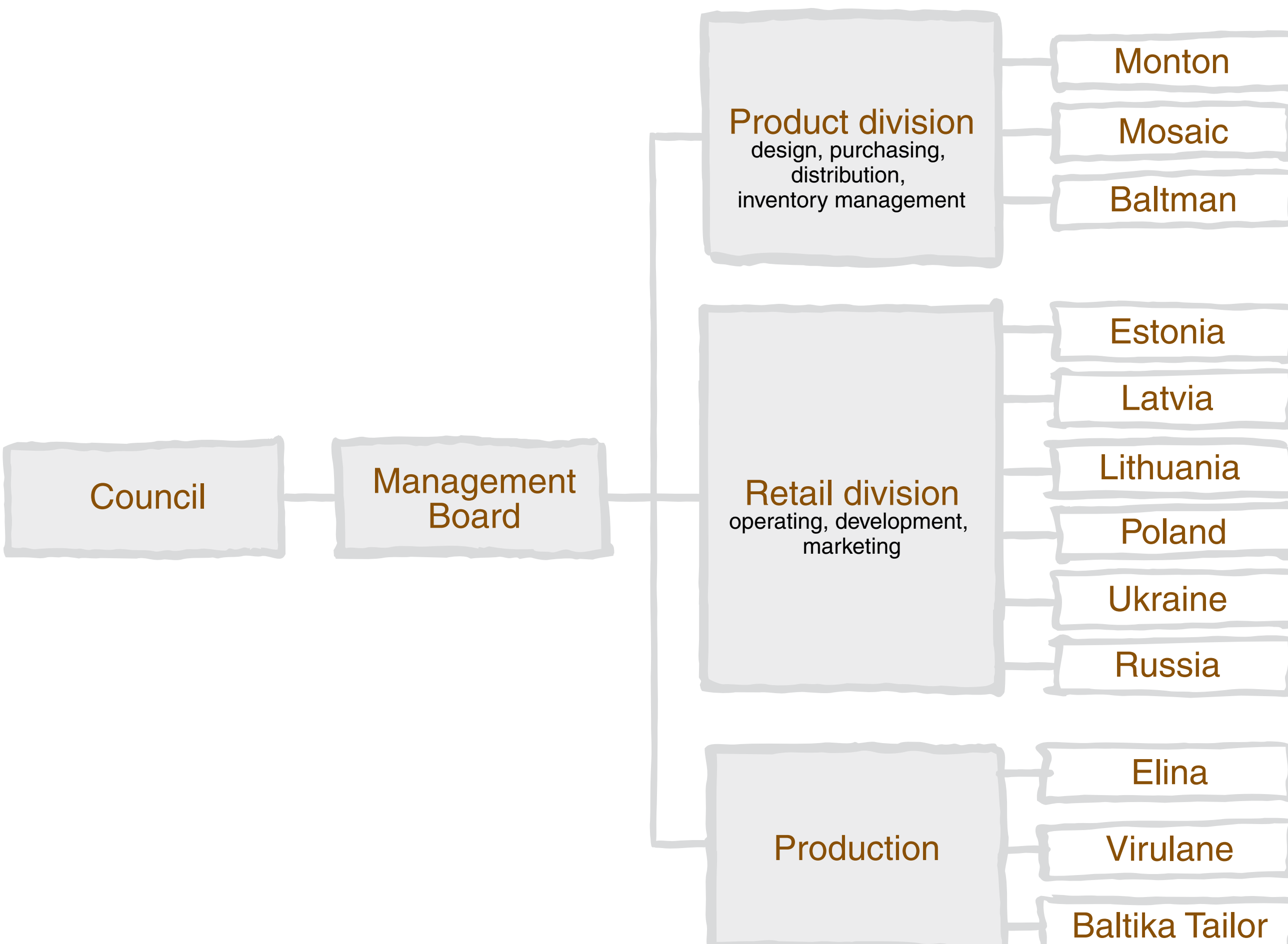
Human capital is the most important asset

In 2003, a system of profit centres was created under the company's various brands and markets. Today a clear company management structure and definite areas of responsibility have developed. In retrospect, it can be said that the transition to the new profit centre structure was a vitally important step for both the smooth organisation of the company's operations and the achievement of its objectives.

Organisational structure

The company has three clearly distinguished areas: the product, retail and production divisions. In addition, there are general supporting functions such as financial administration and accounting, personnel management, IT and logistics. The product division is involved with product design, merchandise purchasing, distribution and inventory management. There are three clearly distinguished brands with their separate teams. The retail division includes store operations, development and marketing. In this area the profit centres are Baltika's retail markets. Production includes Baltika's own factories Elina and Virulane, and joint venture Baltika Tailor.

Management structure of Baltika Group



Personnel strategy

Personnel strategy plays a very important role in the achievement of the Baltika Group's objectives, since our results depend largely on customer satisfaction. For that reason, one of the most important aims of our personnel strategy is to ensure professional, customer-oriented and well-motivated employees.

The Baltika Group has a reward system that makes it possible to recognise the good results of both a team and an individual employee. Among other motivation schemes, Baltika has set up convertible bond schemes for the top and middle management as part of the management's incentive program.

In the preparation of the strategy for the next three years, the company also mapped personnel operations, and as a result of this, personnel strategy and development projects for the years 2006-2008 were elaborated. In the coming years we will continue to devote great attention to our employees' continued development, including the creation of a training program and an occupational evaluation system, the enhancement of management competence and the establishment of a career system.

In the course of all of these innovations, we have not forgotten to recognise the Baltika Group's long-time employees and veterans – those who have worked at the Baltika Group for at least ten years before retirement. In addition to remembering their contribution, Baltika also supports its work veterans financially.

As of the end of 2005, Baltika had a total of 1,678 employees, 630 of whom worked in retail sales, 896 in production and 152 in management. 483 persons were employed outside Estonia.

We consider it very important that the activities developed in personnel work be applied uniformly over the entire Baltika Group, including the subsidiaries that operate in different markets, so as to create a strong basis for shared values throughout the organisation.

Monton's designers presenting new styles at a collection workshop for markets

AS Baltika Supervisory Council

Miles Warwick Burger
Chairman of the Council
Chairman since 1999
Chairman of The Major Oak Clothing Co Ltd.
Baltika shares held on 31.12.2005: 0

Joakim J. Helenius
Member of the Council
Elected 1999
Executive Chairman of Trigon Capital Group
Baltika shares held on 31.12.2005: 0

Reet Saks
Member of the Council
Elected 1997
Attorney, OÜ Advokaadibüroo Raidla & Partnerid
Baltika shares held on 31.12.2005: 0

Claire Chabrier
Member of the Council
Elected 2004
Partner of SGAM AI Private Equity
Baltika shares held on 31.12.2005: 0

AS Baltika Management Board

Meelis Milder
Chairman of the Board
Group Chief Executive Officer
Employed since 1984
Baltika shares held directly on 31.12.2005: 151,617*

Ülle Järv
Member of the Board
Chief Financial Officer
Employed since 1994
Baltika shares held directly on 31.12.2005: 8,158*

Maire Milder
Member of the Board
Retail Division Director
Employed since 1999
Baltika shares held directly on 31.12.2005: 62,161*

Boriss Loifenfeld
Member of the Board
Wholesale and CIS Market Projects Director
Employed since 1990
Baltika shares held directly on 31.12.2005: 12,482*

*The Management Board of AS Baltika also owns shares through the holding company OÜ BMIG. As of 31.12.2005, OÜ BMIG owned 22.07% of the share capital of AS Baltika, and is the company's largest shareholder. Both directly and through companies controlled by them, the members of the Management Board owned 26.44% of AS Baltika as of the end of 2005.

Photos: Olga Makina, Malev Toom, Kaido Haagen, Margus Johanson, Raul Mee
Design: Kaido Känd, Tank

Our special thanks go to Jeff Licata, Lawrence Mason and their students whose photos add emotion to Baltika's Strategy Report. In 2005, Syracuse University of New York organised a workshop for a Photography Master Course in Tallinn, in the course of which USA top fashion photographers Jeff Licata, Lawrence Mason and their students took photos of Baltika's most trendy brand Monton. With kind permission from Jeff Licata and Lawrence Mason, a selection of the photos is reproduced in Baltika's Strategy Report.

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www.mosaic-fashion.com
Baltman:
www.baltman.eu

Baltika Group

Annual Report 2005

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Financial year: 1 January – 31 December 2005

Currency: euro

SUMMARY OF SELECTED FINANCIAL DATA

	2001	2002	2003	2004	2005
Operating results, EUR '000					
Net sales	26,487	31,025	31,767	37,189	43,518
Gross profit*	n/a	n/a	n/a	17,796	22,438
Operating profit	1,478	892	-3,673	1,201	4,787
Profit before taxes	1,077	350	-4,269	896	4,535
Net profit	1,004	434	-4,311	1,067	4,644
Balance sheet data, EUR '000					
Total assets	19,009	23,835	21,051	20,271	24,101
Interest-bearing liabilities	6,292	9,339	8,872	7,697	5,933
Shareholders' equity	9,367	11,311	7,360	9,042	13,290
Other data					
Number of directly managed stores	36	55	66	78	86
Retail space, m^2	4,428	8,684	10,109	11,668	12,736
Number of employees (31 Dec)	1,585	1,725	1,714	1,704	1,678
Key ratios					
Sales growth	21.6%	17.1%	2.4%	17.1%	17.0%
Retail sales growth	41.3%	66.9%	25.7%	30.9%	30.1%
Share of retail sales in net sales	37%	53%	65%	72%	80%
Share of export in net sales	71%	73%	72%	75%	71%
Gross margin*	n/a	n/a	n/a	47.9%	51.6%
Operating margin	5.6%	2.9%	-11.6%	3.2%	11.0%
Net margin	3.8%	1.4%	-13.6%	2.9%	10.7%
Current ratio	2.4	1.8	1.5	1.5	2.1
Debt to equity ratio	67.2%	82.6%	120.5%	85.1%	44.6%
Net gearing ratio	58.2%	76.6%	109.1%	75.9%	31.3%
Inventory turnover	3.83	3.04	3.02	3.89	4.92
ROE	4.4%	0.5%	-42.7%	14.6%	44.1%
ROA	6.1%	0.2%	-17.5%	5.1%	22.2%
Share data, EUR					
Shares outstanding	4,800,000	5,444,450	5,499,450	5,633,950	5,822,950
Weighted average number of shares	4,800,000	5,015,817	5,483,992	5,541,721	5,759,950
Share price (31 Dec)	2.01	2.35	2.10	1.86	13.00
Market cap, EUR mln	9.6	12.8	11.5	10.5	75.7
EPS	0.21	0.09	-0.79	0.19	0.81
Change in EPS	10.2%	-58.6%	-1007%	125%	319%
P/E	9.6	27.1	neg.	9.7	16.1
Book value per share	1.95	2.08	1.34	1.60	2.28
P/B	1.0	1.1	1.6	1.2	5.7
DPS	0	0	0	0.05	0.13**
Dividend yield	0%	0%	0%	2.6%	1.0%**

**Comparable gross profit figures available after the change in the income statement format (introduced in 2005)*
***Proposal to AGM*

Definitions of key ratios

Gross margin = (Net sales-Cost of goods sold)/Net sales

Operating margin = Operating profit/Net sales

Net margin = Net profit (attributable to parent)/Net sales

Current ratio = Current assets/Current liabilities

Debt to equity ratio = Interest-bearing liabilities/Equity

Net gearing ratio = (Interest-bearing liabilities-Cash and bank-Financial assets at fair value)/Equity

Inventory turnover = Net sales/Average inventories*

ROE (Return on equity) = Net profit (attributable to parent)/ Average equity*

ROA (Return on assets) = Net profit (attributable to parent)/ Average total assets*

Market cap = Share price (31 Dec)xShares outstanding

EPS = Net profit (attributable to parent)/Weighted average number of shares

P/E = Share price (31 Dec)/EPS

Book value per share = Equity/Shares outstanding

P/B = Share price (31 Dec)/Book value per share

Dividend yield = DPS/Share price (31 Dec)

**Based on 12-month average*

BRIEF DESCRIPTION OF BALTIKA GROUP

The Baltika Group is an international clothing group, whose parent company is AS Baltika. The Group operates the retail chains of Monton, Baltman, CHR/Evermen (Mosaic as of February 2006) and Baltika factory outlet stores in six countries – Estonia, Latvia, Lithuania, Poland, Ukraine and Russia. The brands of the Baltika Group are marketed through its own retail chains as well as wholesalers, the main brands of which are Baltman, Evermen and Herold (overcoats) for men and CHR and Mascara (overcoats) for women. Men's and women's clothes under the brand name of Monton are sold mainly through the Monton retail chain. Factory outlet stores sell past seasons' clothes of different brands.

The shares of AS Baltika are listed on the Tallinn Stock Exchange.

As of 31 December 2005, the Group employed 1,678 people and as of 31 December 2004, 1,704 people.

The parent company is located and has been registered at Veerenni 24, Tallinn, Estonia.

The Group consists of the following companies:

	Location	Participation 31.12.2005	Participation 31.12.2004
Parent company			
AS BALTIKA	Estonia		
Subsidiaries			
OÜ Baltman	Estonia	100%	100%
Baltika Lietuva	Lithuania	100%	100%
Baltika Latvija	Latvia	75%	75%
Baltika Sweden AB	Sweden	100%	100%
Baltika Ukraina Ltd	Ukraine	99%	99%
Baltika Poland Sp.z.o.o.	Poland	100%	100%
OY Baltinia AB	Finland	100%	100%
AS Elina STC	Estonia	50.10%	50.10%
AS Virulane	Estonia	79.23%	79.23%
OOO Kompania „Baltman Rus"	Russia	50.10%	50.10%
OÜ Baltika TP	Estonia	100%	-
Joint venture			
OÜ Baltika Tailor	Estonia	50%	50%

A subsidiary of AS Baltika, OÜ Baltika TP, whose main activity is real estate development and management was registered and started its operating activities in the financial year.

MANAGEMENT REPORT

The year 2005 was the final year in Baltika's 2002-2005 strategic period, which included a radical turnaround of the company into a vertically integrated retail enterprise. Baltika Group has become one of the leading specialist fashion retailers in Central and Eastern Europe. The Group has three successful retail concepts and retail operations in six countries. As of the end of 2005, the Baltika Group operated 86 shops with total sales area of 12,736 square metres.

Baltika Group's net profit in 2005 amounted to 4.6 million euros, and net margin rose to 10.7% (2004: 2.9%). Baltika's 2005 net sales increased 17.0% to 43.5 million euros, while retail sales posted a growth of 30.1% and wholesale increased 4.4% in comparison with the previous year. Exports comprised 71% of net sales in 2005. The Group's gross margin reached 51.6%, compared with 47.8% in 2004. Operating margin rose to 11.0% (2004: 3.2%), bringing operating profit to 4.8 million euros.

In 2005, all of Baltika's retail markets benefited from improving macroeconomic conditions. The Baltic countries were especially successful, posting economic growth in the range of 7-10%. This is approximately six times higher than the average growth of the Euro zone. The region's economy is developing rapidly and living standards are growing, which triggers higher expenditures on clothing. In Russia and Ukraine we can see shopping centre development gathering speed. As a result, customer habits in that region are changing, and retail chains have good growth prospects.

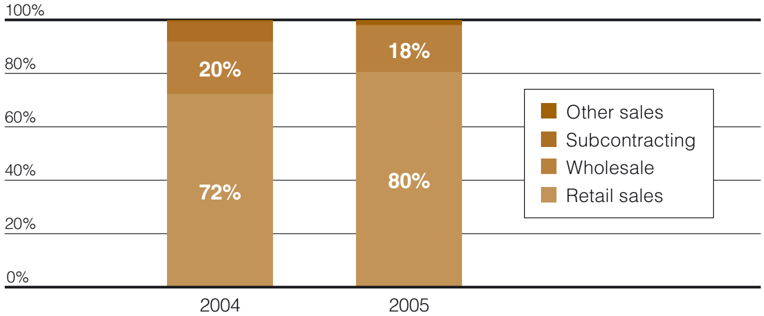
Sales

Sales breakdown by segment

EUR mln	2005	2004	+/-
Retail sales	34.9	26.9	30.1%
Wholesale	7.7	7.4	4.4%
Subcontracting	0.04	2.7	-98.7%
Other sales	0.8	0.2	308.3%
Total	**43.5**	**37.2**	**17.0%**

Due to the establishment of a joint venture in November 2004 on the basis of Baltika's production unit Baltika Tailor OÜ (equal ownership by AS Baltika and Oy Turo Tailor Ab), the principles of the consolidation of the Group's companies changed as of 1 December 2004. The revenues and expenses of the joint venture are not consolidated in the financial statements of Baltika Group, as a result of which the consolidated sales results do not include subcontracting figures starting as of December 2004. Thus in comparable terms, if we consider only the revenues from retail and wholesale, the net sales of the Baltika Group in 2005 grew by 24.5% yoy.

Share of sales by segment



Retail sales

In 2005, Baltika's retail sales continued solid expansion, rising 30.1% compared with 2004, and reaching 34.9 million euros. The share of retail sales in the Group's total sales rose to 80% compared with a 72% share in 2004. The average retail space of the Baltika Group grew 8% in 2005, and sales efficiency (sales/m^2) increased 21% yoy. Like-for-like sales (sales on comparable areas) posted a growth of 23% in 2005.

Baltika's sales in 2005 were positively impacted by higher store traffic in our stores in comparison with 2004. A total of 10.5 million people visited our stores in six markets last year. We notice strengthening brand awareness in our markets and a growing number of loyal customers.

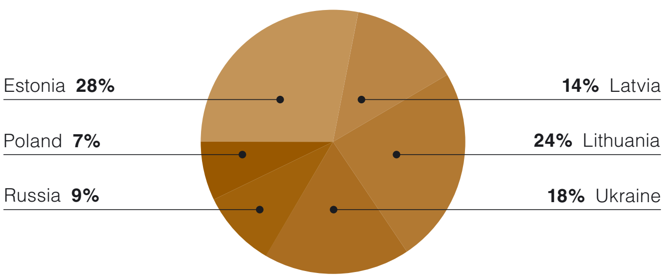
In 2005, all of our brand collections were very well received. Last year's 21% improvement in sales efficiency is proof of that. Among other things, the growth in sales efficiency was driven by gradually improving inventory management: precisely timed season beginnings, well managed discount periods, special offers and promotions – this was all supported by centrally executed stock management. In addition, our store layout and windows became much more attractive.

During the last year, the management of retail activities has become more centrally coordinated and efficient. The centralised management is supported by the expertise of the retail organisations in the markets. We have unified store concepts, marketing, inventory management, human resources development etc. Choosing the right personnel and continuous training of store personnel helps to improve service standards in our stores, thereby increasing customer satisfaction and brand recognition.

Markets

All of Baltika's retail markets posted solid sales growth in 2005, except for the smallest market Poland (representing 7% of retail sales), which experienced a 3% decline in sales. In terms of sales revenues, Estonia was Baltika's largest retail market last year, accounting for 28% of the Group's retail sales. Retail sales in Estonia totalled 9.8 million euros, representing a growth of 31% versus the previous year. The sales were mainly driven by a high rise in sales efficiency (sales/m2) in existing stores – 2005 like-for-like sales growth in Estonia was higher than the Group's average. Nevertheless, three stores were opened in the market, one store was closed and a few were refurbished or relocated to better premises.

Share of markets in retail sales, 2005



Estonia was followed by Lithuania, which accounted for 24% of the Group's retail sales. Lithuanian retail sales totalled 8.3 million euros in 2005, increasing by 22%. Sales growth was also supported by the opening of new stores – a total of eight stores were opened in Lithuania last year, although five of these were opened only in the last month of the year.

The third Baltic state, Latvia, posted very rapid (42%) sales growth in 2005 – to 4.7 million euros. Latvian sales represented 14% of the Group's retail sales. There were no store openings in Latvia last year.

In Ukraine, Baltika's retail sales amounted to 6.3 million euros in 2005, up 39% versus 2004. Ukraine experienced very high like-for-like sales growth – almost double the Group's average figure last year. Two new stores were opened in the first half of 2005, and as of the end of the year, Baltika was represented in six cities across the country. Ukraine comprised 18% of the Group's retail sales in 2005.

Russia generated retail sales of 3.3 million euros in 2005 and accounted for 9% of the Group's retail sales. Sales growth reached 65%, although as retail sales began in May 2004, Russia's annual sales figures are not comparable. On 20 April 2004, Baltika acquired a 50.1% stake in the retail company OOO Kompania "Baltman Rus", managing the sales of Baltika's brands in the Russian market. As a result, Baltika began to operate eight stores in Russia (four in Moscow and four in St. Petersburg). If we consider sales from the second half of 2005, which are fully comparable, the achieved growth in retail sales was 15% yoy. In 2005, three new stores were opened in Russia, one in Moscow and two in Kazan. The last two represent entrance into a new city in Russia.

Poland is currently the smallest of Baltika's markets, with sales comprising 7% of the Group's retail sales and the only market where sales declined (-3%) in 2005. Sales in Poland totalled 2.5 million euros. There were no store openings, and one store was closed. Our goal in Poland is to achieve average efficiency ratios for brands in existing stores. Baltika is present in Poland with two of its brands – Monton and Mosaic.

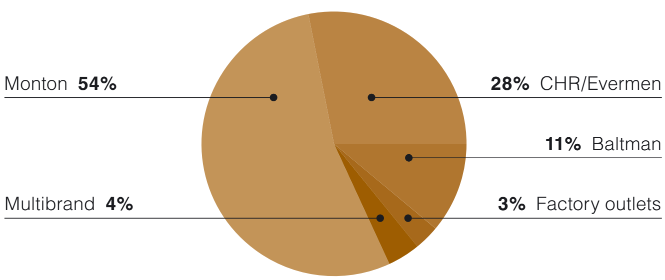
Retail sales by market

EUR mln	2005	2004	+/-
Estonia	9.8	7.5	31%
Latvia	4.7	3.3	42%
Lithuania	8.3	6.8	22%
Ukraine	6.3	4.5	39%
Russia	3.3	2.0	65%
Poland	2.5	2.6	-3%
Sweden	0	0.1	-100%
Total	**34.9**	**26.9**	**30%**

Brands

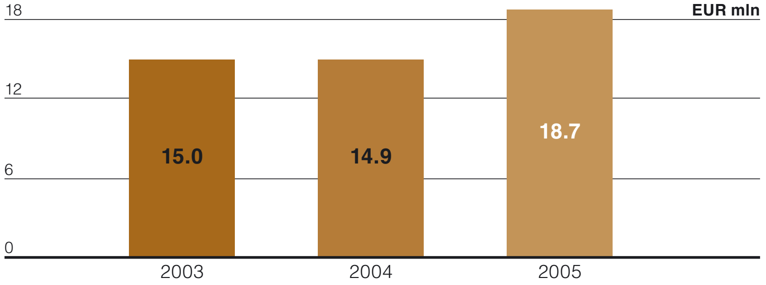
In terms of brands or store concepts, the sales of fast fashion brand Monton accounted for the largest (54%) share of the total retail sales of the Group in 2005. Sales of CHR/Evermen accounted for 28%, and Baltman for 11% of total retail sales. The rest of sales came from factory outlet stores and multibrand stores that sell several brands.

Share of brands in retail sales, 2005



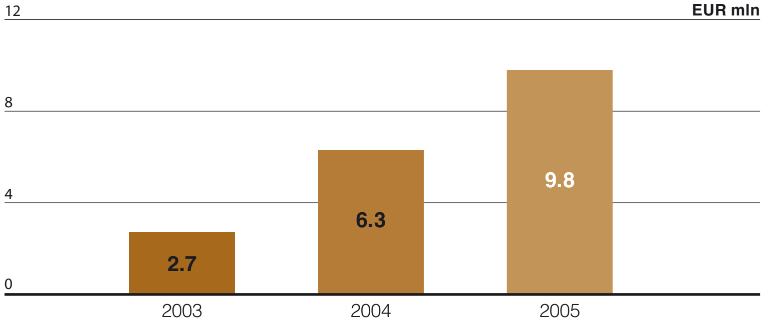
The sales of Monton amounted to 18.7 million euros in 2005, growing by 26% yoy. Major development took place in Monton's men's collection – sales per square meter increased, margins improved and mark-down percentage decreased. The collection has improved in style and fit, and has become more attractive and fresh, which has been received very well by the target customer. Monton's ladies' collection has also found the right touch that distinguishes Monton from other fast fashion brands and makes it more attractive to customers. A significant increase in collection sell-through at the first price is proof of that. Overall, Monton collections did a good job catching trends and meeting its customers' expectations. In 2005, five new Monton stores were opened: three in Lithuania and one in both Estonia and Russia.

Retail sales of Monton



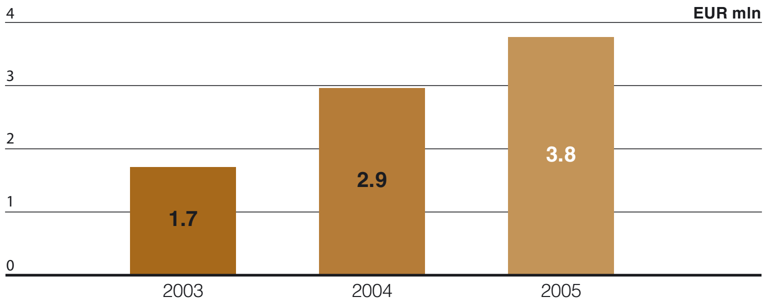
In 2005, the retail sales of CHR/Evermen rose 54%, reaching 9.8 million euros. The growth came both from higher same store sales and the opening of new stores. A total of seven new CHR/Evermen stores were opened last year: five in Lithuania, one in Ukraine and one in Russia. In addition, in the second half of last year, three Monton stores in Poland were converted into CHR/Evermen stores. 2005 was the last year for the CHR/Evermen concept, as the name CHR/Evermen was changed to Mosaic from 14 February 2006 (see the section "Baltika changes CHR/Evermen to Mosaic"). The main difference between the CHR/Evermen and Mosaic collections is that in Mosaic we add more casual wear to our strong business wear range, making the collection more balanced and fresh. This was already the main aim in 2005 in creating the new collections, and thus in the 2006 spring-summer season we have improved the collections, especially the men's collection.

Retail sales of CHR/Evermen



The retail sales of Baltman totalled 3.8 million euros in 2005, growing by 28% yoy. Baltman offers its clients products that are essential for the brand, however, we have continuously added details, different finishes and new product categories to achieve a more personalised collection. In terms of new product categories, Baltman introduced travel wear last year – the Baltman travel suit campaign was very well received in all of our markets. Also, the wider selection of accessories triggered significant growth in Baltman accessories sales last year. A total of four new Baltman stores were opened in 2005.

Retail sales of Baltman



Shops and sales area

As of the end of 2005, the Baltika Group operated 86 shops in six countries, with total sales area of 12,736 square metres. A year ago, Baltika's retail system comprised 78 stores with total sales area of 11,668 square metres. In 2005, Baltika opened a total of 16 stores, including nine of them in the fourth quarter. Eight stores were closed and a few were refurbished or relocated to better premises. The net growth of the retail system was eight stores and 1,068 square metres.

In terms of markets, the largest retail chain expansion took place in Lithuania last year – a total of eight stores were opened. Lithuania was followed by Estonia and Russia with three stores each, and Ukraine with two stores.

Number of stores by market

	31.12.2005	31.12.2004
Estonia	24	23
Latvia	10	10
Lithuania	23	16
Ukraine	12	12
Russia	9	8
Poland	8	9
Total stores	**86**	**78**
Total retail space, m²	**12,736**	**11,668**

In terms of brands, the largest number of stores were opened under the CHR/Evermen name – altogether seven new stores. In addition, three Monton stores in Poland were converted into CHR/Evermen stores in conjunction with the optimisation of the brand portfolio in Poland. A total of five Monton stores and four Baltman stores were opened last year. As of the end of 2005, the stores were divided between the concepts as follows: 32 CHR/Evermen, 31 Monton, 13 Baltman and 6 factory outlet stores. In addition, Baltika owns four multibrand stores that sell several brands together and were acquired with the purchase of the 50.1% holding in the Russian partner. Most of those stores will be converted into full concept stores in as early as March 2006.

Baltika's retail network by markets and brands, 31.12.2005

	Monton	CHR/Evermen*	Baltman	Factory outlets	Multibrand	Total	m²
Estonia	6	9	5	4		**24**	**2,999**
Latvia	4	4	2			**10**	**1,414**
Lithuania	9	9	4	1		**23**	**3,588**
Ukraine	6	5	1			**12**	**1,808**
Russia	2	2	1		4	**9**	**1,228**
Poland	4	3		1		**8**	**1,699**
Total	**31**	**32**	**13**	**6**	**4**	**86**	**12,736**

**Mosaic as of February 2006*

Wholesale

In 2005, wholesale sales of Baltika's brands totalled 7.7 million euros, up 4.4% compared with the previous year. One of Baltika's largest wholesale clients is a Russian company that operates around 25 stores in the Siberia and Ural region that sell Baltika's brands. The other wholesale partners are mainly department stores in the Baltics and Finland. Two brands – Baltman and Mosaic – are mostly distributed wholesale. Monton is only sold wholesale to Baltika's Russian partner.

The share of wholesale sales in Baltika's net sales decreased to 18% in 2005 compared with 20% in 2004. In future, this proportion will most likely decrease further, as retail sales are expected to grow at a faster rate as a result of the aggressive development of the retail system.

Baltika changes CHR/Evermen to Mosaic

In February, Baltika changed the name of one of its concepts – starting from 14 February 2006 the name CHR/Evermen was changed to Mosaic. The name change was carried out in order to simplify the brand's name and thus enhance the concept's international competitiveness.

In the last two years, CHR/Evermen has been Baltika's most rapidly growing chain of stores, the single disadvantage of which has been its relatively long and graceless name. The name change and further development of the store concept is carried out before major expansion. The company expects to benefit from the name change and the new international concept, above all in large markets where brand awareness is currently limited due to the small number of stores. Considering the active development of the Russian and Ukrainian markets, it is prudent and also cheaper to conduct the name change today, before opening more stores in these countries.

The name change also solved the issue of using the Evermen trademark in Latvia. The litigation regarding the sole rights to the Evermen trademark in Latvia began in 2003 when Baltika's wholesale partner SIA Baltik Stils submitted a complaint to the Board of Appeals of the Latvian Patent Board to repeal the registration of Baltika's trademark Evermen. However, according to the decision made by the Supreme Court of Latvia in December 2005, the sole rights to the Evermen trademark remained in the possession of the former business partner of Baltika, who registered the trademark in Latvia in 1998, a few years after the trademark was created by Baltika. After CHR/Evermen was changed to Mosaic, the issue no longer affects Baltika's operations in Latvia.

At the time of the name change, Baltika was operating 35 CHR/Evermen stores in six countries, which will become Mosaic during the first half of 2006. The estimated cost of the name change is 288 thousand euros, of which 32 thousand euros was included in the 4Q 2005 expenses. The expenses involved with the name change include the development of the new name, the change of store logos and the introduction of the new name in stores as well as an advertising campaign in six countries. The company is trying to manage all of the risks in a way that the planned sales growth is achieved regardless of the name change.

In 2005, retail and wholesale sales of CHR/Evermen totalled 15.2 million euros, representing an increase of 29% in comparison with the previous year. CHR/Evermen sales accounted for approximately 35% of the total sales revenues of the Baltika Group in 2005.

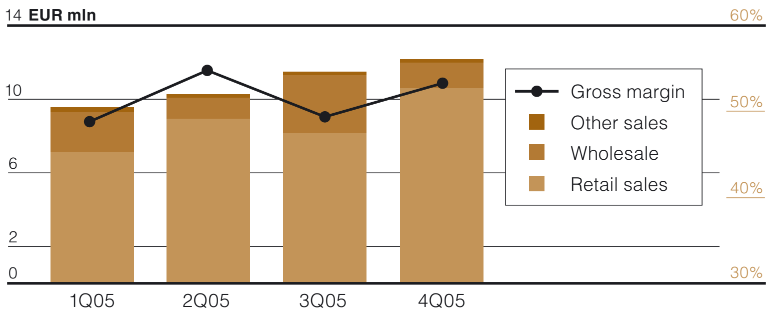
Earnings and margins

In 2005, Baltika completed its four-year strategic turnaround into a retail enterprise. The year was very successful for Baltika – the Group achieved solid profitability improvements across the board. In the coming years, the Group's goal is to maintain the achieved profitability level.

Overall, the 2005 results were driven by the strong growth of retail sales (+30%) and improved sales efficiency (+21%). Gross profitability was bolstered by better intake margins and more accurate product pricing in the markets. The Group has reached a new level in terms of managing sales of discount periods. In comparison with the previous year, higher profitability was achieved during mid-season and end-of-season clearance sales. The sell-through percentage of collections has increased significantly, and old inventory was at a minimum level at the end of seasons. As mentioned earlier, the improvement of inventory management was the key priority in 2005. Success in that area is demonstrated by good sales results and the increase in the inventory turnover ratio from 3.89 to 4.92 over the previous year.

The Group's gross profit margin in 2005 rose to 51.6% from the corresponding figure of 47.8% in 2004, and gross profit increased by 26.1%, to 22.4 million euros. Starting from the fourth quarter of 2005, the Group's gross margin is impacted by the change in taxation in its Russian subsidiary. As a result of its increased sales volume, Baltika's Russian subsidiary was registered under the value-added tax scheme and the subsidiary started to pay the respective tax from 4Q 2005.

Quarterly gross margin as per sales structure



The Group's operating profit in 2005 totalled 4.8 million euros. In the same period of the previous year, operating profit amounted to 1.2 million euros. Operating margin rose to 11.0% in 2005, from 3.2% in 2004.

Baltika's operating profit in 2005 includes some one-off expenses and revenues, the net effect of which is 552 thousand euros. One-off revenues came from the revaluation of the Group's real estate investments in the amount of 878 thousand euros, which includes the revaluation of the production building at Veerenni Street 24 in Tallinn (747 thousand euros) and the building lease on the plot in Lasnamäe Industrial Park in Tallinn which is intended for production purposes (131 thousand euros). Revenues from the revaluation of real estate investments are recorded as other operating income on the income statement and as investment property on the balance sheet.

One-off expenses amounted to 326 thousand euros, including: a reserve for store closing expenses (the store was closed in January 2006) in Poland (78 thousand euros) – recorded in other operating expenses; expenses from recording the management's share options as salary expenses according to IFRS 2 (40 thousand euros) – recorded in administrative expenses; expenses from adjustments made to the calculation of production costs and inventories (176 thousand euros) – recorded in cost of goods sold; and expenses related to the CHR/Evermen name change (32 thousand euros) – recorded in administrative expenses.

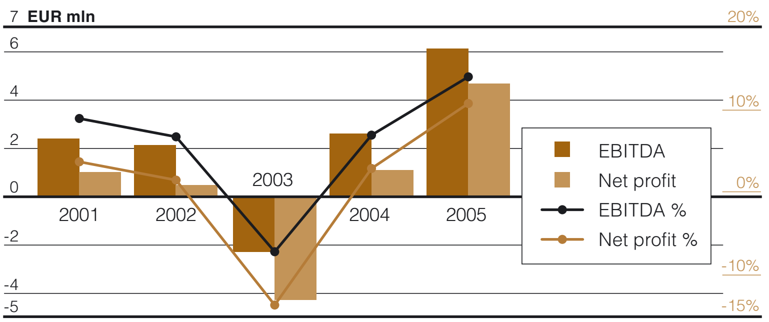
The consolidated operating profit of the Baltika Group before the one-off expenses and revenues amounted to 4.2 million euros, and the corresponding operating margin was 9.7%.

The Group's net financial expenses totalled -252 thousand euros, including interest expenses of 346 thousand euros. Interest expenses declined by 19.0% over the year, due to the decrease in total debt obligations, the reduced cost of borrowing and the lower usage of the bank's overdraft.

The Baltika Group's net profit after taxes and minority shareholding amounted to 4.6 million euros in 2005, compared with 1.1 million euros in 2004. Net margin reached 10.7% (2004: 2.9%). Net profit before the one-off expenses and revenues totalled 4.1 million euros, and the corresponding net margin was 9.4%.

The Group's return on equity rose from 14.6% in 2004 to 44.1% in 2005, and return on assets was 22.2% (2004: 5.1%).

Net profit during the strategic turnaround period



Balance sheet

On 31 December 2005, the total assets of the Baltika Group amounted to 24.1 million euros, up 18.9% in comparison with the end of the previous year.

As of the end of the year, the Group's total inventories stood at 9.2 million euros, declining by 64 thousand euros over the year. The lower level of inventories in combination with the growth in sales is evidence of more efficient inventory management. Correspondingly, the Group's inventory turnover ratio (net sales/average inventories) increased from 3.89 to 4.92 over the previous year.

Stemming from the credit terms of the wholesale sales, accounts receivable increased by 0.8 million euros since the end of 2004, reaching 2.5 million euros. Mostly because of growing purchasing volumes, accounts payable increased by 0.9 million euros to 2.9 million euros by the end of 2005.

At the end of the year, the Group's total interest bearing debt amounted to 5.9 million euros, including bank loans of 4.0 million euros. Over the year, the Group's borrowings from banks have decreased by 2.4 million euros, which includes the repayment of loans (1.1 million euros) and the reduction in the usage of the bank overdraft (1.3 million euros). As of 31.12.2005, the bank's overdraft was not used. The rest of the debt consists of convertible bonds and commercial papers (1.2 million euros), and lease liabilities (0.7 million euros).

As of the end of 2005, the Group's total net debt (Interest-bearing liabilities less Cash and cash equivalents) amounted to 4.2 million euros, and the net debt to equity ratio stood at 31.3%. This represents a significant reduction from the 2004 year-end level of 75.9%.

The Group's equity grew by 4.3 million euros in 2005, and stood at 13.3 million euros as of the end of the year (2004: 9.0 million euros). The Group's share capital increased by 120,793 euros during 2005, as a result of the conversion of 189,000 B-bonds into ordinary shares, and totalled 3,721,543 euros as of the end of 2005. The share premium in the transaction was 290,990 euros.

Cash flow

During 2005, the Group generated a positive cash flow from current operations amounting to 4.8 million euros – almost twice as much as in 2004. As a result, investments made in fixed assets grew, and the debt level was reduced. The net cash flow from investment activities totalled -1.7 million euros, compared with -0.7 million euros in 2004. Over the year, the Group repaid bank loans in the amount of 2.4 million euros. In 2004, repayment of loans amounted to 1.2 million euros. An amount of 2.3 million euros (2004: 1.1 million euros) was used for financing activities and as a result, in 2005 the cash and cash equivalents of the Baltika Group increased by 0.9 million euros. In 2004, the Group's cash and cash equivalents decreased by 21 thousand euros.

Investments

The Group's investments in 2005 totalled 2.3 million euros. In 2004, investments amounted to 1.0 million euros. Investments in the retail system in all of our markets amounted to 0.9 million euros. In August, Baltika acquired building leases on two plots in Lasnamäe Industrial Park in Tallinn for 0.9 million euros. On one of these plots, Baltika will build a new logistics centre in 2006. 0.2 million euros was invested in the construction of the logistics centre last year. The rest of the investments were made in IT (0.1 million euros), production equipment (0.1 million euros) and other fixed assets (0.1 million euros).

Production

The production companies of the Baltika Group (OÜ Baltika Tailor, AS Elina STC and AS Virulane) form a significant part of the Group's vertical business model. These companies specialise in the manufacturing of high quality tailored garments. In 2005, a total of 761,000 products were manufactured, out of which 510,000 products or 67% of the total were Baltika's own products – i.e. carrying Baltika's brand names. The rest was subcontracted production.

Due to the planned real estate development at the 24 Veerenni Street site, Baltika intends to relocate the production premises of Baltika Tailor that are currently located at the same address. For that purpose, Baltika acquired a building lease on a plot in Lasnamäe Industrial Park in the suburbs of Tallinn in 2005. According to the current plans, the new production facility for Baltika Tailor will be completed in 2007. Additionally, Baltika acquired a building lease on another plot in Lasnamäe Industrial Park for the construction of a new logistics centre. The logistics centre is to be relocated from its current site at Veerenni Street in the second half of 2006.

Personnel

As of the end of 2005, the Baltika Group employed 1,678 people (2004: 1,704), including 896 (2004: 988) in production, 630 (2004: 572) in retail and 152 (2004: 144) at the head office. The number of people employed outside Estonia was 483 (2004: 433). The average number of personnel stood at 1,651 in 2005 (2004: 1,709).

In 2005, the Baltika Group's wages and salaries amounted to 6.99 million euros. The remuneration paid to the members of the Management Board and Supervisory Board totalled 323 thousand euros.

Outlook and goals for 2006

In 2006, the Baltika Group will continue developing its position as one of the leading specialist fashion retailers in Central and Eastern Europe. Baltika's plans and goals in 2006 are as follows:

- to increase the Group's retail sales by at least 25%;
- the number of shops anticipated to be opened is 23–30, which will increase the Group's retail system to 105–115 shops with total sales area of 17,000–18,000 square metres by the end of the year;

- by country, the largest expansion of the retail chain is planned in Ukraine, Russia and Lithuania and by concept, in Monton and Mosaic;
- the name change of CHR/Evermen to Mosaic and the further development of the Mosaic shop concept;
- to increase the Group's net sales at least 20%;
- to maintain gross profitability at least at the 2005 level (51.6%);
- to continue the improvement of inventory management (the completion of a new logistics centre and the commencement of the introduction of a new IT system).

Change in income statement format

From the beginning of 2005, Baltika uses a new income statement format. The need to change the format arose from the Group's strategy to transform from a production company to a retail enterprise. The new format of the income statement allows for a better presentation of the financial position of Baltika as a retail group. The income statements of the previous financial year were restated to make them comparable with the new format. The new income statement format is in accordance with the IAS 1 requirements pertaining to mandatory entries and the presentation of financial statements.

THE BALTIKA SHARE

Baltika's share has been quoted on the Tallinn Stock Exchange since 5 June 1997. The Tallinn Stock Exchange belongs to the OMX Group, which also owns and operates stock exchanges in Copenhagen, Stockholm, Helsinki, Riga, and Vilnius.

All of the shares of Baltika are common shares and carry equal rights to votes and dividends.

Basic information on the Baltika share

OMX symbol: BLT1T
ISIN: EE3100003609
Number of shares: 5,822,950
Nominal value of share: EUR 0.64
Voting rights per share: 1 vote

Share data

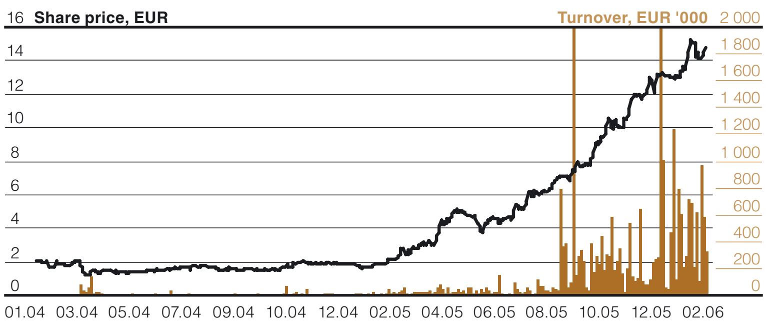
EUR	2001	2002	2003	2004	2005
Shares outstanding	4,800,000	5,444,450	5,499,450	5,633,950	5,822,950
Weighted average number of shares	4,800,000	5,015,817	5,483,992	5,541,721	5,759,950
Share price (31 Dec)	2.01	2.35	2.10	1.86	13.00
EPS	0.21	0.09	-0.79	0.19	0.81
P/E	9.6	27.1	neg.	9.7	16.1
Book value per share	1.95	2.08	1.34	1.60	2.28
P/B	1.0	1.1	1.6	1.2	5.7
DPS	0	0	0	0.05	0.13*
Dividend yield	0%	0%	0%	2.6%	1.0%*

**Proposal to AGM*

Share price and trading

On 31 December 2005, Baltika's total market value amounted to 75.7 million euros, and the share price was 13.00 euros. Baltika's share price increased sevenfold during 2005. In the same period, the OMX Tallinn Stock Index (OMX Tallinn) rose by 48.0%.

Share price and turnover



During the year, 4.4 million Baltika shares were traded on the stock exchange. Around half of this amount (2.1 million shares) represents the block sale of a stake owned by the Baltics Republic Fund (BRF). Baltika's long-term strategic investor BRF sold its 34.6% holding in the company in connection with the closure of the fund. The fund's participation was sold through an international bid. Institutional investors from eight different countries participated in the transaction, and as a result, the liquidity of the Baltika stock increased significantly. In 2005, excluding the transaction for the sale of the BRF stake, the number of Baltika stocks traded on the stock exchange rose by more than three times in comparison with 2004, to 2.3 million stocks.

Share trading history

EUR	2001	2002	2003	2004	2005
High	2.42	2.49	2.55	2.10	13.00
Low	1.79	1.99	1.92	1.16	1.60
Last	2.01	2.35	2.1	1.86	13.00
Change, %	5.00	16.73	-10.64	-11.43	598.92
Traded volume	510,268	580,595	731,037	666,917	4,403,236*
Turnover, mln	1.15	1.32	1.64	1.03	31.08*
Market capitalisation, mln	9.7	12.8	11.6	10.5	75.7

**Includes block sale of Baltic Republics Fund shareholding of 2,124,168 shares at 6.86 euros per share*

Structure of shareholders and share capital

As of the end of 2005, Baltika had 946 shareholders. During the year, the number of shareholders rose by 80% from the 2004 year end number of 527.

After the sale of the BRF stake on 29 September 2005, OÜ BMIG, a holding company owned by Baltika's top management, became the largest shareholder of Baltika. During the BRF block sale, OÜ BMIG acquired an extra 250,000 shares and thus owned 22.07% of the share capital of Baltika as of the end of 2005. As of the same date, the members of the Management Board owned 26.44% of stocks, both directly and through companies controlled by them.

Largest shareholders as of 31.12.2005

	Number of shares	Participation
BMIG OÜ	1,284,980	22.07%
Skandinaviska Enskilda Banken Ab Clients	451,295	7.75%
AS LHV Arbitrage	336,000	5.77%
Tõnis Kotkas	244,000	4.19%
Bank Austria Creditanstalt AG Clients	203,570	3.50%
ING Luxembourg S.A.	200,000	3.43%
JP Morgan Chase Bank, National Association on behalf of Swedish Residents	165,000	2.83%
Central Securities Depository of Lithuania	158,344	2.72%
Meelis Milder	151,617	2.60%
Nordea Bank Finland Plc Clients Account Trading	149,650	2.57%
Skandinaviska Enskilda Banken Finnish Clients	125,859	2.16%
Zina Kevvai	114,973	1.97%
Morgan Stanley Co International Equity Client Account	95,000	1.63%
Pictet & CIE Client Account	95,000	1.63%
Other	2,047,662	35.17%
Total	**5,822,950**	**100%**

As of 31 December 2005, the share capital of Baltika amounted to 3,722 thousand euros, consisting of 5,822,950 common shares. In 2005, the share capital increased by 121 thousand euros as a result of converting 189,000 B-bonds into shares. All of the new share issues must be approved by 2/3 of the participants at the annual shareholders' meeting. Pursuant to the company's articles of association, its maximum share capital is 10,226 thousand euros.

Convertible bond program

The Annual General Meeting of Shareholders of 6 April 2001 approved a convertible bond program intended for the executives of the company. It was decided to issue a total of 576,000 convertible bonds in the period of 2001 to 2003, i.e. 192,000 bonds a year. Three types of convertible bonds were issued: A-, B- and C-bonds. Additionally, the Extraordinary Meeting of Shareholders of 7 December 2004 resolved to issue 200,000 D-bonds to the executives of the Baltika Group.

Detailed information regarding the convertible bonds can be found in Note 17 in the consolidated annual report.

As of the end of 2005, the mentioned convertible bond schemes entitle to the subscription of a total of 392,000 new shares, which account for 6.7% of the current number of shares outstanding. All of the bonds will be converted into shares by the end of 2006.

Dividends

Considering the Group's objectives in the coming years, the limit on the payment of dividends has been set at up to 25% of net profits for the financial year. The dividend proposal will take into account the Group's cash flows, future expansion plans and the need for financing.

In 2005, Baltika's consolidated net profit totalled 4.6 million euros. The Management Board proposes to pay shareholders a dividend of 0.13 euros (2.00 Estonian kroons) per share. In 2005, Baltika paid dividends in the amount of 0.28 million euros or 0.05 euros per share and dividend payment comprised 26% of the net profit of the corresponding financial year.

FINANCIAL STATEMENTS

MANAGEMENT BOARD'S CONFIRMATION OF THE FINANCIAL STATEMENTS

The Management Board confirms the correctness and completeness of AS Baltika's 2005 consolidated financial statements as presented on pages 16–62.

The Management Board confirms that:

1. the accounting policies and presentation of information is in compliance with International Financial Reporting Standards as adopted by the European Union;
2. the financial statements present a true and fair view of the financial position, the results of the operations and the cash flows of the Group;
3. all group companies are going concerns.

Meelis Milder
Chairman of the Management Board
20 March 2006

Ülle Järv
Member of the Management Board
20 March 2006

Boriss Loifenfeld
Member of the Management Board
20 March 2006

Maire Milder
Member of the Management Board
20 March 2006

AS Baltika 2005 Consolidated Annual Report (in thousand of euros)

CONSOLIDATED BALANCE SHEET

	Note	31.12.2005	31.12.2004
ASSETS			
Current assets			
Cash and bank	4	1,659	800
Financial assets at fair value through profit or loss	5	116	39
Trade receivables	6	2,529	1,758
Other receivables and prepaid expenses	7	958	640
Inventories	8	9,233	9,297
Total current assets		**14,495**	**12,534**
Non-current assets			
Investments in joint ventures	9	15	70
Investment property	10	1,738	479
Deferred income tax receivable	11	230	278
Other non-current assets	12	301	181
Property, plant and equipment	13,15	5,630	4,942
Intangible assets	14	1,693	1,788
Total non-current assets		**9,607**	**7,738**
TOTAL ASSETS		**24,102**	**20,272**
LIABILITIES AND EQUITY			
Current liabilities			
Borrowings	16,17	1,935	4,762
Supplier payables		2,862	1,991
Corporate income tax liability	7	60	12
Other tax liabilities	7	1,063	797
Accrued expenses	18	863	672
Other short-term payables	18	30	59
Total current liabilities		**6,813**	**8,293**
Non-current liabilities			
Long-term borrowings	16	3,998	2,936
Total non-current liabilities		**3,998**	**2,936**
TOTAL LIABILITIES		**10,811**	**11,229**
EQUITY	19		
Share capital at par value		3,722	3,601
Share premium		3,176	2,845
Reserves		609	1,712
Retained earnings		5,480	12
Currency translation differences		264	423
Total equity attributable to majority shareholder		**13,251**	**8,593**
Minority interest		40	450
TOTAL EQUITY		**13,291**	**9,043**
TOTAL LIABILITIES AND EQUITY		**24,102**	**20,272**

The Notes to the financial statements presented on pages 21–62 are an integral part of the Annual Report

AS Baltika 2005 Consolidated Annual Report (in thousand of euros)

CONSOLIDATED INCOME STATEMENT

	Note	2005	2004
Not sales	20,21	43,518	37,189
Cost of goods sold	22	21,080	19,396
Gross profit		**22,438**	**17,793**
Distribution costs	23	-13,275	-11,833
Administrative and general expenses	24	-5,447	-4,544
Other operating income	25	1,267	108
Other operating expenses	26	-195	-324
Operating profit		**4,788**	**1,200**
Share of losses from joint ventures		-55	-46
Gains from other investments		77	211
Interest expenses		-346	-427
Foreign exchange gains (losses)		41	-96
Other financial income (expenses)		31	53
Profit before corporate income tax		**4,536**	**895**
Corporate income tax	27	-274	61
Net profit		**4,262**	**956**
Net loss attributable to minority shareholders		-382	-111
Net profit attributable to parent company		**4,644**	**1,067**
Basic earnings per share, EUR	28	0.81	0.19
Diluted earnings per share, EUR	28	0.77	0.19

The Notes to the financial statements presented on pages 21–62 are an integral part of the Annual Report

AS Baltika 2005 Consolidated Annual Report (in thousand of euros)

CONSOLIDATED CASH FLOW STATEMENT

	Note	2005	2004
Operating activities			
Operating profit		4,787	1,201
Adjustments:			
Depreciation, amortisation and impairment of property, plant and equipment and intangibles	13,14	1,324	1,396
Profit (loss) from sale of property, plant and equipment	25,26	86	-16
Revaluation of investment property	10	-878	0
Other non-monetary expenses	17	40	0
Changes in working capital:			
Change in balance of receivables	6,7	-1,467	598
Change in balance of inventories	8	64	317
Change in supplier payables		1,284	-1,279
Interest paid	16	-277	-335
Income tax paid	27	-194	-46
Total cash flow from operating activities		**4,769**	**1,836**
Investing activities			
Purchase of property, plant and equipment and investment properties	13,14	-2,311	-996
Incl. under the operating lease terms	15	700	8
Proceeds from disposals of property, plant and equipment	13,25,26	26	105
Investments in joint venture	9	0	-65
Investments in subsidiaries		0	25
Interest received		11	4
Proceeds from disposal of a share of subsidiary		0	250
Loans granted	29	-96	-42
Repayments of loans granted	29	19	9
Total cash flow from investing activities		**-1,651**	**-702**
Financing activities			
Repayments of borrowings	16	-2,394	-1,168
Finance lease and instalment payments made	15	-42	-97
Dividends paid	19	-286	0
Share issue proceeds	19	400	206
Proceeds from sale of commercial papers	17,19	22	4
Redemption of convertible bonds	17	0	-4
Total cash flow from financing activities		**-2,300**	**-1,058**
Effect of exchange rate changes on cash balance		41	-96
Total cash flow		**859**	**-20**
Cash and cash equivalents at the beginning of the year	4	**800**	**820**
Cash and cash equivalents at the end of the year	4	**1,659**	**800**
Change in cash and cash equivalents		**859**	**-20**

The Notes to the financial statements presented on pages 21–62 are an integral part of the Annual Report

AS Baltika 2005 Consolidated Annual Report (in thousand of euros)

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Share capital	Share premium	Reserves (Note 19)	Retained earnings	Currency translation differences	Total equity attributable to majority shareholders	Minority interest	Total
Balance as of 31.12.2003	**3,515**	**2,716**	**1,463**	**-1,055**	**267**	**6,906**	**456**	**7,362**
Currency translation differences	0	0	0	0	156	**156**	41	**197**
Revaluation reserve (Note 10)	0	0	249	0	0	**249**	0	**249**
Net income (expense) recognised directly in equity	0	0	249	0	156	**405**	41	**446**
Net profit for financial year	0	0	0	1,067	0	**1,067**	-111	**956**
Total recognised income for 2004	**0**	**0**	**249**	**1,067**	**156**	**1,472**	**-70**	**1,402**
Increase of share capital	86	129	0	0	0	**215**	0	**215**
Minority interest of acquired subsidiary (Note 30)	0	0	0	0	0	**0**	64	**64**
Balance as of 31.12.2004	**3,601**	**2,845**	**1,712**	**12**	**423**	**8,593**	**450**	**9,043**
Currency translation differences	0	0	0	0	-159	**-159**	-28	**-187**
Net income (expense) recognised directly in equity	0	0	0	0	-159	**-159**	-28	**-187**
Net profit for financial year	0	0	0	4,644	0	**4,644**	-382	**4,262**
Total recognised income for 2005	**0**	**0**	**0**	**4,644**	**-159**	**4,485**	**-410**	**4,075**
Equity-settled share-based payment transactions (Note 17, 19)	0	40	0	0	0	**40**	0	**40**
Dividends paid (Note 19)	0	0	0	-279	0	**-279**	0	**-279**
Transfers to statutory reserve capital (Note 19)	0	0	53	-53	0	**0**	0	**0**
Increase of share capital (Note 17, 19)	121	291	0	0	0	**412**	0	**412**
Allocations to retained earnings (Note 19)	0	0	-1,156	1,156	0	**0**	0	**0**
Balance as of 31.12.2005	**3,722**	**3,176**	**609**	**5,480**	**264**	**13,251**	**40**	**13,291**

More detailed information on share capital and its changes is provided in Note 19.

NOTES TO THE FINANCIAL STATEMENTS

NOTE 1 Accounting policies and accounting methods used in the preparation of the financial statements

The Group's 2005 consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the European Union. The financial statements have been prepared under the historical cost convention, as modified by the revaluations of investment property and financial instruments at fair value through profit or loss, which are presented at fair value as disclosed in the accounting policies below. The principal accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all the periods presented, unless otherwise stated (refer to Changing the income statement format and Adoption of new or revised standards and interpretations).

All information in the financial statements is presented in thousands of euros.

Comparability

The financial statements have been prepared in accordance with the consistency and comparability principles, the nature of the changes in methods and their effect is explained in the respective notes. When the presentation of items in the financial statements or their classification method has been amended, then also the comparative information of previous periods has been restated.

Changing the income statement format

From the beginning of 2005, Baltika uses a new income statement format. The change of the income statement format was related to the company's strategy-based change from a production company to a retail company. The new income statement format allows paying more attention to the specific nature of the Baltika Group as a retail group and its structure of revenue and expenses is more explicit. Following the principle of comparability, the income statements for 2004 have also been amended. Up to 2004, the expenses were grouped based on the nature of expenses, starting from 2005 the expenses are grouped by function. The new income statement format is in compliance with the requirements of IAS 1 concerning mandatory items and presentation in the income statement.

Adoption of new or revised standards and interpretations

Application of standards

The application of a number of new or amended IAS (IFRS) standards became mandatory for financial years beginning at 1 January 2005. As early application of standards was recommended, amendments to the accounting policies affected by the following standards were already applied in the preparation of the 2004 Annual Report:

IAS 1 (revised 2003) Presentation of Financial Statements
IAS 2 (revised 2003) Inventories
IAS 16 (revised 2003) Property, Plant and Equipment
IAS 21 (revised 2003) The Effects of Changes in Foreign Exchange Rates
IAS 24 (revised 2003) Related Party Transactions
IFRS 3 (issued 2004) Business Combinations
IAS 36 (revised 2004) Impairment of Assets
IAS 38 (revised 2004) Intangible Assets

From 1 January 2005, several amendments to existing standards and new IAS (IFRS) standards have additionally been adopted, which became mandatory for the Group's financial year beginning at 1 January 2005. Below is a list of amended standards, which became applicable for financial years beginning at 1 January 2005 and which the Group has applied since that period:

IAS 8 (revised 2003) Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10 (revised 2003) Events after the Balance Sheet Date

IAS 17 (revised 2003) Leases
IAS 27 (revised 2003) Consolidated and Separate Financial Statements
IAS 28 (revised 2003) Investments in Associates
IAS 31 (revised 2004) Interests in Joint Ventures
IAS 32 (revised 2003) Financial Instruments: Disclosure and Presentation
IAS 33 (revised 2003) Earnings per Share
IAS 39 (revised 2003) Financial Instruments: Recognition and Measurement
IAS 40 (revised 2004) Investment Property
IFRS 2 (issued 2004) Share-based Payment
IFRS 4 (issued 2004) Insurance Contracts
IFRS 5 (issued 2004) Non-current Assets Held for Sale and Discontinued Operations
IFRIC 1 (issued 2005) Changes in Existing Decommissioning, Restoration and Similar Liabilities
IFRIC 2 (issued 2005) Members' Shares in Co-operative Entities and Similar Instruments

The application of new standards or amendments to standards neither caused any material changes in existing accounting policies nor affected the Group's results of operations, with the exception of the application of IFRS 2 which is described below.

In accordance with the requirements of the standards, the presentation of information in the financial statements has been amended and additional disclosures have been presented in the notes to the financial statements. New requirements did not lead to any major changes in last period's comparative information and its presentation.

Application of IFRS 2

The Company is required to retrospectively record the effect of such share-based compensation plans on the Company's financial position, which were introduced at 7 November 2002 and which had not expired by 1 January 2005.

Such share-based compensation transactions at AS Baltika are series D convertible bonds with the right to convert them into AS Baltika shares in 2006. As it is difficult to estimate the fair value of services (work contribution) provided by the employees to the Company, these services were assessed on the basis of fair value of equity instruments (market price) granted to the employees at the grant date and are recognised during the vesting period. As the services received through a share-based payment transaction do not meet the criteria for assets, they are recorded as expenses (Note 17 and accounting policies "Share-based Payments").

Supplementary information of the parent company

In accordance with the Estonian Accounting Act, information on the separate primary financial statements of a consolidating entity shall be disclosed in the notes to the financial statements. In preparing the primary financial statements of the parent company, the same accounting methods have been used as for the consolidated financial statements.

The accounting policy for reporting subsidiaries and associates has been amended in the separate financial statements disclosed as supplementary information in the Annual Report in conjunction with the amendment to IAS 27 "Consolidated and Separate Financial Statements" effective since 1 January 2005. Instead of the previous equity method, subsidiaries and associates are measured at cost (less any impairment losses) in the separate financial statements. The effect of the amendment to the accounting policy was accounted for retrospectively as at 1 January 2004 as an adjustment to the balance of investments in subsidiaries and associates as well as to the balance of retained earnings in the amount 548 thousand euros, likewise, gains/losses from subsidiaries and associates were adjusted in the 2004 income statement in the amount of 860 thousand euros.

Principles of consolidation, accounting for business combinations and subsidiaries

A subsidiary is an entity in which the Group, directly or indirectly, has interest of more than one half of the voting rights or otherwise has power to govern the operating and financial policies so as to obtain economic benefits. All subsidiaries have been consolidated in the Group's financial statements. An associate is an entity, in which the Group owns between 20% and 50% of shares with voting rights and over which the Group has significant influence.

A subsidiary is consolidated from the date on which control is transferred to the Group and is no longer consolidated from the date on which control ceases. The purchase method of accounting is used to account for the acquisition of a subsidiary. The cost of an acquisition is measured at the fair value of the assets given up, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. The date of exchange is the acquisition date where a business combination is achieved in a single transaction, and is the date of each share purchase where a business combination is achieved in stages by successive share purchases. Under the purchase method, acquired and separately identifiable assets and liabilities as well as contingent liabilities of the acquired subsidiary are recognised at their fair values at the acquisition date.

In the consolidated financial statements, the financial statements of the subsidiaries under the control of the parent company (except for the subsidiaries acquired for the purpose of selling) are combined on a line-by-line basis. Intercompany transactions, balances and unrealised gains on transactions between Group companies are eliminated; unrealised losses are also eliminated unless the cost cannot be recovered. The Company and all of its subsidiaries use uniform accounting policies consistent with the Group's policies.

The consolidated financial statements include the consolidated financial information of AS Baltika and its subsidiaries OÜ Baltman, AS Virulane, AS Elina STC, Baltika Lietuva, Baltika Latvija, Baltika Sweden, Baltika Poland, Baltika Ukraina, OY Baltinia, Baltman Rus and OÜ Baltika TP. Where necessary, the accounting policies of the subsidiaries have been changed to ensure consistency with the policies adopted by the Group. The consolidated financial statements had earlier been prepared for subsidiaries with their own subsidiaries which were then used for consolidation purposes.

For those subsidiaries and associates which already at the time of their acquisition met the criteria for non-current assets held for sale (i.e. will most likely be sold within 12 months after their acquisition), the acquired subsidiaries are recognised at the lower of their fair value less costs to sell and their carrying amount and the acquired associates are recognised at the lower of their fair value less costs to sell and their carrying amount.

Investments into subsidiaries and associates are reported at cost (less any impairment losses) in the separate primary financial statements of the parent company.

Minority interest is that part of the net results and of the net assets of a subsidiary, including the fair value adjustments, which is attributable to interests which are not owned, directly or indirectly, by the Company. Minority interest forms a separate component of the Group's equity.

Purchases of minority interests. Difference, if any, between the carrying amount of a minority interest and the amount paid to acquire it is recorded as goodwill or charged to income statement as negative goodwill, if the carrying amount of minority interest is in excess of the amount paid.

Joint ventures

A joint venture is based on a contractual agreement according to which two parties carry out their jointly controlled economic activities. Joint venture's activities are accounted for under the equity method in the balance sheet of a venturer, according to which the interest in a jointly controlled entity is initially recognised at cost and subsequently adjusted with the changes that have occurred in the venturer's interest in the net assets of the jointly controlled entity after the acquisition. In the income statement, the venturer accounts for its interest in the operating results, financial income and financial expenses in the jointly controlled entity.

Functional and presentation currency

Functional currency which is the currency of the primary economic environment in which an entity operates is used to account for foreign subsidiaries. The functional currency of the parent company and subsidiaries located in Estonia is Estonian kroon. The consolidated financial statements have been prepared in euros, which is the presentation currency of these financial statements.

Translation from functional to presentation currency. The results and financial position of each Group entity are translated into the presentation currency as follows:

- assets and liabilities for each balance sheet presented are translated into euros at the closing rate at the date of that balance sheet;
- income and expenses for each income statement are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the dates of the transactions); and
- all resulting exchange differences are recognised as a separate component of equity.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate. When a subsidiary is disposed of through sale, liquidation, repayment of share capital or abandonment of all, or part of, that entity, the exchange differences deferred in equity are reclassified to profit or loss.

Foreign currency transactions

During the year, all foreign currency transactions of AS Baltika and the Group have been recorded in Estonian kroons based on the foreign currency exchange rates of the Bank of Estonia prevailing on the transaction date. Receivables and liabilities denominated in a foreign currency have been translated into Estonian kroons based on the foreign currency exchange rates of the Bank of Estonia prevailing on the balance sheet date. Profits and losses from foreign currency transactions, including arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition, are recognised in the income statement as income or expenses of that period.

Cash and cash equivalents

For the purposes of the balance sheet and the cash flow statement, cash and cash equivalents comprise cash on hand as well as bank account balances (except for overdraft), term deposits with original maturities of three months or less and money-market funds shares. Overdraft is included in short-term borrowings. Cash and cash equivalents are measured at fair value.

Financial assets

The purchases and sales of financial assets are recognised at the trade date. Financial assets are derecognised upon their disposal at the trade date.

Depending on the purpose for which financial assets were acquired as well as management's intentions, financial assets are classified into the following categories:

- financial assets at fair value through profit or loss;
- loans and receivables;
- held-to-maturity investments; and
- available-for-sale financial assets.

Financial assets at fair value through profit or loss are financial assets held for trading purposes (i.e. assets acquired or arisen primarily for the purpose of selling or repurchasing in the near term or a derivative financial instrument that is not a hedging instrument) as well as other financial assets that have been designated at inception as financial assets at fair value through profit or loss. Financial assets belonging to this group are initially recognised at fair value excluding transaction costs. After their initial recognition, the financial assets in this category are measured at fair value with changes in fair value recognised in the income statement.

The Company has not classified any financial assets as “held-to-maturity investments” or “available-for-sale financial assets”.

Trade receivables

Trade receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Receivables are initially recognised at fair value plus transaction costs. After initial recognition, loans and receivables are accounted for at amortised cost using the effective interest rate method. This method is used for calculating interest income on the receivable in the following periods.

When it is probable that the Group is unable to collect all amounts due according to the original terms of receivables, an allowance is set up for the impairment of these receivables. The amount of the allowance is the difference between the carrying amount and the recoverable amount. The recoverable amount is the expected future cash flows discounted at the market rate of interest for similar borrowers. Impairment losses are charged to the income statement.

Other receivables are assessed based on their collectible amounts. The collection of each receivable is assessed separately, taking into consideration all known information on the solvency of the debtor. Doubtful receivables are written down in the balance sheet to the collectible amount. Irrecoverable receivables are derecognised. Receivables are generally included in current assets when they are due within 12 months after the balance sheet date. Such receivables whose due date is later than 12 months after the balance sheet date are reported as non-current assets.

Inventories

Inventories are recorded in the balance sheet at cost, consisting of the purchase costs, direct and indirect production costs and other costs incurred in bringing the inventories to their present location and condition.

Purchase costs include the purchase price, customs duties and other non-refundable taxes and direct transportation costs related to the purchase, less discounts and subsidies. The production costs of inventories include costs directly related to the units of production (such as direct materials and packing material costs, unavoidable storage costs related to work in progress, direct labour), and also a systematic allocation of fixed and variable production overheads (such as depreciation and maintenance of factory buildings and equipment, overhaul costs, and the labour cost of factory management).

The FIFO method is used to account for the cost of inventories. Inventories are measured in the balance sheet at the lower of acquisition/production cost or net realisable value.

Investment property

Real estate properties (land, buildings) that the entity owns or leases under finance lease terms to earn rental income or for capital appreciation and which are not occupied by the Group are recorded under investment property. An investment property is initially recognised at its acquisition cost. It is subsequently remeasured at its fair value which is based on the market value determined annually by external valuers and the management’s judgement based on the comparable transactions at the same location. Earned rental income is recorded in profit or loss within other operating income. Gains and losses resulting from changes in the fair value of investment property are recorded in profit or loss and presented in “Other operating expenses”/ “Other operating income”. If non-current assets used in operating activities are reclassified as investment property, the difference between the carrying amount and the fair value is recognised in an equity reserve unless the difference arising from revaluation reverses an impairment loss recorded in previous periods – in such case the change in fair value is recognised directly in the income statement to the extent it reverses the previous impairment loss. The revaluation surplus included in equity is transferred to retained earnings on the subsequent disposal of investment property.

Property, plant and equipment

Property, plant and equipment are non-current assets used in the operating activities of the entity with a useful life of over one year. An item of property, plant and equipment is initially recognised at its acquisition cost which consists of the purchase price (incl. customs duties and other non-refundable taxes) and other expenditures directly related to the acquisition that are necessary for bringing the asset to its operating condition and location. An item of property, plant and equipment is subsequently stated at cost less any accumulated depreciation and any impairment losses. Cost includes borrowing costs incurred on specific or general funds borrowed to finance construction of qualifying assets.

Subsequent expenditure incurred for an item of property, plant and equipment is recognised as a non-current asset when it is probable that the Company will derive future economic benefits from it and its cost can be measured reliably. The cost of reconstruction carried out on rental spaces of stores is depreciated over the lease term, but not less than 20% p.a. Other maintenance and repair costs are expensed when incurred.

The following depreciation rates are used for depreciating non-current assets:

- buildings and facilities 2.5–20%
- machinery and equipment 15–40%
- other fixtures 15–40%
- land is not depreciated.

The difference between the acquisition cost and the residual value of an asset is depreciated over the useful life of the asset. At each balance sheet, the appropriateness of depreciation rates, methods and the residual value is assessed. When the residual value of the asset exceeds its carrying amount, the depreciation of the asset is ceased.

At each reporting date the management assesses whether there is any indication of impairment of property, plant and equipment. If any such indication exists, the management estimates the recoverable amount, which is determined as the higher of an asset's fair value less costs to sell and its value in use. The carrying amount is reduced to the recoverable amount and the impairment loss is recognised in the income statement. An impairment loss recognised for an asset in prior years is reversed if there has been a change in the estimates used to determine the asset's value in use or fair value less costs to sell.

Gains and losses on disposals determined by comparing proceeds with carrying amount are recognised in profit or loss in the income statement item "Other operating income"/"Other operating expenses".

Non-current assets available for sale

Assets are classified as assets held for sale and are recognised in the balance sheet at the lower of carrying amount and fair value (less costs to sell). Assets are classified as held for sale, when the carrying amount is principally recovered through a sale transaction rather than through continuing use. Non-current assets available for sale are items of property, plant and equipment and intangible assets which the management intends to sell within the next 12 months and with regard to which the management has started active marketing activities and the assets are offered for sale at a realistic price as compared to their fair value. The depreciation of assets held for sale is ceased. Assets held for sale are reported in the balance sheet item "Property, plant and equipment".

Intangible assets (excluding goodwill)

An intangible asset is initially recognised at its acquisition cost, comprising its purchase price and any directly attributable expenditure on preparing the asset for its intended use. After initial recognition, an intangible asset is carried at its acquisition cost less any accumulated amortisation and impairment losses.

Software licenses and development costs are recorded in the balance sheet under intangible assets. Development costs are capitalised under intangible assets if the inflow of incremental economic benefits exceeding cost is probable, the entity is capable of controlling the use of the asset, measuring the income derived from the asset and there are technical and financial opportunities as well as practical solutions for the application of a new project. Research costs are charged to the income statement.

The amortisation of intangible assets with definite useful lives is determined on a straight-line basis over 5–10 years.

Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net assets of the acquired subsidiary, reflecting the part of acquisition cost which was paid for such assets of the acquired company which cannot be separated and accounted for separately. Goodwill is determined upon the acquisition of a new economic entity as the difference between the purchase price and the fair value of the acquired net assets (acquired identifiable assets less liabilities). Goodwill which arose in the acquisition of a subsidiary is recognised as an intangible asset in the consolidated financial statements.

At the transaction date, goodwill is recognised in the balance sheet at its acquisition cost. Goodwill is subsequently carried at its cost less any impairment losses. Goodwill which arose in a business combination is not amortised. At each balance sheet date (or more frequently when an event or change in circumstances indicates that the fair value of goodwill may have become impaired), an impairment test is performed and if necessary, goodwill is written down to its recoverable value (if it is lower than its carrying amount). The excess of the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities acquired over cost ("negative goodwill") is immediately recognised in profit or loss.

Goodwill which arose in the acquisition of an associate or joint venture is included in the carrying amount of the investment.

Goodwill which arose in the acquisition of foreign subsidiaries is translated using the foreign exchange rate of the Bank of Estonia prevailing on the balance sheet date.

Impairment of assets

Intangible assets with indefinite useful lives [property, plant and equipment (land) as well as intangible assets (goodwill)] are not subject to amortisation but they are tested annually for impairment, by comparing their carrying amount with the recoverable amount.

Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If such circumstances exist, the recoverable amount is compared with the carrying amount.

An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating unit).

Assets which were written down are reviewed on each balance sheet date to determine whether their recoverable value has arisen. The reversal of the impairment loss is recorded in the income statement of the financial year as a reduction of the impairment losses.

Finance and operating leases

Leases of property, plant and equipment where the company has substantially all the risks and rewards of ownership are classified as finance leases. Other leases are classified as operating leases.

The Company is the lessee

Finance leases are capitalised at the inception of the lease at the lower of the fair value of the leased property or the present value of minimum lease payments. Each lease payment is allocated between the liability and finance charges (interest expense) so as to achieve a constant rate on the finance balance outstanding. The interest element of the finance cost is charged to the income statement over the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period. Assets leased under finance leases are depreciated similarly to acquired non-current assets whereas the amortisation period is the lower of the asset's expected useful life or the duration of the lease term (when the transfer of ownership is not sufficiently certain).

Payments made under operating leases are charged to the income statement on a straight-line basis over the lease term.

The Company is the lessor

Assets leased out under operating leases are recognised similarly to non-current assets. Operating lease payments are recognised as income on a straight-line basis over the lease term.

Corporate income tax in Estonia

According to the Income Tax Act, the annual profit earned by enterprises is not taxed in Estonia and thus there are no temporary differences between the tax bases and carrying values of assets and liabilities and no deferred tax assets or liabilities arise. Instead of taxing the net profit, the distribution of retained earnings is subject to income tax of 23/77 (until 31 December 2005: 24/76 and until 31 December 2004: 26/74) of the amount paid out as dividends from which income tax paid before 1 January 2000 can be deducted using a respective coefficient. The corporate income tax arising from the payment of dividends is accounted for as an expense in the period when dividends are declared, regardless of the actual payment date or the period for which dividends are paid.

Deferred income tax

In accordance with the current Income Tax Act, no differences arise between the tax bases of assets and liabilities and their carrying amounts for Group companies located in Estonia, as a result of which no deferred tax receivables or tax liabilities arise. In accordance with the local income tax laws, the net profit of companies located in Latvia, Lithuania, Ukraine and Russia that has been adjusted for the permanent and temporary differences as stipulated by law is subject to corporate income tax (the income tax rate is 15% in Latvia and Lithuania, 19% in Poland, 25% in Ukraine and 24% in Russia). In 2004, the effective tax rates were the same.

Deferred income tax is provided using the balance sheet liability method. Deferred income tax is calculated on all significant temporary differences between the tax bases of assets and liabilities and their carrying values in the balance sheet. The main temporary differences arise from the depreciation and the tax loss carryforward. Deferred tax balances are measured at tax rates enacted or substantively enacted at the balance sheet date which are expected to apply to the period when the temporary differences will reverse or the tax loss carry forwards will be utilised. Deferred tax assets and liabilities are netted only within the individual companies of the Group. Deferred tax assets for deductible temporary differences and tax loss carry forwards are recorded only to the extent that it is probable that future taxable profit will be available against which the deductions can be utilised.

Deferred income tax is provided on post acquisition retained earnings of subsidiaries, except where the Group controls the subsidiary's dividend policy and it is probable that the difference will not reverse through dividends or otherwise in the foreseeable future.

Provisions and contingent liabilities

Provisions for liabilities and charges are recognised when the Group has a present legal or constructive obligation as a result of past events, and it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate of the amount can be made.

Provisions are recognised based on the management's (or independent expert's) estimates regarding the amount and timing of the expected outflows. A provision is recognised in the balance sheet in the amount which according to the management is necessary as of the balance sheet date for the meeting of the obligation arising from the provision or transfer to the third party. If a provision is settled later than 12 months after the balance sheet date, it is recognised at the discounted value (at the present value of payments relating to the provision), unless the effect of discounting is immaterial. The expenses of provisions are charged to accounting period expenses.

Promises, guarantees and other commitments that in certain circumstances may become obligations, but it is not probable that an outflow of resources will be required to settle the obligation; or the amount of the obligation cannot be measured with sufficient reliability, are disclosed in the notes to the financial statements as contingent liabilities.

Revenue recognition

Revenue from the sale of goods is recognised at the fair value of the consideration received or receivable, taking into consideration all discounts and concessions made. Revenue from the sale of goods is recognised when significant risks and rewards of ownership of the goods are transferred to the buyer and the amount of revenue and costs incurred in respect of the transaction can be measured reliably.

Retail sales
Revenue from the sale of goods is recognised at the time of selling the goods to the customer at the retail store, generally for cash or by card payment. The sales price also includes fees for card transactions recognised as distribution costs. Past experience is used to estimate and provide for such returns at the time of sale.

Wholesale
Revenue from the sale of goods is recognised when the goods have been delivered to the customer, the customer has accepted the goods and the collectibility of the related receivable is reasonably assured. Accumulated experience is used to estimate and provide for such returns at the time of sale.

Revenue from the rendering of services is recorded in the accounting period in which the services are rendered. If a service is rendered over a longer period of time, revenue from the rendering of a service is recorded using the stage of completion method. Revenue arising from interest is recognised when it is probable that the economic benefits associated with the transaction will flow to the enterprise and the amount of revenue can be measured reliably. Dividend income is recognised when the right to receive payment is established. Revenue from the sale of goods and services is included in the income statement lines “Net sales”, “Interest income” and “Dividend income” and revenue from the sale of investments in the line “Financial income”.

Segment reporting

Groups of assets and operating areas are reported as separate segments, whose risks and rewards are significantly different from those of other segments. In the business segment it predominantly depends on the operating activity and on the type of product or service; with regard to geographical segments on the economic environment in the region in which the segment operates.

The primary segment is the geographical segment by the area of location of the customer and the secondary segment is the business segment which distinguishes retail trade from wholesale trade with other activities and production activities.

The segment’s assets include all assets related to the segment as well as assets whose allocation between the segments is determined by the nature of business. The segment’s liabilities include all liabilities related to the segment and liabilities whose allocation between the segments is determined by the nature of business. Unallocated assets and liabilities and such assets and liabilities whose allocation to segments is not possible or reasonable due to the structure of the Company’s business (for example, corporate income tax, interest receivables and liabilities, dividend receivables and liabilities) are recorded as the joint assets and liabilities of the Group. The segment’s assets and liabilities do not include unallocated financial assets and financial liabilities and the segment’s income and expenses do not include income and expenses arising from the above-mentioned assets and liabilities.

For the purpose of segment reporting, the administrative building is recorded as an unallocated asset; long-term loans, dividends and interest liabilities are recorded as unallocated liabilities; and administrative expenses as unallocated expenses.

With regard to business segment, the retail segment includes goods and services sold in the retail system as well as non-current assets and investments of subsidiaries engaged in retail trade and of factory outlets of the parent company. The wholesale and other activities segment includes goods sold to wholesale customers, services provided by the parent company, non-current assets located at the parent company, investment property, the goodwill of the investment in Russia and liabilities related to the general management of the Group. The production activities segment includes revenue from sewing services sold to non-group customers by the Group's production companies, assets and liabilities related to production processes.

Interest income and expenses

Interest income/expenses have been recognised in the income statement for all instruments that are measured at amortised cost using the effective interest rate method. The effective interest rate is a method for calculating the amortised cost of a financial asset or a financial liability or the method for allocating interest expenses to the respective period. The effective interest rate is the rate that exactly discounts the expected future cash receipts over the expected useful life of the financial asset or the financial liability to its carrying amount. In calculating the effective interest rate, the Company assesses all contractual terms of the financial instrument but does not consider future discounts. All contractual major service fees paid or received between the parties that are an integral part of the effective interest rate, transaction costs and other additional taxes or deductions are used in the calculation. If a financial asset or a group of similar financial assets has been written down due to impairment, interest income is calculated on them using the same interest rate as was used for discounting the future estimated cash receipts in order to determine the impairment loss.

Revenue arising from interest is recognised when it is probable that the economic benefits associated with the transaction will flow to the enterprise and the amount of revenue can be measured reliably. When the receipt of interest is uncertain, interest income is calculated on a cash basis.

Financial liabilities

All financial liabilities (supplier payables, borrowings, accrued expenses, bonds and other short and long-term borrowings) are initially recorded at the proceeds received, net of transaction costs incurred. The amortised cost of short-term liabilities normally equals their nominal value; therefore short-term liabilities are stated in the balance sheet in their redemption value. Long-term receivables are initially recognised at the fair value of the consideration receivable (less transaction costs) and are subsequently measured at amortised cost using the effective interest rate method.

A financial liability is classified as short term when it is due within 12 months after the balance sheet date or the Company does not have an unconditional right to defer the payment for longer than 12 months after the balance sheet date. Borrowings with a due date later than 12 months after the balance sheet date but that are refinanced into long-term after the balance sheet date but before the approval of the annual report, are classified as current. Borrowings that the lender has the right to recall due to the violation of terms specified in the contract are also classified as current liabilities.

Offsetting

Financial assets and financial liabilities are offset only when there exists a legally enforceable right and these amounts are intended to be settled simultaneously or on a net basis.

Share capital

Shares are included in equity. The Company does not have any preference shares. The costs directly related to the issuance of shares are recognised as a reduction of the equity item “Share premium”. Upon the repurchasing of the Company's treasury shares by the Group companies, the payments made for the shares less transaction costs are recognised as a reduction of equity until the issue, sale or recalling of shares. Upon the sale or issue of treasury shares, the consideration received less directly attributable transactions costs is taken to equity.

Statutory reserve capital

In accordance with the Commercial Code, statutory reserve capital is set up from annual net profit allocations. During each financial year, at least one-twentieth of the net profit shall be transferred to reserve capital, until reserve capital reaches one-tenth of share capital. Reserve capital may be used to cover a loss, or to increase share capital. Payments shall not be made to shareholders from reserve capital.

Other reserves

Other reserves are set up in accordance with the resolution of the General Meeting of Shareholders and they can be used to offset losses from prior periods as well as to increase share capital. Payments shall not be made to shareholders from other reserves.

Share-based payments

The Company has equity-settled share-based compensation plans which were introduced after 7 November 2002 and which had not vested by 1 January 2005 (D series convertible bonds issued to executives which give the right to the holder to convert them into Baltika's shares in 2006). Share-based compensation plans introduced before 7 November 2002 and which had vested by 1 January 2005 (A, B, C series convertible bonds) are presented as liabilities in the amount of proceeds received (nominal value).

The fair value of services (work contribution) supplied by the employees to the Company in exchange for the shares is recognised as an expense in the income statement and in share premium in equity during the vesting period (from the grant date of convertible bonds until the vesting date). The fair value of the services received is determined by reference to the fair value (market value) of equity instruments granted to the employees at the grant date. For the executive to receive the right to be able to convert the convertible bond into shares under the share-based payment agreement, there must be an existing employment relationship and therefore at each balance sheet date, the number of estimated convertible bonds expected to vest is assessed and personnel expenses as well as share premium items are adjusted to reflect the change in the number of bonds expected to be converted. The amounts received for shares upon the conversion of a convertible bond less direct transaction costs is recognised in the items "Share capital" and "Share premium" in equity.

Payables to employees

Payables to employees contain the contractual right arising from employment contracts with regard to performance-based pay which is calculated on the basis of the Group's financial results and meeting of objectives set for the employees. Performance-based pay is included in period expenses and as a liability if it is to be paid in the next financial year. In addition to the performance-based pay, this liability also includes accrued social and unemployment taxes calculated on it.

Pursuant to employment contracts and current legislation, payables to employees also include an accrued holiday pay liability as of the balance sheet date. In addition to the holiday pay, this liability also includes accrued social and unemployment taxes.

Earnings per share

Basic earnings per share are determined by dividing the net profit for the financial year by the period's weighted average number of shares issued. Diluted earnings per share are determined by dividing the net profit for the financial year by the weighted average number of shares taking also into consideration the number of dilutive potential shares.

Events after the balance sheet date

Significant circumstances that have an effect on the evaluation of assets and liabilities and that became evident between the balance sheet date and the date of approving the financial statements but that are related to the reporting period of transactions that occurred in earlier periods, are reported in the financial statements. With regard to events after the balance sheet date which are of adjusting kind, the accounting policies or values of assets, liabilities, income and expenses are adjusted. The effect of non-adjusting events is disclosed in the notes to the financial statements. Events after the balance sheet date that have not been taken into consideration while evaluating assets and liabilities but that have a significant impact on the results of the next financial year, have been disclosed in the notes to the financial statements.

New International Financial Reporting Standards and Interpretations of the International Financial Reporting Interpretations Committee (IFRIC)

By the time of preparing these statements, new International Financial Reporting Standards and interpretations have been issued which become mandatory for the Group's financial statements prepared for accounting periods beginning at or after 1 January 2006 or later periods and which the Group has not early adopted:

Amendment to IAS 1, Presentation of Financial Statements: Capital Disclosures. Amendment to IAS 1 is effective for accounting periods beginning at or after 1 January 2007. The Company has decided not to apply the amendments to the standards early. The standard requires additional disclosures in the financial statements.

Amendment to IAS 19, Employee Benefits. The amendment to the standard is effective for accounting periods beginning at or after 1 January 2006. The amendment specifies additional accounting requirements relating to the disclosure of actuarial gains and losses of pension plans. This amendment will not affect the Group's financial statements.

Amendment to IAS 21, The Effects of Changes in Foreign Exchange Rates (effective from 1 January 2006). This amendment will not affect the Group's financial statements.

Amendment to IAS 39, Recognition of Cash Flow Hedges of Intragroup Transactions. The amendment to the standard is effective for periods beginning at or after 1 January 2006. This amendment will not affect the Group's financial statements.

Amendment to IAS 39, Fair Value Option. The amendment to the standard is effective for accounting periods beginning at or after 1 January 2006. The amendment changes the definition of a financial instrument recognised at fair value through profit or loss and limits the ability to classify financial instruments in this category. This amendment will not affect the Group's financial statements.

Amendment to IAS 39 and IFRS 4, Financial Guarantee Contracts. The amendments to the standards are effective for accounting periods beginning at or after 1 January 2006. The amendment requires the initial recognition of financial guarantees previously accounted for as insurance contracts at fair value and their subsequent measurement at the higher of a) the unadjusted balance between the consideration received or receivable and b) expenditure necessary for meeting the commitment as at the balance sheet date. This amendment will not affect the Group's financial statements.

Amendment to IFRS 1, First-time Application of IFRS. The amendments to the standards are effective for accounting periods beginning at or after 1 January 2006. This amendment will not affect the Group's financial statements.

IFRS 6 Exploration for and Evaluation of Mineral Resources (effective from 1 January 2006) and amendment to IFRS 6 Exploration for and Evaluation of Mineral Resources. This amendment will not affect the Group's financial statements.

IFRS 7 Financial Instruments: Disclosures and supplementary appendix of IAS 1, Presentation of Financial Statements (effective from 1 January 2007). IFRS 7 provides an overview of new requirements for the notes in order to improve the presentation of information concerning financial instruments. It requires presentation of qualitative and quantitative information for risks arising from financial instruments containing specific minimum requirements for credit risk, liquidity risk and market risk (including the sensitivity analysis for market risk). It replaces IAS 30, Disclosures in the Financial Statements of Banks and Similar Institutions and IAS 32, Financial Instruments: Disclosure and Presentation. This standard is effective for all entities that prepare their reports in accordance with International Financial Reporting Standards. The amendment to IAS 1 presents additional disclosure requirements for an entity's capital and capital management. The Company's management is considering the application of this standard.

IFRIC 4 Determining Whether an Arrangement Contains a Lease. It will become effective for accounting periods beginning at or after 1 January 2006. IFRIC 4 stipulates that the determination of whether an arrangement contains a lease is based on the substance of the arrangement. For that it is assessed whether a) the fulfilment of the arrangement depends on the use of a specific asset and b) the arrangement transfers the right to use this asset. The Company's management is considering the application of this standard.

IFRIC 5 Rights to Interests Arising from Decommissioning, Restoration and Environmental Funds. It will be applicable to accounting periods beginning at or after 1 January 2006. IFRIC 5 does not affect the Group's financial statements.

IFRIC 6 Liabilities Arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment. IFRIC 6 will be effective for accounting period beginning at or after 1 December 2005. IFRIC 6 will not affect the Group's financial statements.

IFRIC 7 Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies. IFRIC 7 will be effective for accounting periods beginning at or after 1 March 2006. IFRIC 7 will not affect the Group's financial statements.

IFRIC 8 Share-based Payment according to IFRS 2. IFRIC 8 will be effective for accounting periods beginning at or after 1 May 2006. The Company's management is considering the applications of these amendments.

Endorsement by the European Union of IFRS 7 and IAS 21 as well as amendments to IFRS 6 and IFRS 1 is still pending. However, the management has decided to include them in the above disclosures because the European Union may require their application retrospectively before the endorsement. For example, IFRIC 2 was published in the Official Journal dated 7 July 2005, but the Journal stated that the standard would be applied to each financial year starting at or after 1 January 2005. This standard therefore had to be applied retrospectively to a period beginning before the date of endorsement.

NOTE 2 Critical accounting estimates and judgements in applying accounting policies

The Group makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgements are continually evaluated and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Management also makes certain judgements, apart from those involving estimations, in the process of applying the accounting policies. Judgements that have the most significant effect on the amounts recognised in the financial statements and estimates that can cause a significant adjustment to the carrying amount of assets and liabilities within the next financial year include: valuation of financial assets at fair value through profit and loss (Note 5) inventory (Note 8), valuation of goodwill (Note 30), determination of the useful life of property, plant and equipment (Note 13), valuation of investment property (Note 10) and valuation of deferred income tax assets (Note 11).

Financial assets at fair value through profit and loss

The financial assets at fair value through profit and loss (carrying amounts are 116 thousand euros as of 31 December 2005 and 38 thousand euros as of 31 December 2004) are valued by management at fair value based on the stock exchange quotation.

Inventory valuation

Upon valuation of inventories, the management will rely on its best knowledge taking into consideration historical experience, general background information and potential assumptions and conditions of future events. In determining the impairment of inventories, the sales potential as well as the net realisable value of finished goods is considered (carrying amounts of 4,874 thousand euros as of 31 December 2005 and 5,758 thousand euros as of 31 December 2004), upon valuation of raw materials and materials, their potential as a source of finished goods and generating income is considered (carrying amounts of 4,033 thousand euros as of 31 December 2005 and 3,321 thousand euros as of 31 December 2004); upon valuation of work in progress, their stage of completion that can reliably be measured is considered (carrying amounts of 102 thousand euros as of 31 December 2005 and 76 thousand euros as of 31 December 2004).

Valuation of goodwill

Goodwill is the excess of the cost of the acquisition over the fair value of the acquired net assets, reflecting the part of cost that was paid for the acquisition of such assets than cannot be separately identified and recognised. Goodwill as an intangible asset with an indefinite useful life is not amortised but it is tested for impairment at least once a year. The management has performed an impairment test for goodwill which arose on the acquisition of the subsidiary Baltman Rus (carrying amounts of 890 thousand euros as of 31 December 2004 and 903 thousand euros as of 31 December 2005). Future expected cash flows based on the budgeted retail sales volumes in the Russian market have been taken into consideration in finding the recoverable amount of the investment. The future expected cash flows have been discounted using the expected rate of return. If the recoverable amount of the investment is lower than its carrying amount, an impairment loss is recorded to write down the investment to its recoverable amount.

Determination of the useful life of property, plant and equipment

The management has evaluated the economic lives of production equipment and other non-current assets related to production depending on their estimated useful lives. The estimation of economic lives is based on historical experience and takes into consideration production capacity and conditions. The estimation of economic lives of non-current assets used in retail trade is based on the period over which this asset is expected to participate in the generation of revenue as well as the guaranteed duration of lease agreements. The economic life of assets with unlimited use (land) is assessed as indefinite. The total carrying amount of property, plant and equipment with a limited useful life is 4,750 thousand euros as of 31 December 2004 and 4,929 thousand euros as of 31 December 2005. The total carrying amount of land is 192 thousand euros as of 31 December 2004 and 701 thousand euros as of 31 December 2005.

Valuation of investment property

Investment property is initially recognised at the acquisition cost and subsequently measured at fair value in the balance sheet. The management uses the estimate of an asset's market value provided by an independent expert as a basis for fair value estimation. In its absence, the Management Board uses alternative measurement methods. In 2005, the management used an independent expert's opinion for evaluating the registered real estate located at Veerenni Street, Tallinn (carrying amounts of 1,227 thousand euros as of 31 December 2005 and 479 thousand euros as of 31 December 2004) and comparable transactions in the same region for evaluating investment property in Lasnamäe Industrial Park, Tallinn (carrying amount of 511 thousand euros as of 31 December 2005, investment was acquired in 2005).

Deferred income tax

Deferred income tax asset have mostly arisen through tax loss carryforwards from subsidiaries operating in foreign markets and is recoverable through future deductions from taxable profits. Deferred income tax assets are recorded to the extent that realisation of the related tax benefit is probable. In determining future taxable profits and the amount of tax benefits that are probable in the future Management makes judgements and applies estimation based on the future development of the market and its outcomes to evaluate future expected revenue. The profit assumption is based on the attainment of the Company's strategic goals. The carrying amounts of net deferred income tax assets as of 31 December 2005 is 230 thousand euros and as of 31 December 2004 is 278 thousand euros.

NOTE 3 Financial risks

In its daily activities, the Group is exposed to different types of risks whose management is an important and integral part of the business activities of AS Baltika. The organisation's ability to identify, measure and control different risks is a key variable for the Group's profitability. The Group's management defines risk as a potential negative deviation from the expected financial results. The main risk factors are market, credit, operations and liquidity risks.

The basis for risk management at the Group are the requirements set by the Tallinn Stock Exchange, the Financial Supervision Authority and other regulatory bodies, adherence to generally accepted accounting principles, as well as the organisation's internal regulations and risk policies. Overall risk management includes identification, measurement and control of risks. The management of the parent company plays a major role in managing risks and approving risk procedures, but the Supervisory Board of the Group's parent company also plays an important role.

The management of the Group's parent company considers market risk which also includes foreign exchange risk as the most serious risk at the Group.

Market risk

Baltika's operations are mostly affected by the cyclical nature of economies in target markets and changes in competitive positions, as well as risks related to specific markets (especially non-European Union markets in Russia and Ukraine).

To hedge risks, the Group attempts to increase the flexibility of its operations: the sales volumes and the activities of competitors are also being monitored and if necessary, the Group will make adjustments in price levels, marketing activities and collections offered. In addition to central gathering and assessment of information, an important role in analysing and planning actions is played by a marketing organisation in each target market enabling to obtain fast and direct feedback on market developments on the one hand and adequately consider local condition on the other hand.

As improvement of flexibility plays an important role in increasing the Company's competitiveness, continuous efforts are being made to shorten the cycles of business processes and minimise potential deviations. This also helps to improve the relative level and structure of inventories and the fashion collections' meeting of consumer expectations.

Foreign exchange risk

Exports constitute 71% of the sales of AS Baltika Group. The major currencies for exports at the Group's retail markets are LTL (Lithuanian lita), LVL (Latvian lat), UAH (Ukrainian hryvnia), PLN (Polish zloty), RUR (Russian rouble); the Group's other currencies are EUR (Euro), GBP (British pound). The majority of raw materials used in production is imported. The major currencies for imports are EUR (euro) and USD (US dollar). Trading with the countries belonging to the European Monetary Union is handled only in euros.

As the Group primarily sells its goods in euros, then as a retail company, the prices of goods in the markets are fixed in a local currency and consequently, foreign currency risk directly affects the Company's revenue through the pricing of goods at the stores in those markets. A change in the economic environment and relative appreciation/depreciation of a local currency may greatly affect the purchasing power of customers in the market of the respective segment.

The weakening of the USD against the euro poses liquidity risk, which affects the Group's collectible amounts from the countries most affected by the changes in the dollar's exchange rate (Ukraine, Russia, Poland). On the other hand, the weakening of the dollar has a positive impact on importing from the countries with which accounts are settled in dollars.

In 2005, the Group's results were impacted by the changes of average foreign currency exchange rates against the Estonian kroon in those countries where AS Baltika has subsidiaries: Polish zloty +12.3%, Ukrainian hryvnia -4.4% and Latvian lat -4.5%, Russian rouble +2.3%. In 2004, changes of average foreign currency exchange rates against the Estonian kroon were as follows: Polish zloty +15.7%, Ukrainian hryvnia -7.2% and Latvian lat -3.6%, since May, Russian rouble -3%.

No separate instruments were used for hedging foreign currency risks in 2005. The Company mostly uses the euro to settle the accounts with its subsidiaries located in foreign markets; for the Polish subsidiary, accounts are settled in zlotys and since October 2005, accounts are settled in roubles with the Russian subsidiary.

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If feasible, foreign currencies collected are used for the settling of liabilities measured in the same currency.

For foreign currency profits and losses, please refer to Note 25 and 26.

Credit and liquidity risks

Credit risk is a potential loss that would occur by the balance sheet date if the contract parties did not meet their obligations. The Group is exposed to credit risk to the extent of solvency of its business partner in Russia. There are no collaterals for receivables in the balance sheet. Credit risks arising from the Group's seasonal production and sales cycle are not permanent. As of the balance sheet date, the maximum credit risk is 2.53 million euros, including credit risk of the Russian wholesale partner of 1.95 million euros. Russia's credit risk is related to one customer, who is also a minority shareholder of Baltman Rus.

A group account is in use for more flexible management of liquid assets, enabling the Group companies to use the Group resources up to the limit established by AS Baltika (Note 16).

Interest rate risk

Interest rate risk is primarily caused by the potential fluctuations of EURIBOR and the changing of the average interest rates of banks.

Operating risks

The most important operating risk arises from the Company's inability to make collections which would meet customer expectations and the goods that cannot be sold when expected and as budgeted. Another important risk is that the Company's information technology system is unable to ensure sufficiently fast and accurate transmission of information for decision-making purposes.

To ensure good collections, Baltika employs a strong team of designers who monitor and are always aware of fashion trends by using internationally acclaimed channels. Such a structure, procedures and information systems have been set up at the Group which help daily monitoring of sales and the balance of inventories and using it in subsequent activities. In order to upgrade information systems, the plan for 2006 calls for the transition to the integrated system encompassing several areas of operations. In order to avoid supply problems, cooperation with the world's leading procurement intermediaries as well as fabric manufacturers has been expanded.

The unavoidable risk factor in selling clothes is the weather. Collections are created and sales volumes as well as time is planned under the assumption that regular weather conditions prevail in the target market – in case weather conditions differ significantly from normal conditions, the actual sales results may significantly differ from the budget.

NOTE 4 Cash and bank

	31.12.2005	31.12.2004
Cash in hand	121	100
Cash at bank	720	401
Short-term deposits	818	299
Total	**1,659**	**800**

As of the end of 2005, overnight deposits had been deposited by the parent company in the amount of 817.94 thousand euros, with the following interest rates depending on the currency deposited – 2.05% for EEK, 1.55% for EUR and 4% for USD. No other overnight deposits existed at 31 December 2005.

As of the end of 2004, overnight deposits had been deposited by the Polish subsidiary in the amount of 174 thousand euros (PLN 710 thousand), with the interest rate of 5% and by the parent company in the amount of 125.2 thousand euros with the interest rate of 1.9%.

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NOTE 5 Financial assets at fair value through profit or loss

	31.12.2005	31.12.2004
Shares of Tallinna Kaubamaja	116	39

The shares are listed on Tallinn Stock Exchange and are actively traded, thus the basis for the fair value assessment is the closing price quoted on Tallinn Stock Exchange. The increase in the investment is related solely to the rise in the fair value and no additional shares have been acquired during the period.

NOTE 6 Trade receivables

	31.12.2005	31.12.2004
Accounts receivable	2,530	1,763
Allowance for doubtful receivables	-1	-5
Total	**2,529**	**1,758**

Trade receivables include the parent's receivable from the joint venture in the amount of 104 thousand euros (31 December 2004: 159 thousand euros) (Note 29).

Impairment losses have been recognised during 2005 in the amount of 14 thousand euros (2004: 2 thousand euros). Receipt of the receivables or reversal of the impairment losses previously provided for has occurred in the amount of 1.5 thousand euros during 2005 (2004: 0.8 thousand euros).

A certain risk concentration exists regarding a wholesale partner in Russia, see Note 3 – Credit risk. The other receivables are not affected by credit risk concentration.

NOTE 7 Other receivables and prepaid expenses

	31.12.2005	31.12.2004
Other current receivables	228	169
Tax prepayments and tax reclaims	332	222
Prepaid expenses	397	247
Interest receivables	1	2
Total	**958**	**640**

As of 31 December 2005 and 31 December 2004, prepaid expenses include prepaid rental payments, insurance payments, prepayment for information technology services, subscription costs of periodicals, etc.

Tax receivables (prepayments)

	31.12.2005	31.12.2004
Value added tax	308	214
Prepaid income tax	21	3
Other taxes	3	5
Total	**332**	**222**

Tax liabilities

	31.12.2005	31.12.2004
Personal income tax	166	156
Social security tax and unemployment insurance premium	363	288
Value added tax	509	334
Corporate income tax liability	60	12
Other taxes	25	20
Total	**1,123**	**810**

Additional information on corporate income tax is provided in Notes 11 and 27.

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NOTE 8 Inventories

	31.12.2005	31.12.2004
Raw materials	4,195	3,413
Impairment of raw materials	-162	-92
Work-in-progress	102	76
Finished goods and goods purchased for resale	4,973	5,912
Impairment of finished goods and goods purchased for resale	-99	-154
Prepayments to suppliers	224	142
Total	**9,233**	**9,297**

As of 31 December 2005, the inventories of the Group with the carrying amount of 0.48 million euros (31 December 2004: 0.33 million euros) were in the custody of third parties.

The amount of fabric carried at net realizable value was 0.42 million euros as of 31 December 2005 (31 December 2004: 0.12 million euros) and the amount of finished goods and goods for resale carried at net realizable value was 0.45 million euros (31 December 2004: 0.77 million euros). The impairment losses of raw materials in the Group amounted to 70.6 thousand euros in 2005 (2004: 44 thousand euros). No additional losses have been incurred from the realisation of previously impaired raw materials.

The impairment allowance of finished goods and goods for resale has decreased by 0.06 million euros in 2005 and 0.93 million euros in 2004 due to improved planning for selling old inventories

Information on pledged assets is provided in Note 16.

NOTE 9 Investments in joint ventures

			Participation		Investment in balance sheet	
Subsidiary	**Location**	**Activity**	**31.12.2005**	**31.12.2004**	**31.12.2005**	**31.12.2004**
OÜ Baltika Tailor	Estonia	Production	50%	50%	15	70

The goal for setting up the company as a separate legal entity was to ensure better production efficiencies. OÜ Baltika Tailor, where the production division of AS Baltika was transferred from 1 November 2004, was registered in the Commercial Registry in August 2004. On 29 November 2004, 50% of OÜ Baltika Tailor was sold to OY Turo Tailor AB and a joint venture for the production of men's suits, jackets and trousers was set up with the latter. The transaction price was 250,000 euros that was paid for in cash. A gain in the amount of 197 thousand euros was realised in the transaction.

In the Group financial statements for 2004, the income of 2.62 million euros and expenses of 2.68 million euros were included in consolidation until the end of November 2004. Starting from 1 December 2004, the results of the joint venture are accounted for under the equity method in the Group's reporting.

	31.12.2005	31.12.2004
Current assets	528	744
Non-current assets	183	0
Current liabilities	511	604
Non-current liabilities	166	0
	2005	**08.2004-12.2004**
Revenue	4,285	836
Expenses	4,391	4,285

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NOTE 10 Investment property

Balance as of 31.12.2003	**0**
Reclassification from owner-occupied properties	230
Revaluation	249
Balance as of 31.12.2004	**479**
Additions	381
Revaluation	878
Balance as of 31.12.2005	**1,738**

	2005	**2004**
Rental income from investment properties	192	79
Direct operating expenses from investment properties	192	79
Net rental income from investment properties	**0**	**0**

In the Group's balance sheet, investment property consists of:

- a production facility located at Veerenni 24, Tallinn, which is leased out to the joint venture OÜ Baltika Tailor and is recorded at fair value of 1.23 million euros;
- a building lease located in Lasnamäe Industrial Park, Tallinn, which is owned by a subsidiary OÜ Baltika TP according to the building lease agreement and is recorded at fair value of 0.51 million euros.

In conjunction with the transfer of production to OÜ Baltika Tailor, a lease agreement for the usage of the production facility at Veerenni 24, Tallinn, was entered into in 2004. As a result, the purpose of the production facility that had been used for own purposes was reclassified into a leased out investment property. The investment property was revalued to fair value and the resulting increase in value in the amount of 249.13 thousand euros was recorded as a reserve in equity. Upon revaluation of investment property, the valuation of an independent expert of the real estate property was used as the basis for fair value determination. The independent valuer assessed the total value of the real estate property located at Veerenni 24 and the value of the investment property recorded in the balance sheet was separated from the total value of the property.

In August 2005 OÜ Baltika TP, the subsidiary of AS Baltika acquired building leases for two plots of land in the Lasnamäe Industrial Park with an area of 25,061 sq. metres. The building leases have been acquired for 10 years with a renewal option until 50 years. The building leases include an option to purchase the underlying land at a price of 28.8 euros per sq. meter for the total value of 720.73 thousand euros starting from the beginning of the fourth year of lease. As the option to purchase the land is at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable, the building leases have been recorded as finance leases. At the inception of the lease, a payment equalling three years' lease payments was made in the total amount of 254 thousand euros (including direct transaction costs in the amount of 13.74 thousand euros). The acquisition cost of the plots of land includes the consideration paid in cash at the beginning of the lease and the discounted exercise price of the call options exercisable according to building lease agreements (Notes 15 and 16). One plot of land is planned to be used for the construction of the Group's new logistics centre (recorded in property, plant and equipment due to planned occupation by the Group for its own administrative use) and the other plot of land will be the new location for the joint venture's OÜ Baltika Tailor production facilities currently located in the city (recorded as investment property) (see Note 13). The investment property is assessed at fair value by the management by a reference to the similar transactions in the active market at the same location (an independent valuer's opinion was not used).

The Company has no binding obligations to sell or develop the investment property at Veerenni 24. Regarding the plots in Lasnamäe Industrial Park, OÜ Baltika TP has the obligation to develop a production company according to the business plan and to use the land only for the purpose of production and providing for production. The company is also required to create one job per each 50 sq. meter within three years at the latest and to ensure this employment level for another 8 years after the initial requirement is met.

The investment property at Veerenni 24 has been pledged to secure the Company's liabilities (Note 16).

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NOTE 11 Deferred income tax

2005	Poland	Latvia	Lithuania	Ukraine	Total
Deferred income tax liability					
On property, plant and equipment	0	-14	0	0	**-14**
On vacation payroll accrual	0	0	0	0	**0**
On finance lease	-1	0	0	0	**-1**
Deferred income tax receivable					
On property, plant and equipment	11	0	2	0	**13**
On tax loss carry-forwards	73	73	66	0	**212**
On accrued liabilities	20	0	0	0	**20**
Deferred income tax asset, net	**103**	**59**	**68**	**0**	**230**
Incl. current portion (recovered within 12 months)	33	18	42	0	**93**
non-current portion	70	41	26	0	**137**
Deferred income tax income (expense) (Note 27)	**-5**	**-1**	**-40**	**-2**	**-48**

2004	Poland	Latvia	Lithuania	Ukraine	Total
Deferred income tax liability					
On property, plant and equipment	0	-16	0	0	**-16**
Deferred income tax receivable					
On property, plant and equipment	29	0	2	2	**33**
On tax loss carry-forwards	73	76	107	0	**256**
On accrued liabilities	5	0	0	0	**5**
Deferred income tax asset, net	**107**	**60**	**109**	**2**	**278**
Deferred income tax income (expense) (Note 27)	**107**	**40**	**51**	**-67**	**131**

The recovery of the deferred income tax asset arising from tax loss carry-forwards is dependent on future taxable profits at subsidiaries that exceed the existing losses to be carried forward. An analysis of expected future profits was carried out when preparing the financial statements. According to the estimate, the realisation of tax loss carryforwards will take place in Lithuania over a three-year period beginning with 2005, in Latvia over a five-year period beginning with 2005 and in Poland over a four-year period beginning with 2006. The profit assumption is based on the attainment of each respective company's strategic goals.

NOTE 12 Other non-current financial assets

	31.12.2005	31.12.2004
Investment in joint venture (Note 9)	15	70
Other non-current financial assets		
Loan receivable from joint venture (Note 29)	83	0
Loan receivable from the subsidiary's management board member (Note 29)	0	36
Long-term prepayments for rent	215	145
Other long-term financial assets	3	0
Total other non-current financial assets	**301**	**181**

Long-term prepayments for rent have been paid by the retail companies in Latvia, Lithuania, Poland and Russia.

NOTE 13 Property, plant and equipment

The Group's investments in property, plant and equipment totalled 1.86 (2004: 0.80) million euros in 2005. A building lease of a plot of land was acquired in the amount of 0.51 million euros. The land is planned to be used for the construction of a new logistics centre (see Note 10), for which investments have amounted to 0.24 million euros. Investments into retail markets totalled 0.88 (2004: 0.68) million euros during the financial year. In the financial year, investments in the amount of 0.10 (2004: 0.06) million euros were made into production equipment, in the amount of 0.05 (2004: 0.06) million euros into information technology and 0.56 million euros was invested in other equipment.

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Property, plant and equipment of 0.56 (2004: 0.01) million euros were acquired under the finance lease terms, of which 0.51 million euros is related to the aforementioned building lease (Note 10 and 16).

In 2005, non-current assets were sold with an acquisition cost of 0.14 (2004: 0.20) million euros and a residual value of 0.01 (2004: 0.09) million euros at the Group. Obsolete and unusable production equipment was written off with an acquisition cost of 0.45 million euros, store furniture and capitalised construction costs were written off with an acquisition cost of 0.26 million euros, and write-offs of property, plant and equipment amounted to 0.04 million euros at acquisition cost.

In 2004 the Group's non-current assets were increased mainly by the equipment employed by retail outlets in the amount of 0.06 million euros due to the acquisition of the subsidiary in Russia.

Movement of property, plant and equipment at the Group

	Land	Buildings and structures	Machinery and equipment	Other fixtures	Construction in progress	Pre-payments	Total
31.12.2003							
Acquisition cost	**192**	**4,609**	**4,502**	**2,681**	**0**	**14**	**11,998**
Accumulated depreciation and impairment	0	-1,417	-3,686	-1,334	0	0	**-6,437**
Net book amount	**192**	**3,192**	**816**	**1,347**	**0**	**14**	**5,561**
Additions	0	310	104	381	4	0	**799**
Acquisition of a subsidiary	0	0	21	42	0	0	**63**
Disposals	0	-32	-15	-40	0	0	**-87**
Written off	0	-6	-3	-17	0	0	**-26**
Reclassifications to investment property	0	-230	0	0	0	0	**-230**
Reclassification due to change in accounting policy	0	54	0	0	0	0	**54**
Taken into use	0	14	0	0	0	-14	**0**
Depreciation	0	-329	-386	-524	0	0	**-1,239**
Currency translation differences	0	42	-2	7	0	0	**47**
31.12.2004							
Acquisition cost	**192**	**4,450**	**4,519**	**3,062**	**4**	**0**	**12,227**
Accumulated depreciation and impairment	0	-1,435	-3,985	-1,865	0	0	**-7,285**
Net book amount	**192**	**3,015**	**534**	**1,197**	**4**	**0**	**4,942**
Additions	509	381	215	419	121	211	**1,856**
Disposals	0	0	-7	-5	0	0	**-12**
Written off	0	-12	0	-10	0	0	**-22**
Reclassification	0	0	14	-14	0	0	**0**
Impairment	0	-79	0	0	0	0	**-79**
Depreciation	0	-369	-311	-459	0	0	**-1,139**
Currency translation differences	0	35	5	41	3	1	**85**
31.12.2005							
Acquisition cost	**701**	**4,730**	**4,559**	**3,288**	**128**	**211**	**13,617**
Accumulated depreciation and impairment	0	-1,759	-4,109	-2,119	0	0	**-7,987**
Net book amount	**701**	**2,971**	**450**	**1,169**	**128**	**211**	**5,630**

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Impairment allowance of building and structures is recorded to present the assets of a retail outlet closed in Poland after the balance sheet date at the fair value less costs to sell. The impairment cost is recorded in the income statement in the line distribution costs. The fair value less costs to sell was determined based on the actual sales price.

Information on pledged assets is provided in Note 16.

Assets acquired during the financial year under finance lease terms recorded in property, plant and equipment amount to 1,075 (2004: 7.54) thousand euros at acquisition cost. The total net book amount of assets acquired through finance lease included in property, plant and equipment is 1,135 (2004: 153) thousand euros. See Note 15 for lease agreements.

NOTE 14 Intangible assets

Movement of intangible assets at the Group

	Licenses and software	Positive goodwill	Negative goodwill	Total
31.12.2003				
Acquisition cost	**1,150**	**112**	**-59**	**1,203**
Accumulated amortisation	-292	-89	59	**-322**
Net book amount	**858**	**23**	**0**	**881**
Additions	197	0	0	**197**
Acquisition of a subsidiary (Note 30)	0	887	0	**887**
Written off	-1	-22	0	**-23**
Amortisation	-157	0	0	**-157**
Currency translation differences	1	3	0	**4**
31.12.2004				
Acquisition cost	**1,283**	**890**	**0**	**2,173**
Accumulated amortisation	-384	0	0	**-384**
Net book amount	**899**	**890**	**0**	**1,788**
Additions	76	0	0	**76**
Amortisation	-185	0	0	**-185**
Currency translation differences	1	13	0	**14**
31.12.2005				
Acquisition cost	**1,350**	**903**	**0**	**2,253**
Accumulated amortisation	-560	0	0	**-560**
Net book amount	**790**	**903**	**0**	**1,693**

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NOTE 15 Accounting for leases

Operating lease – the Company as the lessee

The future minimum lease payments under non-cancellable operating leases are divided at the Group as follows:

	31.12.2005	31.12.2004
Up to 1 year	3,290	2,389
1–5 years	5,530	3,240
Over 5 years	171	474
Total	**8,991**	**6,103**

Operating lease expenses include the rental expenses for leasing the retail outlet spaces. The future minimum lease payments under non-cancellable operating leases are calculated based on the non-cancellable periods of the leases.

The lease agreements for stores are predominantly not binding for long-term in Estonia, Latvia and Lithuania, most of the lease agreements can be terminated with a two to six month notice. In Poland and Ukraine, the lease agreements usually require finding a new lessee when cancelling the lease agreement. Termless lease agreements are expected to be valid for 5 years. If the termination of the agreement requires a mutual agreement, lease payments are expected to be paid during the following six-month period. If the termination of the agreement requires an advance notice, lease payments are expected to be paid off during the advance notice period. In 2005, operating lease payments totalled 5,536 (2004: 4,888) thousand euros at the Group.

Operating lease – the Company as the lessor

Operating lease income includes rental income for spaces and machinery.

The future minimum lease payments receivable from non-cancellable subleases of the Group:

	31.12.2005	31.12.2004
Up to 1 year	362	9
1–5 years	174	0
Over 5 years	0	0
Total	**536**	**9**

In 2005, operating lease income in the amount of 366 (2004: 63) thousand euros was received. The matching expenses totalled 251 (2004: 13) thousand euros at the Group.

The Company has a lease agreement with a joint venture OÜ Baltika Tailor for the space and production machinery located at Veerenni 24 (see Note 10). The lease agreement for space is effective until 30.06.2007 and the lease agreement for machinery is termless.

Assets leased out under operating lease

	Total
31.12.2003	
Acquisition cost	**14**
Accumulated depreciation	-4
Net book amount	**10**
Additions	1,014
Depreciation	-29

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	Total
31.12.2004	
Acquisition cost	**3,524**
Accumulated depreciation	-2,530
Net book amount	**994**
Additions	0
Revaluations	747
Disposals (at acquisition cost)	-31
Written off (at acquisition cost)	-145
Depreciation	-143
31.12.2005	
Acquisition cost	**4,095**
Accumulated depreciation	-2,185
Net book amount	**1,910**

Finance lease – the Company as the lessee

	Building lease	Equipment and fittings of the factory	Passenger cars and equipment	Total
31.12.2003				
Acquisition cost	**0**	**310**	**51**	**361**
Accumulated depreciation	0	-128	-18	**-146**
Net book amount	**0**	**182**	**33**	**215**
Additions	0	0	8	**8**
Depreciation	0	-38	-14	**-52**
Disposals (at net book amount)	0	0	-18	**-18**
31.12.2004				
Acquisition cost	**0**	**310**	**30**	**340**
Accumulated depreciation	0	-165	-22	**-187**
Net book amount	**0**	**145**	**8**	**153**
Additions	1,021	1	53	**1,075**
Depreciation	0	-47	-9	**-56**
Disposals (at net book amounts)	0	0	-7	**-7**
31.12.2005				
Acquisition cost	**1,021**	**233**	**61**	**1,315**
Accumulated depreciation	0	-171	-9	**-180**
Net book amount	**1,021**	**62**	**52**	**1,135**

Minimum lease payments at the Group

	31.12.2005	31.12.2004
Short-term – up to 1 year	16	29
Long-term – 1–5 years	767	1
Total	**783**	**30**
Future interest expense of operating lease	**-86**	**0**
Present value of future minimum lease payments	**697**	**30**

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Present value of future minimum lease payments

	31.12.2005	31.12.2004
Short-term – up to 1 year	12	29
Long-term – 1–5 years	685	1
Total	**697**	**30**

NOTE 16 Borrowings

	31.12.2005	31.12.2004
Short-term borrowings		
Future repayments of long-term bank loans	731	1,511
Short-term bank loans	0	1,994
Short-term finance lease liabilities (Note 15)	12	28
Convertible bonds (Note 17)	14	24
Bonds (Note 17)	1,178	1,205
Total	**1,935**	**4,762**
Long-term borrowings		
Long-term bank loans	3,313	2,934
Long-term finance lease liabilities (Note 15)	685	1
Other non-current liabilities	0	1
Total	**3,998**	**2,936**

Bank loans of the Group at 31.12.2005

	Loan payable on 31.12.2005	Short-term portion up to 1 year	Long-term portion 1–5 years	Interest
Nordea Pank	359	60	299	6 month Euribor+2.5%
Nordea Pank	186	53	133	3 month Euribor+2.5%
Hansapank	3,088	481	2,607	6 month Euribor+1.5%
Hansapank	411	137	274	6 month Euribor+2.35%
Total	**4,044**	**731**	**3,313**	

All bank loans as of 31 December 2005 are subject to a floating interest rate, which is dependent on the Euribor changed and fixed every six months. As the loans are subject to the floating interest rate and the interest margin is based on the Group's business risk, the management of the parent company estimates that all loans have been taken under the market conditions with the market rate of interest, thus the fair value of the loans is close to the carrying value.

All bank loans are denominated in euros and the bank overdraft is denominated in kroons, thus no currency risk is assumed.

Bank loans of the Group on 31.12.2004

	Loan payable on 31.12.2004	Short-term portion up to 1 year	Long-term portion 1–5 years	Interest
Nordea Pank	460	115	345	6 month Euribor+2.5%
Nordea Pank	400	266	134	3 month Euribor+2.5%
Hansapank	3,037	992	2,045	6 month Euribor+2.25%
Hansapank	703	703	0	4.5%
Hansapank	548	138	410	6 month Euribor+2.35%
Hansapank (bank overdraft)	1,291	1,291	0	4.2%
Total	**6,439**	**3,505**	**2,934**	

In 2005, a short-term loan from Hansapank received in 2003 was refinanced, the due date was extended until the year 2012 and the interest rate was reduced. Additionally, the payment schedule of the loan from Nordea Pank was extended by three years until the year 2009.

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During the financial year, AS Baltika made loan payments in the amount of 0.31 million euros to Nordea Pank and 0.65 million euros to Hansapank. In 2004, the loan payments of AS Baltika amounted to 0.81 million euros. AS Virulane made loan payments to Hansapank in the amount of 0.13 million euros both in 2004 and 2005.

AS Baltika has a commercial pledge used as collateral for the overdraft and loans in the amount of 4.45 million euros and a mortgage on the real estate property at Veerenni 24, Tallinn in the amount of 2.56 million euros. Mortgages on registered real estate properties located at Kalda 10A, Rakvere in the amount of 0.47 million euros and at Õpetajate 5, Ahtme in the amount of 0.77 million euros, a commercial pledge in the amount of 0.91 million euros and a guarantee by AS Baltika are used as the loan collateral for AS Virulane.

The Group companies AS Virulane, AS Elina STC, OÜ Baltman, OÜ Baltika TP and OÜ Baltika Tailor are included in the AS Baltika group account. The Group uses the overdraft limit of 2.05 million euros through the group account. As of 31 December 2005, the overdraft was not used. As of 31 December 2004, the parent company was the sole user of the overdraft limit in the amount of 1.39 million euros. Users of the group account are jointly responsible for the fulfilment of obligations arising from the group account agreement.

Interest expense at the Group amounted to 0.35 million euros during the financial year (2004: 0.43 million euros). Interest expenses have been recorded as financial expenses.

For information on guarantees issued, see Note 32.

NOTE 17 Bonds

Convertible bonds

According to the resolution of the General Meeting of Shareholders held on 6 April 2001, it was decided to issue 576,000 (192,000 per year) convertible bonds with the nominal value of 0.06 euros (1.00 Estonian kroons) to the management over the period of 2001–2003.

Three different types of convertible bonds were issued as follows:

A-bonds were converted into ordinary shares by paying an additional 1.53 euros per share.
B-bonds were converted into ordinary shares by paying an additional 2.13 euros per share;
C-bonds are convertible into ordinary shares for an additional payment of 2.34 euros per share.

In case the bonds are neither converted into ordinary shares nor redeemed during the conversion period, they will become interest bearing loans under market conditions according to the agreement by both parties. Until then, no interest is calculated on bonds. 5,500 unconverted bonds have been redeemed as repayments of loans in the amount of 0.35 thousand euros.

	Issue date	Total nominal value of issue	Bond conversion period	Bonds converted into shares	Repaid as loans	Convertible bonds 31.12.2005
A-bond	01.05.2001	12.27	01.05.2002–01.05.2004	189,500	2,500	0
B-bond	01.05.2002	12.27	01.05.2003–01.05.2005	189,000	3,000	0
C-bond	01.05.2003	12.27	01.05.2004–01.05.2006	0	0	192,000
Total		**36.81**		**378,500**	**5,500**	**192,000**

In 2005, 189,000 holders of B-bonds decided to subscribe for the shares in exchange for the convertible bonds. In accordance with the owners' request, the Management Board of AS Baltika decided to increase the share capital of AS Baltika by 120,793 euros. After the increase, the share capital of the Company is 3,721,543 euros, consisting of 5,822,950 shares with the nominal value of 0.64 euros (10.00 Estonian kroons) per share. The share premium of the share issue was 290,990 euros. At the exercise date the share price at the market was 4.22 euros.

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In accordance with the terms of the bonds, an employee who has left the Company during the year has the obligation to sell the bonds back to the Company. In 2005 no bonds were repurchased.

At the Extraordinary Meeting of Shareholders held on 7 December 2004, it was decided to issue 200,000 D-type convertible bonds with the nominal value of 0.006 euros (0.10 Estonian kroons) per bond to the executives of the Company.

The bonds are convertible into shares at the price of 1.85 euros, equalling the weighted average share price of AS Baltika on Tallinn Stock Exchange on the trading date preceding the adoption of the resolution. The vesting condition for the conversion of bonds into shares is that the market price of AS Baltika's shares equals at least 2.88 euros per share and the employee who has left the Company during the year has the obligation to sell the bonds back to the Company.

The aforementioned convertible bonds have been recorded as a financial liability in full, as the equity component is immaterial.

	Issue date	Total nominal value of issue	Bond conversion period	Bonds converted into shares	Convertible bonds 31.12.2005
D-bond	21.12.2004	1.28	01.07.2006–30.12.2006	0	20,000

The accounting policies described in IFRS 2 have been adopted to account for the D-bonds (Note 19).

The fair value of the services (employee contribution) acquired by the entity from the employees in exchange for the shares was determined by reference to the fair value of the convertible bonds granted and was valued by an independent expert at 0.31 euros per one convertible bond. The Black-Scholes option pricing model was used in valuing the convertible bond. The following parameters were used in determination of the price of the instrument: share price at the date prior to the grant date, exercise price, weighted average share price, expected volatility by a reference to the history of volatility based on the history of fluctuations of the market prices of the share and the expected life of the option.

As of 31 December 2005, the Company had 200,000 convertible bonds, for which 0.06 euros had been paid and which is recorded as a liability in the total amount of 1,278 euros. Therefore the Company has recognised the impact of the convertible bond in the financial statements from 1 January 2005 as follows:

- in 2005, the amount of 40.2 thousand euros is expensed in payroll costs and a respective increase in the owners' equity is recorded for the vesting period until 31 December 2005, and
- in 2006, the remaining amount of 20.1 thousand euros is recognised in payroll costs and owners' equity for the remainder of the vesting period from 1 January 2006 until 30 June 2006 (the bond conversion period begins on 1 July 2006).

Closed issue of bonds

On 26 September 2003, AS Baltika issued bonds via closed issue in the amount of 1.12 million euros. The issue yielded 1.09 million euros. The redemption date of bonds is on 17 March 2006. The coupon rate of bonds is 7.0%. The effective interest rate on the bonds is approximately 7.7%. The borrowing is unsecured.

On 17 March 2005 the Company paid coupon on the bond in the amount of 0.12 million euros. The next coupon is paid at the redemption on 17 March 2006.

	Quantity	Nominal (EUR)	Issue price (EUR)	Balance as of 31.12.2005	Coupon interest rate	Maturity
Bonds	1,750	639.12	631	1,177.83	7.0%	17.03.2006

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NOTE 18 Accrued expenses and other short-term liabilities

	31.12.2005	31.12.2004
Payables to employees (accrued wages and salaries, vacation payroll accrual, bonus accrual, etc.)	816	670
Dividends payable	0	0
Interest payable	2	2
Customer prepayments	26	13
Other short-term payables	48	46
Total	**892**	**731**

All of these financial liabilities have been designated by the parent company's management as payable within 12 months after the balance sheet date and are therefore recorded as current liabilities.

NOTE 19 Equity

Share capital

Under the articles of association, the minimum number of shares is 4,000,000 and the maximum number of shares is 16,000,000. All shares have been paid for.

	31.12.2005	31.12.2004
Share capital	**3,722**	**3,601**
Number of shares (pcs)	5,822,950	5,633,950
Nominal value of shares (EUR)	0.64	0.64

Change in the number of shares

	Issue	Number of shares
Number of shares on 31.12.2002		**5,444,450**
Issued 20.01.2003	Conversion of A-bonds	15,500
Issued 16.05.2003	Conversion of A-bonds	39,500
Number of shares on 31.12.2003		**5,499,450**
Issued 30.04.2004	Conversion of A-bonds	88,000
Issued 12.11.2004	Conversion of A-bonds	46,500
Number of shares on 31.12.2004		**5,633,950**
Issued 30.04.2005	Conversion of B-bonds	189,000
Number of shares on 31.12.2005		**5,822,950**

The number of shares of AS Baltika was increased by 189,000 in connection with the conversion of B-bonds to shares (Note 17). The issued shares grant the right to receive dividends from the year 2005.

In 2005, AS Baltika paid dividends to shareholders at the rate of 0.05 euros per share, totalling 0.28 million euros. Corporate income tax did not arise on this transaction, as these were paid out from the profits earned during 1994–1999, on which the corporate income tax has already been paid. No dividends were paid in 2004.

From 1 January 2006 income tax of 23/77 of net dividend paid (until 31 December 2004: 24/76 and until 31 December 2003: 26/74) is imposed on the profit distributed as dividends. Of the retained earnings as of 31 December 2005, 4,422 thousand euros can be paid out as net dividends to the shareholders with corresponding income tax of 1,321 thousand euros. As of 31 December 2004, the Company did not have material retained earnings that would have been possible to pay out as dividends to the shareholders.

Reserves

	31.12.2005	Change	31.12.2004	Change	31.12.2003
Statutory reserve	360	53	307	0	307
Revaluation reserve	249	0	249	249	0
Other reserves	0	-1,156	1,156	0	1,156
Total	**609**	**-1,103**	**1,712**	**249**	**1,463**

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During the financial year, 53 thousand euros was transferred to the mandatory legal reserve from the net profit, other reserves were transferred to retained earnings in the amount of 1,156 thousand euros. In 2004, other reserves increased by the revaluation reserve of investment property by 249 thousand euros.

In 2005, the share premium was increased by 331 thousand euros, of which 290 thousand euros was originated by the difference in the exercise price and the nominal value of the 189,000 converted B-bonds and remaining 41 thousand euros was related to the application of IFRS 2 on D-bonds (Note 17).

Shareholders as of 31.12.2005

	Number of shares	Participation %
1. BMIG OÜ	1,284,980	22.07
2. Skandinaviska Enskilda Banken Ab Clients	451,295	7.75
3. AS LHV Arbitrage	336,000	5.77
4. Members of the Management Board and persons related to them		
Meelis Milder	151,617	2.60
Maire Milder	62,161	1.07
Boriss Loifenfeld	12,482	0.21
Ülle Järv	8,158	0.14
5. Other minority shareholders	3,516,257	60.39
Total	**5,822,950**	**100.00**

Shareholders as of 31.12.2004

	Number of shares	Participation %
1. Baltic Republics Fund	2,012,400	35.72
2. OÜ BMIG	1,098,147	19.49
3. Members of the Management Board and persons related to them		
Meelis Milder	115,617	2.05
Maire Milder	30,161	0.54
Boriss Loifenfeld	30,882	0.55
Ülle Järv	3,458	0.06
4. Other minority shareholders	2,343,285	41.59
Total	**5,633,950**	**100.00**

The investment company OÜ BMIG is under the control of the board members of AS Baltika. The shares of the parent company are listed on Tallinn Stock Exchange. The parent company does not have a controlling shareholder or any shareholders jointly controlling the entity.

NOTE 20 Segments

During the previous financial years the Group has assessed its primary segment as the business segment by the areas of operations and its secondary segment as the geographical segment according to the client's location. Starting from 2002, the Group has been actively driven to change strategically from a production and wholesale company to a retail company directed to several markets. From 2005, the parent company's management can declare that the strategic change has been implemented. Therefore the Company now addresses its primary segment by the geographical operations located in different markets, which is the source of main risks and returns for the Company. As a result, the primary segment is defined as the geographical segment according to the client's location and the secondary segment is defined as the business segment by the areas of operations. The comparatives have been restated for 2004 and are presented in the note below.

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Geographical segment by client's location – primary segment

As of 31 December 2005, the Company is active in the following markets:

- Estonia, Latvia, Lithuania, Russia, Ukraine, Poland – defined as separate geographical segments, as each market generates significantly different risks and returns and each market separately is significant enough to form a separate segment;
- other markets (Finland, Sweden, etc.) where the Company's presence is small or less strategic and these markets separately do not form a segment for the segment reporting.

2005	**Estonia**	**Latvia**	**Lithuania**	**Russia**	**Ukraine**	**Poland**	**Other**	**Intersegment transactions**	**TOTAL**
Non-group sales	12,486	5,262	8,464	7,125	6,301	2,503	1,377	0	**43,518**
Inter-segment sales	0	2,997	5,360	1,104	2,345	1,370	194	-13,370	**0**
Total sales (Note 21)	**12,486**	**8,259**	**13,824**	**8,229**	**8,646**	**3,873**	**1,571**	**-13,370**	**43,518**
Operating profit of the segment	2,582	328	260	741	1,524	70	278	0	**5,783**
Unallocated operating expenses and income									**-995**
Total operating profit									**4,788**
Other financial income (expenses)									**-252**
Corporate income tax (Note 27)									**-274**
Net profit before minority interest									**4,262**
Minority interest									**-382**
Net profit for the financial year									**4,644**
Assets	8,772	1,311	3,309	5,637	1,988	1,079	27	-4,791	**17,332**
Group's unallocated assets									**6,770**
Incl. assets used in production									**5,853**
Assets used for administrative use									**429**
Other unallocated assets									**488**
Total assets									**24,102**
Liabilities	911	1,096	2,277	1,666	1,042	407	0	-5,552	**1,847**
Group's unallocated liabilities									**8,964**
Incl. liabilities related to production activity									**1,302**
Other unallocated liabilities									**7,662**
Total liabilities									**10,811**
Property, plant and equipment acquired (Note 13)	197	22	444	317	57	42	0	0	**1,079**
Property, plant and equipment acquired, unallocated									**853**
Depreciation (Note 13, 14)	545	81	185	38	107	186	0	0	**1,324**
Incl. depreciation of property, plant and equipment	390	73	168	38	106	182	0	0	**957**
Depreciation of intangible assets	155	8	17	0	1	5	0	0	**185**
Depreciation of property, plant and equipment, unallocated									**182**
Impairment losses of property, plant and equipment (Note 13)						79			**79**
Other material non-monetary expenses	-79	0	0	0	0	-5	-1	0	**-85**

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2004	Estonia	Latvia	Lithuania	Russia	Ukraine	Poland	Other	Intersegment transactions	TOTAL
Non-group sales	9,450	4,206	6,961	4,911	4,535	2,572	4,554	0	**37,189**
Inter-segment sales	0	2,061	4,155	781	1,838	1,257	614	-10,706	**0**
Total sales (Note 21)	**9,450**	**6,267**	**11,116**	**5,692**	**6,373**	**3,829**	**5,168**	**-10,706**	**37,189**
Operating profit (loss) of the segment	2,002	153	167	1,078	447	-642	264	0	**3,469**
Unallocated operating expenses and income									**-2,269**
Total operating profit									**1,200**
Other financial income (expenses)									**-305**
Corporate income tax (Note 27)									**61**
Net profit before minority interest									**956**
Minority interest									**-111**
Net profit for the financial year									**1,067**
Assets	5,690	1,533	3,246	3,363	2,443	2,184	220	-5,488	**13,191**
Group's unallocated assets									**7,081**
Incl. assets used in production									**6,303**
Assets used for administrative purposes									**457**
Other unallocated assets									**321**
Total assets									**20,272**
Liabilities	1,781	1,297	2,064	1,305	2,339	982	76	-7,397	**2,447**
Group's unallocated liabilities									**8,782**
Incl. liabilities related to production activity									**1,070**
Other unallocated liabilities									**7,712**
Total liabilities									**11,229**
Property, plant and equipment acquired (Note 13,14)	182	119	168	166	215	100	0	0	**950**
Property, plant and equipment acquired, unallocated									**61**
Goodwill related to acquisition of subsidiary				887					**887**
Depreciation (Note 13,14)	452	74	207	21	100	175	7	0	**1,036**
Depreciation of property, plant and equipment, unallocated									**361**
Other material non-monetary expenses	-1,000	0	0	0	0	0	0	0	**-1,000**

In 2004, the Company acquired a business in Russia, which did not change the substance of the sales of the Russian segment, as previously the Group's goods had been sold in the same outlets through the wholesale partner. However, the assets and liabilities of the Russian segment were changed through the addition of the assets and liabilities acquired in the business combination (Note 13).

Allocated income and expenses are directly related to the segment – revenue from sales to customers, cost of sales, payroll and rental costs and other costs related to the market. Unallocated operating income and expenses are the general administrative expenses of the Group, such as the central management expenses, marketing expenses, information technology costs, etc.

The assets of the segment mainly consist of inventories and fixtures located at retail outlets, also other necessary working capital (e.g. cash). Additionally, the segment assets include the deferred income tax assets consolidated in the Group balance sheet arising from operating in certain markets. The liabilities of the segments are related to the payables of the retail outlets, mainly connected to rental agreements, payroll and taxes. Payables for the inventories are mostly to the parent company and have been eliminated in consolidation, thus they are not presented in the segment report.

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The unallocated assets of the Group are the administrative building, office equipment used for general administration, other equipment and current assets related to general activities. Additionally, the Group's assets used in production have been presented as unallocated assets, as these assets service all geographical segments and there is no reasonable basis for dividing these assets among the markets. All assets related to production activity are located in Estonia.

The unallocated liabilities of the Group are mainly the borrowings related to the financing of the Group – loans and bonds. In addition to that also production-related liabilities have been classified as unallocated, such as accounts payable for raw materials and payroll liabilities of production personnel.

According to the parent company management's estimate, the inter-segment transactions have been carried out at arm's length and the conditions applied do not differ materially as compared to the transactions with third parties.

Business segment by area of operations – secondary segment

As of 31 December 2005, the Company operated in the following areas, generating significantly different risks and returns compared to each other and each activity is material enough to form a separate segment:

- retail and managing retail outlet chains in markets;
- wholesale and other services;
- production.

Other areas of operations (sewing as a subcontractor, renting of assets, etc.) are less strategic and less material as compared to the main activities and these activities do not form a separate segment.

	Net sales		Assets		Additions to property, plant and equipment	
	2005	**2004**	**31.12.2005**	**31.12.2004**	**2005**	**2004**
Retail	34,945	26,863	8,164	8,411	1,009	1,655
Wholesale	7,723	7,389	3	77	821	182
Production and other	850	2,937	5,053	3,694	101	55
Unallocated	0	0	10,882	8,090	0	0
Total	**43,518**	**37,189**	**24,102**	**20,272**	**1,931**	**1,892**

NOTE 21 Sales revenue

	2005	**2004**
Sale of goods	42,668	34,252
Sale of sewing services	36	2,730
Rental income	363	63
Other	452	143
Total	**43,518**	**37,189**

NOTE 22 Cost of goods sold

	2005	**2004**
Materials and supplies	18,510	13,837
Change in allowance for inventories	16	-929
Other production costs	327	766
Payroll costs in production	2,001	4,774
Depreciation of assets used in production	177	199
Change in inventories	49	749
Total	**21,080**	**19,396**

AS Baltika 2005 Consolidated Annual Report (in thousand of euros)

NOTE 23 Distribution costs

	2005	2004
Rental expenses	5,199	4,550
Payroll expenses	4,263	3,387
Advertising expenses	842	856
Depreciation	751	763
Transportation expenses	303	296
Credit card expenses	236	189
Bank fees	137	98
Communication expenses	123	118
Information technology expenses	88	48
Renovation of retail outlets	70	63
Accounting and auditing expenses	65	40
Expenses for uniforms	58	118
Packing expenses	58	47
Other selling expenses	1,082	1,260
Total	**13,275**	**11,833**

In 2005, the development costs in the amount of 0.03 million euros were recognised, relating to the change in the brand name of CHR/Evermen (new brand name Mosaic). In 2004, no development costs were incurred.

NOTE 24 Administrative expenses

	2005	2004
Payroll costs	3,488	2,602
Depreciation	395	434
Management and consulting fees	266	178
Rental expenses	235	241
Information technology expenses	161	252
Business trips	146	95
Fuel, heating and electricity	89	89
Communication costs	77	154
Sponsorship	68	25
Bank fees	65	54
Other administrative expenses	457	420
Total	**5,447**	**4,544**

NOTE 25 Other operating income

	2005	2004
Gain from revaluations of investment property	878	41
Profit from the sale of non-current assets	14	0
Foreign exchange gains	315	0
Other operating income	60	67
Total	**1,267**	**108**

NOTE 26 Other operating expenses

	2005	2004
Losses from the sale and write-offs of non-current assets	100	24
Foreign exchange losses	0	87
Fines, penalties on late payment and interest expenses on tax	2	58
Representation costs	62	69
Other operating expenses	31	86
Total	**195**	**324**

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NOTE 27 Corporate income tax

Accounting for income tax in the Group

	2005	2004
Income tax expense	-226	-70
Deferred income tax income (expense)	-48	131
Total income tax income (expense)	**-274**	**61**

The theoretical corporate income tax calculated from the Group's profits is different from the effective corporate income tax expense for the reasons described below.

Income tax by countries for 2005

	Poland	Latvia	Lithuania	Ukraine	Estonia	Russia	Sweden/ Finland	Total
Profit (loss) before income tax	71	226	255	1,524	2,902	-441	-1	**4,535**
Income tax rate in 2005	19%	15%	15%	25%	0%	15%;24%*	28%/29%	
Theoretical income tax expense	-13	-34	-38	-381	0	-25	0	**-492**
Income tax expense on dividends	0	0	0	0	-2	0	0	**-2**
Effect of non-taxable income	-5	0	0	0	0	0	0	**-5**
Effect of non-taxable expenses	189	-16	18	0	0	1	0	**192**
Change in off-balance sheet deferred tax assets	-175	49	-21	186	0	6	0	**34**
Actual income tax expense (income)	**0**	**0**	**0**	**-193**	**-2**	**-30**	**0**	**-225**
Deferred income tax expense (income) (Note 11)	**-5**	**-1**	**-40**	**-2**	**0**	**0**	**0**	**-48**

* In the subsidiary Baltman Rus, the profit is taxable at a rate of 24%, in most of its subsidiaries at a rate of 15%. Two subsidiaries of Baltman Rus use a simplified taxation scheme, whereby the taxation of the company is based on the retail space square meters at a rate of 15%.

Income tax by countries for 2004

	Poland	Latvia	Lithuania	Ukraine	Finland/ Sweden	Estonia	Russia	Total
Profit (loss) before income tax	-637	-41	222	348	1,148	-127	-18	**896**
Income tax rate in 2004	19%	15%	15%	25%	0%	15%;24%*	28%/29%	
Theoretical income tax expense	121	6	-33	-87	0	-30	-5	**-28**
Effect of non-taxable income	-6	0	0	0	0	0	0	**-6**
Effect of non-taxable expenses	113	-13	20	283	0	4	0	**407**
Change in off-balance sheet deferred tax assets	-121	47	65	-308	0	0	5	**-312**
Actual income tax expense (income)	**0**	**0**	**0**	**-44**	**0**	**-26**	**0**	**-70**
Deferred income tax expense (income) (Note 11)	**107**	**40**	**51**	**-67**	**0**	**0**	**0**	**131**

* In the subsidiary Baltman Rus, the profit is taxable at a rate of 24%, in most of its subsidiaries at a rate of 15%. Two subsidiaries of Baltman Rus use a simplified taxation scheme, whereby the taxation of the company is based on the retail space square meters at a rate of 15%.

NOTE 28 Earnings per share

Basic earnings per share		2005	2004
Weighted average number of shares	Pcs	5,759,950	5,541,721
Net profit	EUR '000	4,644	1,067
Basic earnings per share	**EUR**	**0.81**	**0.19**

Diluted earnings per share		2005	2004
Weighted average number of shares	Pcs	5,998,761	5,541,721
Adjusted net profit	EUR '000	4,644	1,067
Diluted earnings per share	**EUR**	**0.77**	**0.19**

The weighted average additional dilutive ordinary shares are calculated separately for each type of convertible bond issued to senior managers outstanding during the period, assuming the conversion of all potential ordinary shares.

Shares issued for no consideration – B-bond – 1.5 thousand shares
Shares issued for no consideration – C-bond – 108 thousand shares
Shares issued for no consideration – D-bond – 129 thousand shares

The average share price of Baltika at the market was 5.51 euros during 2005.

As the average share price of Baltika at the stock exchange was 1.55 euros during 2004, e.g. lower than the exercise price of convertible bonds, the convertible bonds did not impact the calculation of diluted earnings per share.

NOTE 29 Related parties

For the purpose of these financial statements, parties are considered to be related if one party has the ability to control the other party, is under common control, or can exercise significant influence over the financial and management decisions of the other one in accordance with IAS 24 "Related Party Disclosures". Not only the legal form of the transactions and mutual relationships, but also their actual substance has been taken into consideration when defining related parties.

In compiling the Annual Report of AS Baltika, the following entities have been considered related parties:

a) owners, that have either significant influence or control, generally implying an ownership interest of 20% or more (Note 19);
b) members of the management, the management board and the supervisory board;
c) close relatives of the persons mentioned above;
d) entities under the control of the members of the management board and the supervisory board;
e) subsidiaries (Note 30);
f) joint ventures (Note 9).

AS Baltika has purchased (sewing services, goods for resale, non-current assets) and sold its goods and rendered services (management services, other services) to the following related parties:

	2005		2004	
	Purchases	**Sales**	**Purchases**	**Sales**
Purchases and sales of goods				
Joint venture	5	273	0	24
Companies related to the members of the Management Board and the Supervisory Board	0	0	154	0
Total purchases and sales of goods	**5**	**273**	**154**	**24**

AS Baltika 2005 Consolidated Annual Report (in thousand of euros)

	2005		2004	
	Purchases	Sales	Purchases	Sales
Purchases and sales of services				
Joint venture	1,660	449	61	72
Companies related to the members of the Management Board and the Supervisory Board	0	0	38	839
Total purchases and sales of services	**1,660**	**449**	**99**	**911**

The parent company sold intermediated goods and services to joint venture in the amount of 0.4 million euros in 2005 and 0.1 million euros in 2004.

Compensation for key managers (in total 8 members of management and supervisory boards)

	2005	2004
Salaries, remuneration of the members of the supervisory board	318	231
Termination benefits	0	37
Post-employment compensation	0	1
Total	**318**	**269**

Convertible bonds

As of 31 December 2005, the members of the Management Board had been issued and subscribed for 227,953 C and D convertible bonds, in the amount of 9 thousand euros, as of 31 December 2004 respectively 329,953 B, C and D convertible bonds, in the amount of 15 thousand euros (Note 17).

Loans to management members

	2005	2004
Balance at beginning of year	37	9
Loans granted	0	42
Repayments of loans received	-18	-9
Foreign exchange gains (losses)	4	-5
Balance at end of year	**23**	**37**

In 2004, a loan was granted to the manager of Baltika's subsidiary Baltika Ukraina. The maturity date of the loan is on 31.12.2006 and no interest is computed during the term of the employment contract. A loan was repaid by the manager of Baltika's subsidiary Baltika Lietuva during 2004.

Balances with related parties

	31.12.2005	31.12.2004
Joint venture	110	160
Companies related to the members of the management board and the supervisory board	0	82
Total current receivables	**110**	**242**
Joint venture	0	46
Total current liabilities	**0**	**46**

Current receivables from joint venture include 6.2 thousand euros for prepaid services and 104.0 thousand euros for production materials.

	31.12.2005	31.12.2004
Joint venture	83	0
Total non-current receivables	**83**	**0**

A loan has been granted to the joint venture OÜ Baltika Tailor with a purpose of investing in production. The loan amount is 96 thousand euros, the loan's annual interest rate is 1%. In the balance sheet, the loan has been discounted at 4% and is carried at 83 thousand euros.

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The Company's management estimates that the prices used in related party transactions do not materially differ from the market prices.

NOTE 30 Investments in subsidiaries

Subsidiary	Location	Activity	Participation 31.12.2005	Participation 31.12.2004
OÜ Baltman	Estonia	Retail	100%	100%
Elina STC AS	Estonia	Production	50.10%	50.10%
Virulane AS	Estonia	Production	79.23%	79.23%
OÜ Baltika TP	Estonia	Real estate development	100%	-
Baltika Latvija	Latvia	Retail	75%	75%
Baltika Lietuva	Lithuania	Retail	100%	100%
Baltinia OY	Finland	Retail	100%	100%
Baltika Sweden	Sweden	Retail	100%	100%
Baltika Poland	Poland	Retail	100%	100%
Baltika Ukraina	Ukraine	Retail	99%	99%
Baltman Rus	Russia	Retail	50.10%	50.10%

Investment in subsidiary in Russia

On 20 April 2004, AS Baltika purchased from its previous wholesale partner a 50.1% interest in a new subsidiary – OOO "Baltman Rus" located in Russia, whose core activity is the retail sales of AS Baltika's products. The consideration was paid by offsetting trade receivables in the amount of 0.92 million euros, equalling the transaction price.

Baltman Rus has eight subsidiaries engaged in retail business with an ownership interest of 24%. The shareholders' agreement has been entered into between Baltman Rus and the other owner of these subsidiaries, according to which Baltman Rus controls the activities of the subsidiaries and hence the subsidiaries have been consolidated in the financial statements of Baltman Rus. The subsidiaries are Stelsing, Baltman Klassik, Moda Baltman in Moscow and Vektra, Olivia, Retail and Klassika in St. Petersburg.

The transaction was between independent parties under market conditions and it was accounted for under the purchase method. An impairment test for goodwill that arose in the transaction is performed on each balance sheet date and if necessary, an impairment loss is recognised. The carrying amounts of goodwill are 890 thousand euros as of 31 December 2004 and 903 thousand euros as of 31 December 2005.

An impairment test was performed as of 31 December 2005 to determine the recoverable value of Baltman Rus using the present value of future estimated operating cash flows (value in use) for the next five years. Management has estimated the five year period to be appropriate for that purpose, as the detailed and reliable financial budgets/forecasts of future cash flows are not available for periods longer than five years. Management is confident that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes. The growth rates used here have been derived from the past experience of the growth in respective industry and the management expectations of the respective growth rates in the projected future years in the region. The discount rate used was the interest rate of AS Baltika's overdraft rate of 4.2%, which is an appropriate discount rate for companies operating in similar industries and economic environment. The test showed that the recoverable value exceeded the carrying amount. The carrying amount of goodwill was allocated to one cash-generating unit defined as the whole of Russian market.

NOTE 31 Contingent liabilities

A tax authority has not performed a tax audit in years 2004–2005.

The tax authorities may at any time inspect the books and records of the Company within six years subsequent to the reported tax year, and may as a result of their inspection impose additional tax assessments and penalties.

The Company's management is not aware of any circumstances which may give rise to a potential material liability in any Group company in this respect.

NOTE 32 Guarantees issued

As of 31 December 2005, the Group has guaranteed the future payments of bills of credit to the banks in the amount of 9.33 thousand euros (2004: 0.07 million euros) and the lease payments of the outlets of subsidiaries in the amount of 0.68 million euros (2004: 0.51 million euros).

NOTE 33 Fair value

According to the management, there are no significant differences between the carrying values and fair values of financial assets and liabilities.

NOTE 34 Events after the balance sheet date

In February 2006, AS Baltika acquired additional 12.4% of the shares of the subsidiary AS Elina STC. The participation of AS Baltika after the transaction is 62.5%. The purchase consideration amounted to 11.37 thousand euros, which was paid in cash. The goodwill arising on the transaction was immaterial.

In March 2006, 192,000 holders of C-bonds decided to subscribe for the shares in exchange for the convertible bonds. On 14 March 2006, In accordance with the owners' request, the Management Board of AS Baltika decided to increase the share capital of AS Baltika by 122,710 euros. After the increase of the share capital, the share capital of the Company is 3,844,254 euros, consisting of 5,822,950 shares with the nominal value of 0.64 euros (10.00 Estonian kroons) per share. The share premium of the share issue was 338,312 euros. The convertible bonds give the right to dividend since the year 2006.

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SUPPLEMENTARY DISCLOSURES ON THE PARENT COMPANY OF THE GROUP

AS BALTIKA
Balance sheet

	31.12.2005	31.12.2004
ASSETS		
Current assets		
Cash and bank	1,034	174
Financial assets at fair value through profit or loss	116	39
Accounts receivable	2,229	1,440
Other receivables and prepaid expenses	5,087	6,109
Income tax prepayment	20	0
Inventories	5,007	4,250
Total current assets	**13,493**	**12,012**
Non-current assets		
Investments in subsidiaries	4,362	4,350
Investments in joint venture	64	64
Investment property	1,227	479
Other long-term assets	705	56
Property, plant and equipment	1,094	1,357
Intangible assets	1,597	1,691
Total non-current assets	**9,049**	**7,997**
TOTAL ASSETS	**22,542**	**20,009**
LIABILITIES AND EQUITY		
Current liabilities		
Borrowings	1,786	4,596
Accounts payable	2,382	2,026
Taxes payable	213	189
Accrued liabilities	359	259
Other short-term liabilities	825	46
Total current liabilities	**5,565**	**7,116**
Non-current liabilities		
Long-term borrowings	3,039	2,523
Total non-current liabilities	**3,039**	**2,523**
TOTAL LIABILITIES	**8,604**	**9,639**
EQUITY		
Share capital	3,722	3,601
Share premium	3,176	2,845
Reserves	609	1,712
Retained earnings	6,431	2,212
TOTAL EQUITY	**13,938**	**10,370**
TOTAL LIABILITIES AND EQUITY	**22,542**	**20,009**

AS Baltika 2005 Consolidated Annual Report (in thousand of euros)

AS BALTIKA
Income statement

	2005	2004
Net sales	27,144	24,479
Cost of goods sold	19,423	18,038
Gross profit	**7,721**	**6,441**
Distribution costs	-780	-1,067
Administrative and general expenses	-4,716	-3,951
Other operating income	1,136	358
Other operating expenses	-875	-174
Operating profit	**2,486**	**1,607**
Dividend income	18	0
Gains from other investments	77	211
Reversal of impairment	1,110	1,256
Interest expenses	-313	-393
Foreign exchange gain (loss)	18	-12
Other financial income (expenses)	0	50
Net profit for the financial year	**3,396**	**2,719**

AS Baltika 2005 Consolidated Annual Report (in thousand of euros)

AS BALTIKA
Cash flow statement

	2005	2004
Operating activities		
Operating profit	2,486	1,607
Depreciation	436	605
Profit from the sale of non-current assets	-4	-13
Gains on revaluations of investment property	-747	0
Other non-monetary expenses	40	376
Changes in receivables	1,891	-1,642
Changes in inventories	-757	1,141
Change in supplier payables	672	-1,511
Interest paid	-251	-300
Cash flow from operating activities	**3,766**	**263**
Investing activities		
Acquisitions of non-current assets and investment property	-69	-402
Of which under finance leases	1	4
Proceeds from the sale of non-current assets	6	244
Investment in joint ventures	0	-65
Interest received	12	2
Proceeds from the sale of subsidiary	0	250
Loans granted	-739	-42
Repayments of loans granted	19	460
Cash flow from investing activities	**-770**	**451**
Financing activities		
Repayments of loans	-2,296	-1,031
Finance lease payments	-1	-4
Dividend paid	-279	0
Share issue proceeds	400	206
Proceeds from the sale of convertible bonds	22	4
Redemption of convertible bonds	0	-4
Cash flow from financing activities	**-2,154**	**-829**
Foreign exchange gains (losses)	18	-13
Total cash flow	**860**	**-128**
Cash and cash equivalents at the beginning of the year	**174**	**302**
Cash and cash equivalents at the end of the year	**1,034**	**174**
Change in cash and cash equivalents	**860**	**-128**

AS Baltika 2005 Consolidated Annual Report (in thousand of euros)

AS BALTIKA
Statement of changes in equity

	Share capital	Share premium	Reserves	Retained earnings	Currency translation differences	Total
Balance on 31.12.2003						
As reported in 2003 Annual Report	**3,515**	**2,716**	**1,463**	**-1,055**	**267**	**6,906**
Effects of changes in accounting policies	0	0	0	548	-267	**281**
Adjusted balance on 1 January 2004	**3,515**	**2,716**	**1,463**	**-507**	**0**	**7,187**
Revaluation of investment property	0	0	249	0	0	**249**
Net income recognised directly in equity	0	0	249	0	0	**249**
Net profit for the financial year	0	0	0	1,067	0	**1,067**
Total recognised income for 2004	0	0	249	1,067	0	**1,316**
Share issue	86	129	0	0	0	**215**
Balance at 31.12.2004						
As reported in 2004 Annual Report	**3,601**	**2,845**	**1,712**	**12**	**423**	**8,593**
Effects of changes in accounting policies				2,199	-423	**1,776**
Adjusted balance on 31 December 2004	**3,601**	**2,845**	**1,712**	**2,211**	**0**	**10,369**
Book value of holdings under control or significant influence						**-4,414**
Value of holdings under control or significant influence, calculated under equity method						**2,637**
Adjusted unconsolidated equity on 31 December 2004						**8,593**
Net profit for the financial year	0	0	0	3,396	0	**3,396**
Total recognised income for 2005	0	0	0	3,396	0	**3,396**
Dividend paid	0	0	0	-279	0	**-279**
Transfers to mandatory legal reserve	0	0	53	-53	0	**0**
Share issue	121	291	0	0	0	**412**
Transfer of reserves	0	0	-1,156	1,156	0	**0**
Equity-settled share-based payments	0	40	0	0	0	**40**
Balance on 31.12.2005	**3,722**	**3,176**	**609**	**6,431**	**0**	**13,938**
Book value of holdings under control or significant influence						**-4,426**
Value of holdings under control or significant influence, calculated under equity method						**3,739**
Adjusted unconsolidated equity on 31 December 2005						**13,251**

AUDITOR'S REPORT

PRICEWATERHOUSECOOPERS

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AUDITOR'S REPORT

(Translation of the Estonian original)

To the shareholders of AS Baltika

We have audited the accompanying consolidated balance sheet of AS Baltika (the Parent Company) and its subsidiaries (the Group) as of 31 December 2005 and the related consolidated statements of income, cash flows and changes in shareholders' equity for the year then ended. These financial statements as set out on pages 16 to 62 are the responsibility of the Parent Company's Management Board. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the accompanying consolidated financial statements give a true and fair view of the financial position of the Group as of 31 December 2005 and of the results of its operations and cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the European Union.

Tiit Raimla
Authorised Auditor

Relika Mell
Authorised Auditor

20 March 2006

PROFIT ALLOCATION PROPOSAL

The Management Board of AS Baltika makes a proposal for allocating the net profit of 2005 in the amount of 4,644 thousand euros as follows:

1. transfers to mandatory legal reserve – 12 thousand euros;
2. retained earnings – 4,632 thousand euros.

The Management Board also proposes to pay out dividends to the shareholders from the profit earned until 31 December 2004 in the amount of 769 thousand euros, which amounts to 0.13 euros (2.00 Estonian kroons) per share.

SIGNATURES OF THE MANAGEMENT BOARD AND SUPERVISORY BOARD TO THE 2005 ANNUAL REPORT

The signing of AS BALTIKA 2005 Annual Report on 24 March 2006.

Meelis Milder
Chairman of the Management Board
24 March 2006

Miles Warwick Burger
Chairman of the Supervisory Board
24 March 2006

Ülle Järv
Member of the Management Board
24 March 2006

Joakim J. Helenius
Member of the Supervisory Board
24 March 2006

Maire Milder
Member of the Management Board
24 March 2006

Reet Saks
Member of the Supervisory Board
24 March 2006

Boris Loifenfeld
Member of the Management Board
24 March 2006

Claire Chabrier
Member of the Supervisory Board
24 March 2006

STRUCTURE OF BALTIKA GROUP 31.12.2005

Baltika Group

AS Baltika

- OÜ Baltman **100%**
- Baltika Latvija **75%**
- Baltika Lietuva **100%**
- Baltika Ukraina **99%**
- Baltman Rus **50.10%**
- Baltika Poland **100%**
- Elina STC AS **50.10%**
- Virulane AS **79.23%**
- OÜ Baltika TP **100%**
- Baltinia OY **100%**
- Baltika Sweden **100%**
- OÜ Baltika Tailor **50%**

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AS Baltika's annual shareholders' meeting
will be held on 3 May 2006
at Veerenni Street 24, Tallinn.

Baltika's 2006 interim financial results
will be published on:

1Q 2006 – April 25
2Q 2006 – July 25
3Q 2006 – October 24

Baltika also publishes monthly sales results in the beginning of every month.

Additional information:

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