AS Merko Ehitus

Group

Consolidated Annual Report

Beginning of financial year: 01.01.2007

End of financial year: 31.12.2007

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Main activity:	general contracting of construction
Auditor:	AS PricewaterhouseCoopers

TABLE OF CONTENTS

MANAGEMENT REPORT

General information

Merko Ehitus is a leading construction group offering complete solutions, with companies located in Estonia, Latvia and Lithuania. Merko Ehitus was set up in 1990. The Group consists of 36 subsidiaries and 7 associates and joint ventures, the largest of which are SIA Merks (100%), UAB Merko Statyba (100%), Tallinna Teede AS (100%), AS Gustaf (75%), OÜ Gustaf Tallinn (80%), AS Merko Tartu (66%), OÜ Woody (100%), OÜ Fort Ehitus (75%) and AS Tartu Maja Betoontooted (25%).

Key changes occurred at the Group in 2007:

- At 5 April 2007, AS Merko Ehitus acquired a 75% holding in OÜ Fort Ehitus (registration no. 10722444). The main activity of OÜ Fort Ehitus is piling and hydrotechnical works. The goal of the acquisition of the holding was to strengthen the competencies of the Group in the area of piling works and hydrotechnical construction.
- Due to the need to simplify the Group's structure, AS Merko Ehitus launched the liquidation of its subsidiaries AS Merko Insenerehitus, OÜ Merko Ehitustööd and OÜ Pire Projekt in 2007.

At 15 October 2007, the Prosecutors' Office launched criminal proceedings against AS Merko Ehitus and Chairman of the Company's Supervisory Board Toomas Annus, suspected of giving bribes and misuse of trust. The substance of suspicions is incomprehensible to the management of AS Merko Ehitus, as the activities of the Company and its governing bodies have always been appropriate and in compliance with the laws of the Republic of Estonia. The substance of suspicions was published in the stock exchange announcement at 22.10.2007 (http://www.baltic.omxgroup.com/market/?pg=details&instrument=EE3100003559&list=2&tab=news&news_id=218499). The effect of the suspicions on the Company's results of operations for the year 2007 is negligible. However, the Management Board considers it necessary to note that the filing of suspicions may impact the Company's competitiveness and the competitive position of the Estonian construction market as a whole.

At a joint meeting held at 14 March 2008, the Management Board and the Supervisory Board of AS Merko Ehitus adopted a resolution to restructure the Company and separate operating activities from the criminal proceedings related to the land swap. The Company's management estimates that the restructuring of the Company is the best way to ensure its sustainable development and protect the interests of shareholders and employees in the long-lasting criminal proceedings related to the land swap.

The delay in the process of criminal proceedings related to the land swap launched in 2005 and the accompanying ambiguity and speculation in the media have started to take a toll on the Company's operations and thus harming the interests of the Company and its shareholders. The Company has entered into advisory agreements with the investment bank GildBankers and the law office Tark & CO for the implementation of the process and evaluating the related legal and economic impact.

At 15 April 2008, the management of AS Merko Ehitus presented the Company's restructuring plan (http://www.baltic.omxgroup.com/market/?pg=details&instrument=EE3100003559&list=2&tab=news&news_id=222602), according to which AS Merko Ehitus will be split up/demerged so that AS Merko Ehitus, e.g. assets (other than liquid assets in the amount of EEK 300 million), liabilities and contracts as well as the business name will be separated and transferred to the new company being set up (hereinafter AS Uus Merko). As a result of the demerger, each shareholder will receive one share of AS Uus Merko for each share of AS Merko Ehitus and the shares of AS Uus Merko will be listed on the Tallinn Stock Exchange as soon as possible. The business name of AS Merko Ehitus will also be changed and the Company's shares will continue to be listed on the Tallinn Stock Exchange. The sole member of the Management Board of the new company will be Toomas Annus.

The Management Board of AS Merko Ehitus will prepare the demerger plan outlining the details of the demerger, incl. size of share capital of AS Uus Merko, members of the Management Board and Supervisory Board, distribution and exchange ratio of the shares of AS Uus Merko to be transferred to shareholders, terms of transferring shares, a list of assets and liabilities to be transferred to AS Uus Merko. In addition, the Management Board will prepare the demerger report explaining the demerger from the legal and economic point of view.

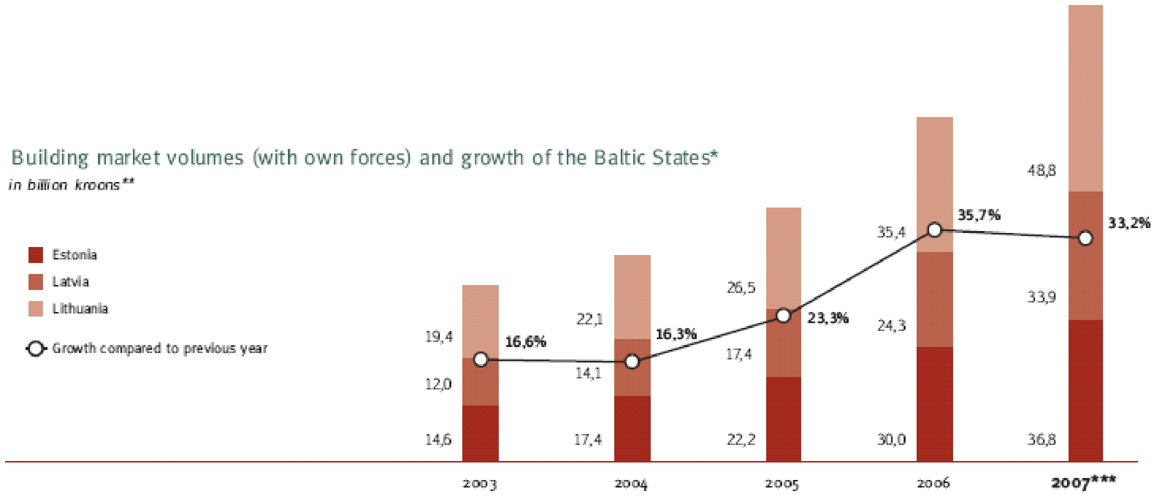
The demerger plan will be presented for approval at the General Meeting of Shareholders of AS Merko Ehitus. At least 2/3 of the voting power represented at the meeting is required to adopt the resolution.

Baltic construction market

In 2007, the Baltic construction market as a whole grew by 33.2%. In 2007, construction works with own resources were performed in the Baltic region for EEK 119.6 billion which is EEK 29.8 billion more than in 2006.

The year was characterised by the regional polarisation of markets – the fast growth of the last couple of years continued in Latvia and Lithuania, whereas the construction market stabilised in Estonia. The fastest growth occurred in Latvia, where the construction market grew by 40.2% in current prices (2006:39.7%) and reached EEK 33.9 billion. Lithuania's growth of 38.0% fell short of the respective figure of Latvia, but exceeded its own last year's growth rate of 33.4% by EEK 13.5 billion. The Estonian market was the only one not to reach the growth rate of previous years. According to the data by Estonian Statistics Board construction works with own resources were performed for EEK 36.8 billion in 2007. As compared to 2006, the Estonian construction companies performed construction works for EEK 6.7 billion or 22.4% more than last year. Despite their faster growth rates, Latvia and Lithuania could not surpass Estonia with regard to construction production per capita. Construction works per capita were performed for EUR 1751 in Estonia, EUR 953 in Latvia and EUR 922 in Lithuania.

The year 2007 was characterised by moderate growth in the residential housing market in Lithuania and stagnation in Latvia and Estonia. High prices of residential housing, lower sense of security of consumers and higher cost of financing significantly reduced the demand for residential housing. However, the provision of new dwellings increased significantly. A total of 7232 operating permits were issued in Estonia, 9319 in Latvia and 9286 in Lithuania for new dwellings, the selling periods of apartments got longer and a moderate correction of prices occurred in less liquid development projects.

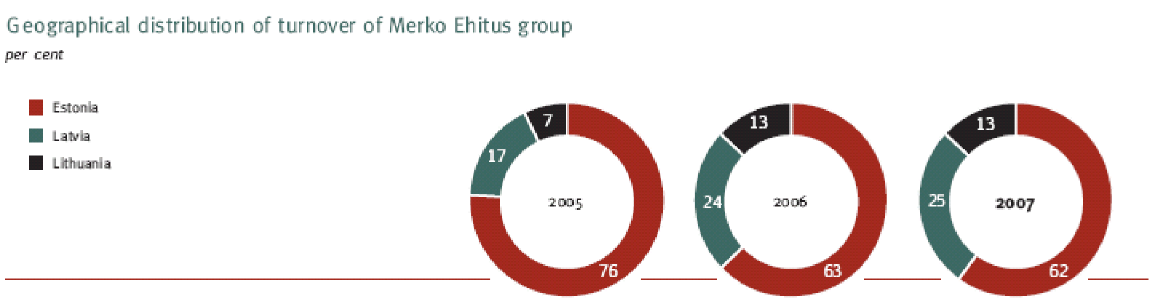


* Based on the data of local statistical offices.
** According to the unofficial central exchange rate of Eesti Pank.
*** Data of 2007 tenative, based on short-term statistics.

Similarly to the growth of construction volumes, the construction prices continued to appreciate in 2007. For the second consecutive year, the fastest growth occurred in Latvia, and Estonia and Lithuania swapped their places. As compared to 2006, construction services appreciated by 26.2% in Latvia, 13.7% in Lithuania and 12.7% in Estonia, including appreciation of labour costs by 45.5% in Latvia, 22.1% in Estonia and 20.6% in Lithuania

Operating results

The year 2007 turned out to be an extraordinary one for the Group in many respects. In 2007, the sales revenue of the Merko Ehituse Group was EEK 5510.8 billion, increasing by 24.8% in a year. In 2007, Estonia contributed 61.4%, Latvia 25.2% and Lithuania 13.4% to sales growth. As compared to 2006, sales revenue increased by 31.3% in Latvia, 30.9% in Lithuania and 21.2% in Estonia.

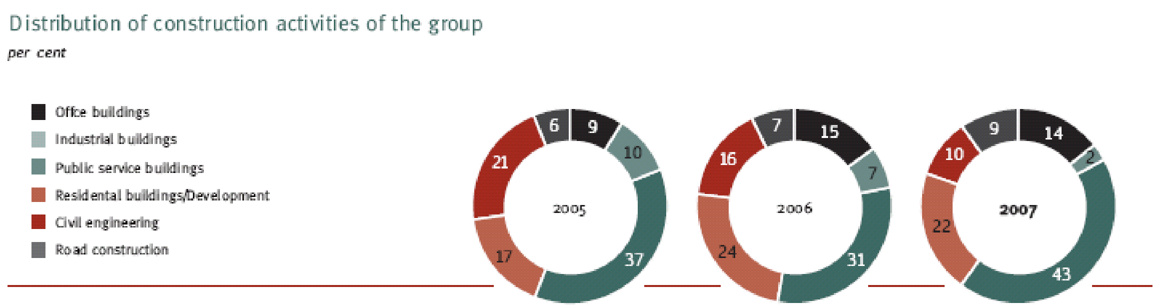


The consolidated sales revenue of the Group's largest companies:

in thousand EEK and EUR

	2007		2006	
	EEK	EUR	EEK	EUR
Estonian companies				
AS Merko Ehitus (parent company)	2 221 823	142 000	1 864 882	119 188
AS Gustaf (75% ownership)	153 123	9 786	97 049	6 203
OÜ Gustaf Tallinn (80% ownership)	146 568	9 367	124 068	7 929
AS Merko Tartu (66% ownership)	309 282	19 767	255 769	16 347
Tallinna Teede AS (100% ownership)	363 272	23 217	317 591	20 298
OÜ Woody (100% ownership)	218 642	13 974	306 354	19 580
Latvian companies				
SIA Merks (100% ownership)	1 225 816	78 344	973 636	62 227
Lithuanian companies				
UAB Merko Statyba (100% ownership)	696 010	44 483	507 309	32 423

Engineering construction contributed 10%, residential construction/development 22%, administrative buildings 43%, office buildings 14%, industrial buildings 2% and road construction 9% to the Group's revenue. Of construction activities, 83% was new structure and 17% was renovation and reconstruction works. In 2007, the Group entered into construction contracts with the total volume of EEK 4351 million and as at 31.12.2007, the Group's contract portfolio totalled EEK 4136 million.



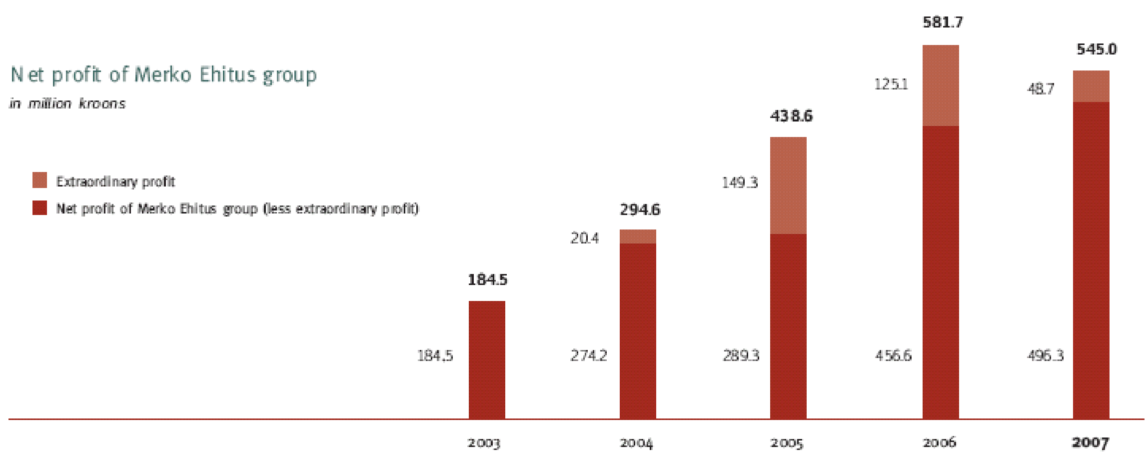
The largest completed projects in 2007

Sõpruse Ärimaja	new facility	Sõpruse pst 145, Tallinn	25 055 m^2	AS Merko Ehitus
Tallink Spa & Conference Hotel	new facility	Sadama 11a, Tallinn	33 318 m^2	AS Merko Ehitus
Nordic Hotel Forum	new facility	Narva mnt 1a/ Viru Väljak 2a, Tallinn	16 849 m^2	AS Merko Ehitus
Tornimäe multi-functional skyscraper, residential building	new facility	Tornimäe tn 3, Tallinn	14 885 m^2	AS Merko Ehitus
Extension of Smuuli Road (overpass)	new facility	Smuuli Road in the section of St. Petersburg Highway – Suur- Sõjamäe St, Tallinn	370 m	AS Merko Ehitus

Puurmanni road intersection	new facility	Tallinn-Tartu-Võru-Luhamaa Highway 147.6-149.4 km		AS Merko Ehitus
Residential and office building	new facility	Sõpruse pst 29, Tallinn	4 078 m^2	OÜ Woody
Furniture centre of Spice	new facility	Jaunmoku tn 12, Riia	28 156 m^2	SIA Merks
Production facilities of Valmiera fibre class plant	new facility	Cempu 13, Valmiera	21 485 m^2	SIA Merks
Office building	new facility	Hospitalu 55, Riia	19 450 m^2	SIA Merks
Business centre and bus station	new facility	Tilžes 109, Šiauliai	51 938 m^2	UAB Merko Statyba
Production facility of Glaskek	new facility	Tähtvere rural municipality, Tartumaa	11 405 m^2	AS Merko Tartu

In a year, the cost of goods sold of the Group increased by 26.9% and distribution and administrative expenses increased by 43.0%, representing 85.9% and 4.5%, respectively, of sales revenue. Due to fast growth of service and labour costs, the gross margin decreased from 15.6% to 14.1% in a year, and the operating margin decreased from 14.3% to 9.5% in a year.

In 2006, the Group's net profit totalled EEK 545.0 million, of which EEK 48.7 million was earned as extraordinary income from the sale of registered immovables, EEK 337.5 million from development activities, EEK 147.8 million from construction activities and EEK 11.0 million from financing activities. Profit from main operations increased from EEK 456.6 million to EEK 496.4 million or 8.7%. Similarly to a decline in gross and operating margins, the net margin also decreased, from 13.2% in the comparable period to 9.9%. The Group's net profit margin before extraordinary income was 9.0% and the profit margin from construction activities was 3.2%.



In 2007, the Group's total cash flows amounted to EEK –469.0 million, of which the cash flows from operating activities totalled EEK –488.9 million. The cash flows from operating activities of the reporting period were mostly affected by the operating profit EEK +521.0 million, a change in inventories EEK –665.4 million, a change in receivables and prepayments related to operating activities EEK –108.4 million, a change in liabilities and prepayments –127.7 million, adjustment of revenue from construction contracts EEK –130.9 million and corporate income tax paid EEK –34.6 million. The Group's cash flows from investing activities totalled EEK –73.4 million, of which EEK +150.8 million were loan repayments received and interest, EEK –145.7 million loans granted during the period, EEK –48.8 million investments into property, plant and equipment and EEK –32,9 million investments in subsidiaries and associates. The Company's cash flows from financing activities totalled EEK +93,3 million, of which the balance of credit liabilities assumed/repaid was EEK +222.3 million and dividends paid EEK –129.0 million.

The period's negative cash flow was covered through additional loans (period's net cash flows from borrowing EEK +236.5 million) and the Group's liquid assets.

The ratios and methodology of calculating the financial ratios describing the Company's main operations:

	2005	2006	2007
Net profit margin	13.6%	13.2%	9.9%
Net profit margin (excluding extraordinary profit)	9.0%	10.3%	9.0%
EBITDA margin	14.3%	14.5%	10.7%
Operating profit margin	13.5%	14.3%	9.5%
Return on equity per annum	48.2%	43.2%	30.2%
Return on assets per annum	24.9%	21.4%	15.3%
Equity ratio	49.6%	49.6%	51.5%
Current ratio	2.0	2.0	2.4
General expense ratio	4.6%	3.9%	4.5%
Personnel expense ratio	7.3%	8.0%	9.3%
Debt ratio	28.8%	27.8%	34.9%
Accounts receivable turnover (in days)	33	46	59
Accounts payable turnover (in days)	38	45	41
Sales revenue per employee (in million EEK)	4.651	5.193	5.376
Average number of full-time employees at the Group	695	850	1025

Net profit margin: Net profit / Sales revenue
EBITDA margin: Profit before tax / Sales revenue
Operating profit margin: Operating profit / Sales revenue
Return on equity per annum: Net profit / Average equity of the period*
Return on assets per annum: Net profit / Average assets of the period
Equity ratio: Owners' equity* / Total assets
Current ratio: Current assets / Current liabilities
General expense ratio: General expenses / Sales revenue
Personnel expense ratio: Personnel expenses / Sales revenue
Debt to equity ratio: Interest-bearing liabilities / Owners' equity*
Accounts receivable turnover: Trade receivables / Sales revenue x 365
Accounts payable turnover: Payables to supplies / Cost of goods sold x 365
Sales revenue per employee: Sales revenue / Average number of full-time employees

* Calculated as attributable to the equity holders of the parent company

Business risks

Market risk. One of the peculiarities of construction activities is the fact that the execution of the contracts entered into will take months, making the sector immune to changes in the economic environment. Due to this the changes having both a negative and positive effect on the demand for construction services will reach construction industry with a lag of approximately 12 months. This time lag enables the sector to arrange its activities to be prepared for potential setbacks as well as booms.

It is much more difficult to estimate the changes in the demand for residential housing development. The concurrent occurrence of several risks described in previous years – fast price appreciation, appreciation of loan interest, lack of investing interest due to stabilisation of dwelling prices led to a significant decline in the demand for new residential housing in Estonia and Latvia. The situation was further aggravated by the explosive growth of apartments available for sale. The Lithuanian market clearly stood out in the Baltic market with its demand and supply in balance and where most of the completed apartments were sold. In order to anticipate potential problems, we closely follow the changes in sales figures, the process of selling apartments is launched in the early stages of construction, preliminary contracts are entered into with the buyer at the first opportunity and a deposit is collected from them to ensure the execution of contractual obligations. The largest projects are divided into stages so that they can be frozen quickly and with few expenses. In 2007, real estate development made up 16.6% of the sales revenue of Merko Ehitus, including residential construction of 12.2%. As at 31.12.2007, 58 completed apartments with the cost price of EEK 79.4 million and 1287 unfinished apartments with the cost price of EEK 1022.5 million, of which 556 apartments had been sold to buyers under preliminary contracts, had not been sold by the Group.

Operating risk. The Group concludes complete risk insurance contracts with insurance companies in order to hedge unanticipated loss events occurring in the construction process. The general policy is entered into for one year and it compensates the customer, subcontractors and third parties for any losses caused by Merko Ehitus or its subcontractor for up to EUR 10 million. The risks of projects which cost exceeds 10 million euros or which the annual policy does not cover (water construction, railroad construction, bridges, etc.) are additionally mapped out and an insurance contract is concluded separately for each object taking into consideration its peculiarities. In concluding employment contracts for design work, an insurance contract for professional liability is required from subcontractors covering the losses arising from design, erroneous measuring, advice and instructions. The services of insurance brokers are used in mapping out risks, concluding insurance contracts and handling loss events. In 2007, indemnity applications totalling EEK 7.1 million and insurance benefits were received in the amount of EEK 4.5 million.

A warranty reserve has been set up at the Company to eliminate the construction errors which have become evident during the warranty period. In 2007, warranty provisions were set up in the total amount of EEK 13.3 million and disbursements amounted to EEK 7.4 million. As at the year-end, the Company's warranty provision amounted to EEK 15.6 million. With regard to work performed by subcontractors, the subcontractor shall eliminate the errors that became evident during the warranty period. With regard to significant contracts, the performance of contractual obligations of the contractor arising from contracts of services is guaranteed with bank guarantees.

One important part of managing operating risks is the mapping out of the situation and anticipation of risks. ISO 9001/14001 management systems have been set up at the four largest group companies and the occupational health and safety system OHSAS 18001 has been set up at the parent company. Sixteen full-time quality control specialists work at the Group whose work responsibilities include ensuring the development and functioning of quality, work safety and management systems.

Credit risk is an inevitable part of business. In managing credit risk, close attention is paid to the payment behaviour of partners, their financial position is analysed and if necessary, third parties are involved as guarantors. With regard to prepayments to suppliers, a bank guarantee by suppliers is required. In 2007, the payment discipline of customers somewhat improved, the amount of invoices exceeding 30 and more days decreased from EEK 22.4 million to EEK 10.0 million and at the same time the amount of doubtful receivables collected increased from EEK 1.6 million to EEK 2.1 million. Due to participation in several large public procurements, the accounts receivable turnover increased from 46 days to 54 days in a year. Management estimates that the liabilities as at the year-end do not contain significant credit risk. The Company's available funds are held in short-term deposits at the banks with a high credit rating (Moody's rating of A3/P-2 and higher).

Interest rate risk. As at 31.12.2007, the Group's interest-bearing liabilities totalled EEK 702.6 million, of which short-term loans and the current portion of long-term debt totalled EEK 304.9 million and long-term loans and finance lease liabilities totalled 397.7 million. The volume of interest-bearing liabilities increased by 259.5 million kroons in a year end as at the year-end, these liabilities made up 17.9% of the Company's balance sheet total. Most of the Group's loans relate to short-term development projects the duration of which does not exceed 36 months. Due to the short-term nature of loans, the effect of interest rate increases is immaterial on the final results of projects and therefore, the hedging of interest risks of these obligations is not considered reasonable.

Liquidity risk. Due to stricter control over money supply, lower turnover speed of development projects and potential negative scenarios with regard to the payment discipline, one of the major challenges in the field in the near future will be liquidity risk. As at 31.12.2007, the Group's current ratio was 2.4 (2006: 2.0) and quick ratio was 1.0 (2006: 1.1). To ensure liquidity and better management of the cash flows, the group companies have concluded overdraft contracts with banks in the total amount of EEK 90 million. In addition to overdraft credits, the Company has a working capital loan with the limit of EEK 150 million from AS Merko Grupp. Management estimates that the Group's capital structure – high equity rate of 52% of the balance sheet total and a low share of borrowings of 18% of the balance sheet total – ensures the Company's trustworthiness in the eyes of creditors also during difficult times and significantly improves the feasibility of the extension of existing financial liabilities and raising additional debt. In 2008, the Group's liquidity will be positively impacted by the expiration of several projects with unusually long accounts receivable turnover and the transfer of dwellings included in inventories to buyers.

Foreign currency risk. The Group's construction contracts are mostly concluded in a foreign currency of the country of location and open foreign currency positions in daily activities are being avoided. The most significant foreign contracts are concluded in euros. The Latvian lats (exchange rate on EUR 1 = LVL 0.702804 +/- 1%), the Lithuanian litas and the Estonian kroons are pegged to the Euro and hence the foreign currency risks of intra-group transactions have been eliminated.

Legal risks. Due to different interpretation of contracts, regulations and laws, there is a risk that some buyers, contractors or supervisory authorities consider the Company's activities to be in conflict with the laws or contracts. As at 31.12.2007, the Company had set up provisions for potential claims and legal costs in the amount of EEK 22.7 million. In 2007, legal costs in the amount of EEK 3.1 million were covered from the provisions and new reserves were set up in the amount of EEK 21.8 million.

At 15 October 2007, the Prosecutors' Office launched criminal proceedings against AS Merko Ehitus and Chairman of the Company's Supervisory Board Toomas Annus, suspected of giving bribes and misuse of trust. The suspicion filed is arbitrary and is grounded to a great extent on an impracticable interpretation of risks related to industry practices and business as well as inability to estimate the effect of time on events and real estate prices.

Management estimates that the Company has followed the prevailing laws of the Republic of Estonia and good industry practices.

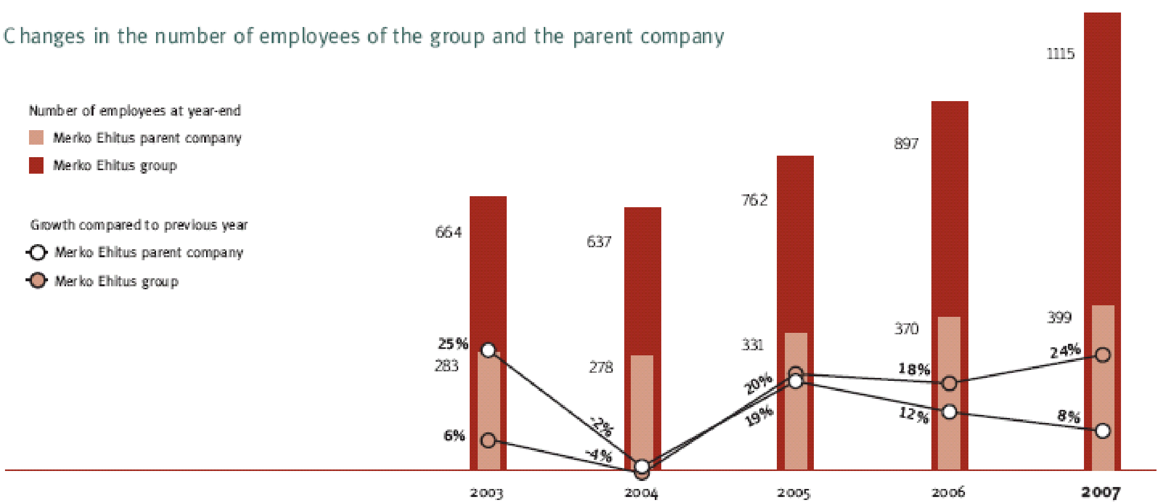
The substance of suspicions is disclosed in the Company's stock exchange announcement from 22.10.2007 (http://www.baltic.omxgroup.com/market/?pg=details&instrument=EE3100003559&list=2&tab=news&news_id=218499). The analysis of the substance of suspicions prepared by the law office of Teder, Glikman & Partnerid defending Merko Ehitus were presented to the shareholders at the Extraordinary Meeting of Shareholders at 19 February 2008 and the document is available on the website of Merko Ehitus (http://www.merko.ee/eng/investor/generalmeeting/2008).

The theoretical maximum penalty in case of criminal conviction is EEK 250 million and the Company's compulsory liquidation. Management estimates that no *de facto* basis exists for convicting the Company. However, it should be taken into account that that a prolonged investigation, a potential court case and the related agiotage will hinder the Company's competitiveness regardless of the outcome of the process.

The Company and its people

One of the main values of Merko Ehitus is its people. In a year, the number of the Group's full-time employees increased by 218 people and at 31.12.2007, the Group had 1115 full-time employees. The gross wages and salaries of the Group's full-time employees totalled EEK 406.6 million, of which basic wages and salaries made up 70.5% and bonuses made up 29.5%, or 46.3% more than in 2006. As compared to 2006, the average number of Group's employees increased by 24.3% and the average wages per employee grew by 17.7%. The number of employees of the parent company of AS Merko Ehitus was 399 at the year-end 2007, increasing by 29 people in a year. Gross wages and salaries paid to full-time employees totalled EEK 177.3 million, for the annual growth of 40.6%, including the growth of basic wages of 36.2% and that of bonuses of 48.3%.

Changes in the number of employees of the group and the parent company



The Management Board of AS Merko Ehitus has five members. The members of the Management Board are all full-time employees of AS Merko Ehitus and their gross remuneration in 2007 totalled EEK 14.8 million, incl. basic remuneration of EEK 3.2 million and bonuses of EEK 11.6 million. The Supervisory Board of AS Merko Ehitus has three members and their gross remuneration in 2007 totalled EEK 7.0 million, incl. basic remuneration of EEK 1.8 million and bonuses of EEK 5.2 million. All members of the Supervisory and Management Boards currently work on the basis of service contracts. Upon the premature removal of a member of the Supervisory and Management Boards or non-extension of their service contracts, members are paid severance pay which equals their last 12 months' remuneration.

In 2007, the Group sponsored sports, culture and education with EEK 9.4 million. The Group's largest sponsorship project was the initiative launched in collaboration with Hansabank, Eesti Energia and the Ministry of Culture of the Republic of Estonia as well as the Estonian Ski Association called the Estonian hiking tracks.
In sports, we sponsored the youth cross-country skiing team Merko Team in Estonia and the ice-hockey club Riga 2000 in Latvia. In culture, we supported the awarding of music prizes of the Estonian Music Council, the Latvian choral song festival, arrangement of the exhibition *Landscapes of Joan Miro* at the KUMU museum of fine arts and we concluded a three-year sponsorship agreement with the Estonian Drama Theatre. In 2007, we signed two important collaboration agreements in the administration field – a contract was signed with Tallinn University of Technology for long-term collaboration in the fields of development, research and studies and with the Development Fund of Tallinn University of Technology for granting the scholarship bearing the name of professor Heinrich Laul for young lecturers/scientists with a Doctor's degree in construction science. We continued to sponsor the granting of master's degree scholarships at Tallinn University of Technology and paid Merko Scholarship to 14 students.

Shares and shareholders

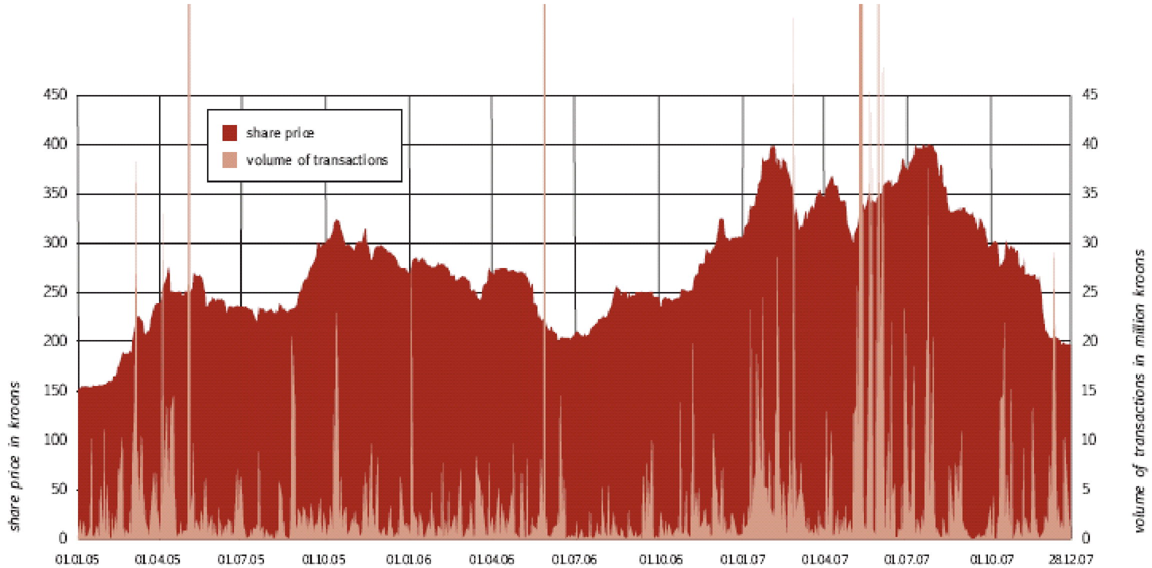
Information on securities

Name of security	Shares of Merko Ehitus
ISIN	EE3100003559
Type of security	Freely transferable ordinary shares
Issuer	AS Merko Ehitus
Activity of issuer	Construction
Residency of issuer	Estonia
Nominal value	10.00
Currency	EEK
Number of securities	17 700 000
Number of votes per share	1 vote
Registration at ECSD	09.05.1997
Stock Exchange List	Main List

	31.12.2005	31.12.2006	31.12.2007
Basic earnings per share (EPS), EEK	24.78	32.87	30.79
Owners' equity per share, EEK	62.23	90.05	113.88
P/B (price to book ratio)	4.34	3.41	1.79
P/E (price / earnings ratio)	10.89	9.35	6.61

In 2007, 4899 transactions with the shares of Merko Ehitus were performed in the course of which 5.5 million shares were traded and the total monetary value of transactions was EEK 1830.7 million. The lowest share price was EEK 191.67 and the highest price was 402.12 per share. The closing price of the shares as at 28.12.2008 was 203.41.

Performance of Merko Ehitus share at Tallinn Stock Exchange



The share prices preceding the bonus share issue have been adjusted to the number of shares which resulted from the bonus share issue carried out in 2005.

Trading history of securities	2005	2006	2007
Highest	327.01	326.23	402.12
Lowest	150.21	197.46	191.67
Closing	269.90	307.46	203.41
Change, %	+77.47	+13.92	-33.84
Traded shares	2 847 923	3 434 847	5 532 018
Turnover, million EEK	1 052.38	832.59	1 830.68
Market value, in million EEK, as at the year-end	4 777.23	5 442.04	3 600.35

Structure of shareholders as at 31.12.2007

Number of shares	Number of shareholders	% of shareholders	Number of shares	% of shares
1-100	294	40.83%	14 908	0.09%
101-1000	309	42.92%	120 371	0.68%
1001-10 000	79	10.97%	246 741	1.39%
10 001 – 100 000	25	3.47%	776 407	4.39%
100 001 – 1 000 000	11	1.53%	2 784 637	15.73%
1 000 001 - ...	2	0.28%	13 756 936	77.72%
Total	720	100%	17 700 000	100%

The main shareholders of AS Merko Ehitus as at 31.12.2007

	Number of shares	Proportion
AS Merko Grupp	12 742 686	71,99%
Skandinaviska Enskilda Banken Ab, clients	1 014 250	5,73%
ING Luxembourg S.A., clients	909 500	5,14%
J.P. Morgan Bank Luxembourg S.A., clients	387 900	2,19%

State Str. Munich Care of SSB Boston/DWS Invest. S.A. for DWS Osteuropa	215 904	1,22%
Danske Bank, clients	191 709	1,08%
The Bank of New York/ING Bank Slaksi A/C ING Parasol	189 683	1,07%
Mellon Treaty Omnibus	179 678	1,02%

Outlook for 2008

Construction market and its developments

The overall global negative background to the real estate and financial sector, current account deficit in the Baltic States, extremely fast economic growth and accompanying inflation have led to negative assessment of future economic growth in the Baltic States. Appreciation of interest, stricter control over money supply and negative expectations have undermined the sense of security of consumers and investment activities of investors due to which the domestic consumption which has been the driving force behind the economic growth in the Baltic States is expected to decrease. Most of the changes described above will have a direct impact on the real estate and construction sector in 2008.

We believe that the appreciation of construction prices will slow down in 2008 and as supply exceeds demand, prices will stabilise. However, with regard to certain materials and construction stages, moderate price declines can be expected in 2008. Under the circumstances of intensifying competition, efficiency and quality will become more important, as a result of which the providers of unprofessional services will be impacted the most.

In 2008, a number of structural changes are expected to take place in the construction sector. The share of infrastructure and environmental projects funded from the Structural Funds of the European Union and by the public sector will increase in construction. At the same time, it can be expected that the general slowdown of consumption will lower the revenue base of the public sector, weaken the budgets of central and local governments and clearly hinder their investment capacities. In 2007/2008, the developers will be engaged in launching completed rental projects and sale of residential housing and therefore, their interest in new projects will be low. Serious interest in new projects may arise in the second half of 2009, when the market will have absorbed the existing supply and reached a balance between supply and demand. Until then, the biggest challenge facing the sector will be coping with scarcer funding opportunities and skilful management of liquidity risks related to lengthening of the sales period of apartments.

Analysis of comparative indicators in the construction sector, construction works per capita of EUR 1751 in Estonia, EUR 953 in Latvia and EUR 922 in Lithuania and growth rates for 2007 allow expecting regional segregation of growth rates: fast growth will continue in Latvia and Lithuania, activity will be lower in Estonia and volumes will stall. The growth rates attained in 2007 will be unattainable in 2008 and the market growth will remain between 0 - 15%.

The year 2008 will be challenging for real estate and construction areas. It will be important to adapt to the changing environment and cope with the risks related to theses changes. The year 2008 will not be able to repeat the success of the previous year, but it will offer new opportunities and lay a good foundation for success in the future. Merko Ehitus is ready for it.

Corporate Governance Code (CGC)

From 2006, the Corporate Governance Code (CGC) which lays down the general principles of managing companies and treating shareholders applies to the issuers of equity securities which are listed on the Tallinn Stock Exchange. The application of the CGC principles is recommended to the publicly traded companies and the companies are free to decide whether to follow the main CGC principles or not. The Corporate Governance Code is based on the principle of *follow or explain* according to which a company shall explain its standpoints and activities with regard to those CGC provisions which it does not follow.

Merko Ehitus places great value on the equal treatment of its shareholders, the transparency of the Company's management processes as well as the reliability of its activities. This report deals with those CGC principles which AS Merko Ehitus does not follow for technical, economic or other reasons.

I General Meeting of Shareholders

The Company's highest governing body is the General Meeting of Shareholders, the authorities of which are regulated by legislation and the articles of association of the Company.

The Company shall announce the time, place, and agenda of the General Meeting as well as the recommendations of the Supervisory Board with regard to the items on the agenda in a national daily newspaper, on the Company's website and through the stock exchange system. The General Meeting shall be held at the place shown in the notice, on a working day and between 9 a.m. and 6 p.m. enabling most of the shareholders to participate in the General Meeting of Shareholders. Any shareholder or his authorised representative may participate in the General Meeting. No picture taking or filming is allowed at the General Meeting, because it may disturb the privacy of shareholders. Participation in the General Meeting cannot be accomplished through the means of communication because there are no reliably ways to identify shareholders and to ensure the privacy of participating shareholders.

On behalf of the Company, the Chairman of the Management Board and the Chairman of the Supervisory Board shall participate in the General Meeting of AS Merko Ehitus, and if necessary, other members of the Management and Supervisory Boards shall be involved. The Company does not consider the participation of all members of the Management and Supervisory Boards in the General Meeting relevant.

II Management Board

The Management Board of AS Merko Ehitus represents the Company and manages its daily operations. The Management Board of AS Merko Ehitus has five members and the activities of the members are divided by areas of operation: general management – Tõnu Toomik, construction – Andres Agukas, development – Tõnu Korts, technology – Veljo Viitmann, finance – Alar Lagus. The Chairman of the Management Board, Tõnu Toomik, leads the work of the Management Board.

The members of the Management Board have entered into three-year service contracts with the Company. The Company discloses the total amount of remuneration and bonuses of the members of the Management Board in the annual report, as it believes that the disclosure of personalised remuneration does not create additional value and disturbs the privacy of the members of the Management Board. Upon premature termination or non-extension of the service contract and under the condition that the members of the Management Board shall not compete with the Company, severance pay shall be paid to the members of the Management Board equalling twelve-month basic remuneration of the member of the Management Board.

In paying bonuses to the members of the Management Board, the financial performance of the companies managed by the Group and the Management Board shall be considered. Besides reviewing the quarterly results of operations, the Supervisory Board shall review and approve the bonuses payable to the Management Board. Twenty-five per cent of the bonuses payable on the basis of interim financial statements shall be withheld and paid after the approval of the annual report by the General Meeting of Shareholders. No share options have been used to motivate the members of the Management Board.

III Supervisory Board

The General Meeting of Shareholders shall elect the Supervisory Board. The Supervisory Board shall determine the Company's operating strategy, endorse the transactions as authorised by the articles of association, elect the members of the Management Board and monitor the performance of the Management Board during the time the General Meetings are not held. The Supervisory Board of AS Merko Ehitus has three members: Teet Roopalu, Jaan Mäe and Chairman of the Supervisory Board, Toomas Annus.

Merko Ehitus does not have any independent members of the Supervisory Board meeting the definition of the CGC, as the members also participate in the work of the companies controlled by the Company and in the Supervisory Boards of the Company's controlling shareholder. The members of the Supervisory Board shall be elected on the basis of their knowledge and experience in the field of construction and real estate development. The peculiarity of the work procedures of the Supervisory Board of Merko Ehitus is the fact that the members work full-time on the basis of service contracts. Such a work procedure adds responsiveness to the activities of the Group, ensures better informativeness of the Supervisory Board and altogether enables more efficient supervision over the activities of business units which are dispersed geographically and have diverse operations.

The General Meeting of Shareholders shall approve the remuneration of the members of the Supervisory Board. The terms and conditions of the service contracts in force, including the procedures for paying remuneration to the members of the Supervisory Board were approved by the General Meeting of Shareholders in May 2006.

The performance-based pay of the members of the Supervisory Board shall be determined on the basis of the financial performance of the Group. The payment of bonuses occurs on a quarterly basis after the publication of the issuer's interim financial statements. Twenty-five per cent of the bonuses payable on the basis of interim financial statements shall be paid after the approval of the annual report by the General Meeting of Shareholders. Upon the premature termination or non-extension of the service contract and under the condition that the members of the Supervisory Board shall not compete with the Company, severance pay shall be paid to the members of the Supervisory Board equalling their twelve month basic remuneration.

IV Collaboration of the Management and Supervisory Boards

To ensure that the Company's interests are met as best as possible, the Management and Supervisory Boards shall collaborate extensively. At least once a month, a meeting between the members of the Supervisory and Management Boards shall take place, at which the Management Board shall inform the Supervisory Board of significant issues regarding the Company's business operations, the fulfilment of the Company's short and long-term goals and the risks impacting them.

Corporate Governance Code (CGC)

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FINANCIAL STATEMENTS

MANAGEMENT DECLARATION

The Management Board confirms the correctness and completeness of AS Merko Ehitus consolidated financial statements as presented on pages 18-70.

The Management Board confirms that to the best of its knowledge:

- the accounting methods used for preparing the financial statements are in compliance with International Financial Reporting Standards as adopted by the European Union;
- the financial statements give a true and fair view of the financial position, the results of operations and the cash flows of the Group:
- the parent company and all group companies are going concerns.

Tõnu Toomik	Chairman of the Management Board	15.04.2008
Alar Lagus	Member of the Management Board	15.04.2008
Veljo Viitmann	Member of the Management Board	15.04.2008
Andres Agukas	Member of the Management Board	15.04.2008
Tõnu Korts	Member of the Management Board	15.04.2008

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Initsiaalid/initials M. M
Kuupäev/date 30. 04. 08
PricewaterhouseCoopers, Tallinn

CONSOLIDATED INCOME STATEMENT

in thousands of		EEK		EUR	
	Note	**2007**	**2006**	**2007**	**2006**
Revenue	2,3	5 510 760	4 414 361	352 202	282 129
Cost of goods sold	4	(4 731 752)	(3 727 561)	(302 415)	(238 234)
Gross profit		779 008	686 800	49 787	43 895
Marketing expenses	5	(32 472)	(23 390)	(2 075)	(1 495)
Administrative and general expenses	6	(213 806)	(148 792)	(13 665)	(9 501)
Other operating income	7	6 424	148 205	411	9 463
Other operating expenses	8	(18 109)	(29 952)	(1 157)	(1 914)
Operating profit		521 045	632 871	33 301	40 448
Financial income	9	11 016	8 303	704	530
Financial expenses	10	(17 762)	(20 353)	(1 135)	(1 301)
Profit from sale of subsidiaries		-	2 326	-	149
Profit from associates and joint ventures	19	76 440	17 461	4 885	1 116
Profit before tax		590 739	640 608	37 755	40 942
Corporate income tax expense	11	(30 830)	(49 917)	(1 970)	(3 190)
Net profit for financial year		559 909	590 691	35 785	37 752
incl. net profit attributable to					
equity holders of the parent company		545 049	581 738	34 835	37 180
minority interest		14 860	8 953	950	572
Earnings per share for profit attributable to equity holders of the parent company (basic and diluted, in kroons/ euros)	12	30.79	32.87	1.97	2.10

The notes set out on pages 24-70 are an integral part of these consolidated financial statements.

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CONSOLIDATED BALANCE SHEET

in thousands of		EEK		EUR	
	Note	**31.12.2007**	**31.12.2006**	**31.12.2007**	**31.12.2006**
ASSETS					
Current assets					
Cash and cash equivalents	14	205 564	676 143	13 138	43 213
Trade and other receivables	15	1 199 566	854 103	76 666	54 587
Prepaid corporate income tax		2 376	6 428	152	411
Inventories	17	2 025 426	1 356 734	129 448	86 712
Assets held for sale		-	733	-	47
		3 432 932	2 894 141	219 404	184 970
Non-current assets					
Investments in associates and joint ventures	19	272 964	200 798	17 446	12 833
Other long-term loans and receivables	20	14 492	8 476	926	542
Deferred income tax assets	21	3 396	6 592	217	421
Investment property	22	7 361	3 900	470	249
Property, plant and equipment	23	172 912	90 445	11 051	5 781
Intangible assets	24	12 574	10 177	804	650
		483 699	320 388	30 914	20 476
TOTAL ASSETS		3 916 631	3 214 529	250 318	205 446
LIABILITIES					
Current liabilities					
Borrowings	26	304 879	283 792	19 485	18 138
Trade and other payables	27	1 015 492	1 081 396	64 902	69 114
Corporate income tax liability		16 718	18 868	1 068	1 206
Government grants	28	1 498	1 498	96	96
Short-term provisions	29	73 212	33 517	4 680	2 142
		1 411 799	1 419 071	90 231	90 696
Non-current liabilities					
Long-term borrowings	26	397 713	159 335	25 418	10 183
Other long-term trade payables	30	57 423	23 277	3 670	1 488
		455 136	182 612	29 088	11 671
TOTAL LIABILITIES		1 866 935	1 601 683	119 319	102 367
EQUITY					
Minority interest		33 939	18 904	2 169	1 208
Equity attributable to equity holders of the parent company					
Share capital	32	177 000	177 000	11 312	11 312
Statutory reserve capital		17 700	17 700	1 131	1 131
Currency translation differences		(5 085)	(5 751)	(325)	(368)
Retained earnings		1 826 142	1 404 993	116 712	89 796
		2 015 757	1 593 942	128 830	101 871
TOTAL EQUITY		2 049 696	1 612 846	130 999	103 079
TOTAL LIABILITIES AND EQUITY		3 916 631	3 214 529	250 318	205 446

The notes set out on pages 24-70 are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

in thousands of ***EEK***	Note	Equity attributable to equity holders of the parent company					Minority interest	Total
		Share capital	Statutory reserve capital	Currency translation differences	Retained earnings	Total		
Balance as at 31.12.2005		177 000	8 850	(5 059)	920 605	1 101 396	10 552	1 111 948
Currency translation differences		-	-	(692)	-	(692)	-	(692)
Net profit for financial year		-	-	-	581 738	581 738	8 953	590 691
Total recognised income for 2006		-	-	(692)	581 738	581 046	8 953	589 999
Minority interest sold		-	-	-	-	-	2 799	2 799
Dividends	13	-	-	-	(88 500)	(88 500)	(3 400)	(91 900)
Transfer to statutory reserve capital		-	8 850	-	(8 850)	-	-	-
Balance as at 31.12.2006		177 000	17 700	(5 751)	1 404 993	1 593 942	18 904	1 612 846
Currency translation differences		-	-	666	-	666	-	666
Net profit for financial year		-	-	-	545 049	545 049	14 860	559 909
Total recognised income for 2007		-	-	666	545 049	545 715	14 860	560 575
Minority interest of acquired subsidiary		-	-	-	-	-	5 240	5 240
Dividends	13	-	-	-	(123 900)	(123 900)	(5 065)	(128 965)
Balance as at 31.12.2007		177 000	17 700	(5 085)	1 826 142	2 015 757	33 939	2 049 696

*in thousands of **EUR***	**Equity attributable to equity holders of the parent company**					**Minority interest**	**Total**
	Share capital	**Statutory reserve capital**	**Currency translation differences**	**Retained earnings**	**Total**		
Balance as at 31.12.2005	11 312	566	(323)	58 837	70 392	674	71 066
Currency translation differences	-	-	(45)	-	(45)	-	(45)
Net profit for financial year	-	-	-	37 180	37 180	572	37 752
Total recognised income for 2006	-	-	(45)	37 180	37 135	572	37 707
Minority interest sold	-	-	-	-	-	179	179
Dividends	-	-	-	(5 656)	(5 656)	(217)	(5 873)
Transfer to statutory reserve capital	-	565	-	(565)	-	-	-
Balance as at 31.12.2006	11 312	1 131	(368)	89 796	101 871	1 208	103 079
Currency translation differences	-	-	43	-	43	-	43
Net profit for financial year	-	-	-	34 835	34 835	950	35 785
Total recognised income for 2007	-	-	43	34 835	34 878	950	35 828
Minority interest of acquired subsidiary	-	-	-	-	-	335	335
Dividends	-	-	-	(7 919)	(7 919)	(324)	(8 243)
Balance as at 31.12.2007	11 312	1 131	(325)	116 712	128 830	2 169	130 999

The notes set out on pages 24-70 are an integral part of these consolidated financial statements.

CONSOLIDATED CASH FLOW STATEMENT

in thousands of		EEK		EUR	
	Note	**2007**	**2006**	**2007**	**2006**
Cash flows from operating activities					
Operating profit		521 045	632 871	33 301	40 448
Adjustments:					
depreciation and impairment charge	2,22-24	28 670	30 747	1 832	1 965
profit/loss from sale of non-current assets	7,23	(275)	(122 403)	(18)	(7 823)
adjustment of revenue from construction contracts under stage of completion method		(130 927)	38 109	(8 368)	2 436
interest income from business activities		(2 844)	(2 335)	(182)	(149)
change in government grants and other provisions		49 456	5 455	3 161	349
profit on acquisition of subsidiary	18	(720)	-	(46)	-
Change in trade and other receivables related to operating activities		(108 379)	(189 193)	(6 927)	(12 092)
Change in inventories		(665 436)	(363 595)	(42 529)	(23 238)
Change in trade and other payables related to operating activities		(127 742)	186 197	(8 164)	11 900
Interest paid		(17 144)	(16 168)	(1 096)	(1 033)
Other financial income		(11)	(7)	(1)	(1)
Corporate income tax paid		(34 597)	(43 991)	(2 211)	(2 812)
		(488 904)	155 687	(31 248)	9 950
Cash flows from investing activities					
Investment into subsidiaries	18	(29 575)	(3 029)	(1 890)	(195)
Proceeds from sale of subsidiaries	18	500	(2)	32	0
Subsidiary liquidation proceeds to minority shareholders		-	(20)	-	(1)
Investments into associates and joint ventures	19	(3 352)	(7 866)	(214)	(503)
Proceeds from sale of associates and joint ventures		-	1 847	-	118
Proceeds from sale of other financial assets		-	3 004	-	192
Purchase of property, plant and equipment		(48 757)	(76 264)	(3 116)	(4 874)
Proceeds from sale of property, plant and equipment		2 718	290 753	174	18 583
Purchase of intangible assets		(4 413)	(6 739)	(282)	(431)
Sale of a business unit		-	9 717	-	621
Loans granted	16	(145 692)	(275 353)	(9 311)	(17 598)
Loan repayments received	16	134 599	286 953	8 602	18 340
Interest received		16 226	8 393	1 037	536
Dividends received		4 380	3 000	280	192
		(73 366)	234 394	(4 688)	14 980
Cash flows from financing activities					
Proceeds from borrowings	26	582 283	268 726	37 215	17 175
Repayments of borrowings	26	(345 739)	(144 017)	(22 097)	(9 204)
Finance lease principal payments	26	(14 260)	(11 163)	(911)	(714)
Dividends paid		(128 965)	(91 900)	(8 242)	(5 873)
		93 319	21 646	5 965	1 384
Net increase/decrease in cash and cash equivalents		(468 951)	411 727	(29 971)	26 314
Cash and cash equivalents at beginning of the period	14	676 143	268 446	43 213	17 157
Exchange losses on cash and cash equivalents		(1 628)	(4 030)	(104)	(258)
Cash and cash equivalents at end of the period	14	205 564	676 143	13 138	43 213

The notes set out on pages 24-70 are an integral part of these consolidated financial statements.

NOTES

Note 1 Summary of significant accounting policies

1.1. General information

The consolidated financial statements of AS Merko Ehitus (hereinafter the parent company) and its subsidiaries (hereinafter the Group) for the year ended 31 December 2007 were signed by the Management Board on 15 April 2008.

Pursuant to the Commercial Code of the Republic of Estonia, the annual report prepared by the Management Board and approved by the Supervisory Board and which also includes the consolidated financial statements shall be approved at the General Meeting of Shareholders. Shareholders have the right not to approve the annual report prepared and presented by the Management Board and demand preparation of a new annual report.

AS Merko Ehitus is a company registered in the Republic of Estonia (Commercial Register no: 10068022, address: Järvevana tee 9G, Tallinn) and it operates in Estonia, Latvia and Lithuania. Its main activities are construction and real estate development.

From 22 July 1997, the shares of AS Merko Ehitus are listed on the Tallinn Stock Exchange. As at 31 December 2007, the majority shareholder AS Merko Grupp owned 71.99% of the shares of the company.

1.2. Basis of preparation

The consolidated financial statements of Merko Ehitus Group have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union.

The consolidated financial statements have been prepared under the historical cost convention.

Several financial figures are based on management's estimates, including for example, assessment of profitability of construction contracts upon the application of the stage of completion method, assessment of useful lives of items of property, plant and equipment, assessment of impairment losses of receivables and inventories, recognition of provisions for warranty obligations. Management's estimates have been made to the best of its knowledge, but they may not be accurate. The effect of changes in accounting estimates is reported in the financial statements of the period in which the change occurred.

Assets and liabilities are classified as current and non-current in the balance sheet. Current assets include assets that are expected to be used within the next financial year. Current liabilities include liabilities the due date of which is within 12 months after the balance sheet date. The remaining assets and liabilities are classified as non-current.

Expenses are classified according to their function in the income statement.

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates (the functional currency): Estonian kroons, Latvian lats and Lithuanian litas. The consolidated financial statements are presented in Estonian kroons. The primary financial statements and notes are presented in thousands of kroons. Pursuant to the requirements of the Tallinn Stock Exchange, the primary financial statements are also presented in thousands of euros. As the Estonian kroon is pegged to the Euro (EUR 1=EEK 15.6466), no exchange rate differences arise in the translation of the financial statements.

1.3. New International Financial Reporting Standards, amendments and International Financial Reporting Interpretations Committee (IFRIC) interpretations

a) Standards, amendments and interpretations effective from 1 January 2007

IAS 1 (amendment) – Presentation of Financial Statements: Capital Disclosures. The standard requires additional disclosures in the financial statements regarding capital and its management. The adoption of amended IAS 1 did not have an effect on the existing evaluation and recognition principles.

IFRS 7 Financial Instruments: Disclosures. IFRS 7 requires additional disclosures in the financial statements in order to improve the quality of information related to financial instruments. It requires disclosure of qualitative and quantitative information with regard to the risks arising from financial instruments, containing specific minimum requirements for credit risk, liquidity risk and market risk (including sensitivity analysis). The standard does not have an effect on the classification and value of existing financial instruments. The Group made certain amendments to the presentation of financial information and supplementary information (including comparatives) is disclosed in these consolidated financial statements.

IFRIC 10 – *Interim Financial Reporting and Impairment*. According to this interpretation, an impairment loss recognised in an interim period in respect of goodwill or an investment in either an equity instrument or financial asset carried at cost shall not be reversed. The adoption of this standard did not have an effect on the Group's consolidated financial statements.

IFRS 4 – Insurance Contracts(effective 1 January 2007);

IFRIC 7 – Applying the restatement approach under IAS 29 Financial Reporting in Hyperinflationary Environments (effective for periods beginning on or after 1 March 2006);

IFRIC 8 – Scope of IFRS 2. This interpretation requires evaluation of whether such transactions under which the consideration received for equity instruments issued is less than the fair value of these instruments are within the scope of IFRS 2 or not.

IFRIC 9 – Reassessment of Embedded Derivatives (effective for annual periods beginning on or after 1 June 2006);

b) Standards, revisions and interpretations issued but not yet in force in 2007 and that the Group has not adopted early

By the time of preparing these financial statements, new International Financial Reporting Standards and their interpretations have been issued which are effective for the Group's annual periods beginning at or after 1 January 2008 but that the group has not adopted early. Below is an estimate of the Group's management on the potential effect of new standards and interpretation in the period of their first-time adoption:

IFRS 8 – *Operating Segments* (effective for annual periods beginning at or after 1 January 2009). IFRS 8 supersedes IAS 14 – *Segment Reporting*. The new standard specifies new requirements in respect of the disclosure of information on business segments, as well as information on products and services, geographical areas where the business is conducted and major customers. IFRS 8 requires a "managerial approach" to reporting the performance of business segments. The Group is evaluating the effect of the new standard on segment reporting in the consolidated financial statements.

IAS 23 revised – *Borrowings Costs* (effective for annual periods beginning at or after 1 January 2009). The main amendment relates to the elimination of an option to immediately expense borrowing costs attributable to assets that necessarily take a substantial period of time to get ready for their intended use or sale. Entities need to capitalise such borrowing costs within the acquisition cost of the asset. The amended standard is applied prospectively to borrowing costs attributable to specific assets that need to be capitalised from 1 January 2009. The Group estimates that the adoption of the amended standard will not have an effect on the consolidated financial statements.

IAS 1 revised – Presentation of Financial Statements (effective for annual periods beginning at or after 1 January 2009). The main amendment to IAS 1 is the replacement of the income statement with the statement of comprehensive income which also includes non-owner changes in equity, such as changes in the revaluation surplus of available-for-sale financial assets. Two statements are allowed to be presented as an alternative: a separate income statement and a statement of comprehensive income. The amended IAS requires also the disclosure of the financial position (balance sheet) for the opening balances of the comparable period when comparative information has been adjusted due to reclassifications, changes in accounting policies or correction of errors. The Group estimates that the amended IAS 1 will have an effect on the presentation of financial information but it is not relevant to the recognition and measurement principles used until now in the consolidated financial statements.

IAS 27 revised – *Consolidated and Separate Financial Statements* (is effective for annual periods beginning at or after 1 July 2009). The standard requires that the effects of transactions with minority shareholders be recognised directly in equity, on the condition that control over the entity is retained by the parent company. In addition, the standard elaborates on the accounting treatment of the loss of control over a subsidiary, i.e. it requires that the remaining shares be restated to fair value, with the resulting differences recognised in the income statement. The Group is evaluating the effect of the amended standard on the consolidated financial statements.

IFRS 3 revised – *Business Combinations* (effective for business combinations the acquisition date of which is in the first annual period beginning at or after 1 July 2009). The amendments introduced include the choice to disclose minority interests either at fair value or their share in the fair value of the net assets identified, a restatement of shares already held in an acquired entity to fair value, with the resulting differences to be recognised in the income statement, and additional guidance on the application of the purchase method, including the recognition of transaction costs as an expense in the period in which they were incurred, measurement of goodwill in acquiring additional shares and rules of recognition when the fair value of the consideration contingent upon additional conditions changes due to a change in the estimate after the business combination. The Group is evaluating the effect of the amended standard on the consolidated financial statements.

Amendment to IFRS 2 – Share-based Payment – Vesting Conditions and Cancellations (effective for annual periods beginning at or after 1 July 2008). The amendment explains that the transfer of ownership may be conditional upon satisfying vesting conditions and performance conditions. Other conditions of share-based payments are not vesting conditions. The amendment explains that all cancellations whether by the Group or other parties shall be accounted for in a similar manner. The Group will evaluate the effect of the amended standard on the consolidated financial statements.

IFRIC 13 – Customer Loyalty Programmes (effective for annual periods beginning at or after 1 July 2008). IFRIC 13 includes guidance on the accounting treatment of transactions resulting from loyalty programmes implemented by an entity for its customers, such as loyalty cards or awarding of points. In particular, IFRIC 13 indicates the correct accounting for the entity’s obligation to provide free or discounted goods or services if and when customers redeem points. The amendment to the standard is not relevant to the Group’s operations and management estimates that it does not have a major impact on the Group's consolidated financial statements.

IAS 32 and amendment to IAS 1 amendment – *Puttable Instruments and Obligations Arising on Liquidation* (effective for annual periods beginning at or after 1 January 2009). The amendment requires the classification of some financial instruments which meet the definition of financial liabilities as equity instruments. The Group estimates that the adoption of the amended standard will not have an effect on the consolidated financial statements.

IFRIC 11 IFRS 2 – *Group and Treasury Share Transactions* (effective for annual periods beginning at or after 1 March 2007). The interpretation contains guidelines on the following issues: applying IFRS 2 *Share-based Payment* for transactions of payment with shares which are entered into by two or more related entities; and adopting an accounting approach in the following instances: an entity grants its employees rights to its equity instruments that may or must be repurchased from a third party in order to settle obligations towards the employees; or an entity or its owner grants the entity's employees rights to the entity's equity instruments, and the provider of those instruments is the owner of the entity. The Group estimates that the adoption of this interpretation will not have an effect on the consolidated financial statements because the Group does not have any transactions enabling employees to acquire equity instruments through third parties.

IFRIC 12 – *Service Concession Arrangements* (effective for annual periods beginning at or after 1 January 2008). The interpretation contains guidelines on applying the existing standards by entities being parties to service concessions between the public and the private sector. IFRIC 12 pertains to arrangements where the ordering party controls what services are provided by the operator using the infrastructure, to whom it provides the services and at what price. The Group estimates that the adoption of the interpretation will not have an effect on the consolidated financial statements.

IFRIC 14 IAS 19 – *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* (effective for annual periods beginning at or after 1 January 2008). The Interpretation contains general guidance on how to assess the limit of the surplus of fair value of a defined benefit plan over the present value of its liabilities which can be recognised as an asset, in accordance with IAS 19. In addition, IFRIC 14 explains how the statutory or contractual requirements of the minimum funding may affect the values of assets and liabilities of a defined benefit plan. The Group estimates that the adoption of the interpretation will not have an effect on the consolidated financial statements because it does not have any such assets.

1.4. Critical accounting estimates and judgments

The preparation of financial statements in conformity with International Financial Reporting Standards requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Group's accounting policies. Although these estimates are based on management's best knowledge of current events and actions, actual results ultimately may differ from those estimates. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are relevant to the consolidated financial statements of Merko Ehitus Group, are disclosed below. Changes in management's estimate are reported in the income statement of the period of the change.

The most significant management estimates are as follows:

Revenue under the stage of completion method
Revenue from construction in progress is recognised under the stage of completion method (Note 1.24), which also assumes that the stage of completion of construction contracts can be determined reliably. A precise, systematic calculation and estimation of costs, forecasting and reporting of income and expenses has been introduced to determine the stage of completion. The estimated final result to be derived from each construction project is being constantly monitored, deviations from the budget are analysed and if necessary, the profit estimate is adjusted. As at 31.12.2007, after evaluating the stage of completion of construction in progress, a provision for onerous construction contracts in the amount of 31 512 thousand kroons (Note 29) was recognised. Risk analysis showed that a change in the stage of completion of construction projects in the range of +/-10% will result in a change in the net profit between an increase of 307 419 thousand kroons and a decrease of 397 293 thousand kroons.

Determination of the useful lives of items of property, plant and equipment
Management has estimated the useful lives of items of property, plant and equipment, taking into consideration conditions and volumes of business activities, historical experience in this area and future outlook. Management estimates that the useful lives of buildings and facilities are between 10 and 33.3 years depending on their structure and use. The average useful lives of machinery and equipment are on average between 3 and 5 years and those of other fixtures between 2.5 to 5 years depending on the purpose of use of the asset.

1.5. Consolidation

Subsidiaries or entities that are either directly or indirectly through fellow subsidiaries controlled by the parent company AS Merko Ehitus, have been consolidated on a line-by-line basis in the consolidated financial statements. Control exists when the parent company owns more than one half of the voting power of the subsidiary or otherwise has power to govern the operating and financial policies of the other entity. Subsidiaries are reported in the financial statements of the Group from the date of acquiring control until the date at which control ceases.

The parent company and its subsidiaries are treated as one economic entity in the consolidated financial statements. Upon consolidation, intra-group receivables and liabilities, income and expenses as well as unrealised profits and losses arising from intra-group transactions have been eliminated unless the asset is not recoverable. Minority interest is reported separately.

Group companies use uniform accounting policies for similar transactions occurred under similar circumstances.

1.6. Business combinations

Business combinations are accounted for under the purchase method. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. From the date of acquisition, the revenue and expenses of the acquired entity are reported in the income statement of the Group and goodwill is reported in the balance sheet of the Group.

Goodwill is the excess of the cost of acquisition over the fair value of assets acquired, reflecting the portion of the acquisition cost which was paid for such assets of the acquired entity that cannot be separated and recognised separately. Goodwill is recognised at its acquisition cost as an intangible asset at the date of acquisition.

Goodwill is subsequently measured at its acquisition cost less any impairment losses. Goodwill arising in a business combination is not amortised. Instead, an impairment test is carried out once a year. Goodwill is written down to its recoverable amount if the carrying amount is not recoverable (Note 1.12).

If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised directly in the income statement.

Goodwill is subject to impairment test at least once a year or whenever an indication of impairment arises.

Transactions with minority interests
The Group applies a policy of treating transactions with minority interests as transactions with parties external to the Group. Disposals to minority interests result in gains and losses for the Group that are recorded in the income statement. Purchases from minority interests result in goodwill, being the difference between any consideration paid and the relevant share acquired of the carrying value of net assets of the subsidiary.

1.7. Associates

Associates are all entities over which the Group has significant influence but does not control their operating and financial policies. Significant influence is presumed to exist when the parent owns between 20% and 50% of the voting rights. Investments in associates are initially recognised at cost and subsequently measured using the equity method of accounting. The Group's investments in associates include goodwill identified on acquisition, net of any accumulated impairment losses.

The Group's share of its associates' post-acquisition profits or losses is recognised in the Group's income statement, and its share of post-acquisition movements in equity is recognised directly in the Group's equity items. The cumulative post-acquisition movements are adjusted against the carrying amount of the investment. When the Group's share of losses in an associate equals or exceeds its interest in the associate, the Group does not recognise further losses, unless it has incurred obligations or made payments on behalf of the associate.

Unrealised gains on transactions between the Group and its associates are eliminated to the extent of the Group's interest in the associates. Unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. The accounting policies of associates have been changed where necessary to ensure consistency with the policies adopted by the Group.

1.8. Joint ventures

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control. Joint ventures are accounted for under the equity method. A holding in a jointly controlled entity is initially recognised at acquisition cost and subsequently adjusted by the changes that have occurred in the Group's share of the net assets under common control. The income statement of the Group includes the Group's share in the profits or losses of the entity under common control.

1.9. Jointly controlled operations

Under IAS 31 *Interests in Joint Ventures*, jointly controlled operations are joint operations with third parties, whereby the assets and other resources of venturers are used without the establishment of a new company or another unit or creation of a separate financial structure. Each venturer uses its own property, plant and equipment and carries its own inventories in the balance sheet. The venturer also incurs its own expenses and liabilities and raises its own funds which represent its own obligations. In respect of its interest in jointly controlled operations, a venturer recognises in its financial statements:

- the assets that it controls and the liabilities it incurs;
- the expenses that it incurs and its share of revenue that it earns from the sale of goods or services of the joint venture.

1.10. Foreign currency

Foreign currency transactions are recorded based on the foreign currency exchange rates of the Bank of Estonia prevailing at the dates of the transactions. Monetary financial assets and liabilities denominated in foreign currencies at the balance sheet date are translated into Estonian kroons based on the foreign currency exchange rates of the Bank of Estonia prevailing at the balance sheet date. Exchange rate differences from translation are reported in the income statement of the accounting period.

The functional currency of subsidiaries located abroad is the currency of their business environment; therefore the financial statements of such subsidiaries are translated into Estonian kroons for consolidation purposes. The asset and liability items are translated using the foreign exchange rates of the Bank of Estonia prevailing at the balance sheet date, income and expenses using the weighted average foreign exchange rates for the year and other changes in equity using the foreign exchange rates at the date at which they arose. Exchange rate differences arising from translation are reported in the equity item *Currency translation differences*.

1.11. Financial assets

The purchases and sales of financial assets are recognised at the trade date.
Depending on the purpose for which financial assets were acquired, financial assets are classified into the following categories at the Group:

- financial assets at fair value through profit or loss;
- loans and receivables not held for trading purposes;
- held-to-maturity investments;
- available-for-sale financial assets.

Management determines the classification of its financial assets at initial recognition.

Financial assets at fair value through profit or loss include financial assets held for trading purposes (i.e. assets acquired or created principally for the purpose of selling or repurchasing in the short term; or a derivative financial instrument which is not a hedging instrument) and other financial assets that have been designated by management at their initial recognition as at fair value through profit or loss. Assets in this category are classified as current assets if they are principally held for trading purposes or are expected to be sold within 12 months after the balance sheet date. After initial recognition, financial assets in this category are carried at fair value.

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans and receivables are included within current assets except for maturities greater than 12 months after the balance sheet date. Such assets are classified as non-current assets. Loans and receivables are initially recognised at their fair value less transaction costs. After initial recognition, the Group carries loans and receivables at amortised cost (less any impairment losses), calculating interest income on the receivable in the following periods using the effective interest rate method.

Receivables are assessed based on the collectible amounts. Each receivable is assessed separately considering all known information on the solvency of the party to transaction. Receivables whose collection is improbable are written down during the accounting period.

Available-for-sale financial assets are non-derivatives that are either designated in this category or not classified in any of the other categories. They are included in non-current assets unless management intends to dispose of the investment within 12 months after the balance sheet date. Changes in the fair value of monetary and nonmonetary securities classified as available for sale are recognised in equity. When securities classified as available for sale are sold or impaired, the accumulated fair value adjustments recognised in equity are included in the income statement as gains and losses from investment securities. Interest on available-for-sale securities calculated using the effective interest method is recognised in the income statement as part of other income. Dividends on available-for-sale equity instruments are recognised in the income statement as part of other income when the Group's right to receive payments is established.

The Group does not have any held-to-maturity financial assets. The Group does not have any derivatives.

1.12. Impairment of assets

Financial assets at amortised cost

The Group assesses at each balance sheet date whether there is any indication that a financial asset or group of financial assets is impaired. A financial asset or group of financial assets is impaired and impairment losses are incurred only if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (loss events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. Objective evidence that a financial asset or group of assets is impaired includes observable data that is available to the Group regarding the following events:

- significant financial difficulties of the debtor;
- a breach of contract, such as a default or delinquency in payments;
- it is probable that the debtor will enter bankruptcy;
- the disappearance of an active market for that financial asset because of financial difficulties; or
- observable data indicating that there is a measurable decrease in the estimated future cash flows from a financial asset or a group of financial assets, although the decrease cannot yet be measured reliably.

If there is objective evidence that an impairment loss has incurred for loans and receivables or held-to-maturity investments carried at amortised cost, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have already been recognised), discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognised in the income statement.

If in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as improved credit rating), the previously recognised impairment loss is reversed by adjusting the allowance account. The amount of the reversal is recognised in the income statement.

Non-financial assets

Assets that have indefinite useful lives (including goodwill) are not subject to amortisation but they are tested annually for impairment, by comparing their carrying amounts with their recoverable amounts. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. In the event of such circumstances, the recoverable amount of the asset is assessed and 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 its value in use. For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating unit). Non-financial assets other than goodwill that suffered an impairment loss are reviewed for possible reversal of impairment at each reporting date and if necessary, the impairment loss is reversed.

1.13. Inventories

Inventories are recorded in the balance sheet at their acquisition cost, which consists of the purchase costs, production costs, transportation and other costs incurred in bringing the inventories to their present location and condition.

In case of separately identifiable inventory items, their cost is determined based on expenditure incurred specifically for the acquisition of each asset. If inventory items are not clearly distinguishable from each other, then the weighted average cost method is used.

Inventories are recognised in the balance sheet at the lower of acquisition cost and net realisable value. The net realisable value is the sales price less estimated costs to sell.

Expenditure incurred for real estate development is reported in the balance sheet line *Inventories* either as work-in-progress or finished goods, depending on the stage of completion. A completed real estate property is sold either in parts (by houses, apartments, office spaces, etc.) or as a whole. Sales revenue on real estate development is recognised as income from the sale of goods (Note 1.23). Upon the sale of real estate properties, a notarially certified agreement is entered into between the Group and the acquirer for transferring the property and the respective entry is made in the land register.

1.14. Investment property

Investment property is real estate property which is primarily held for the purpose of earning rental income or for capital appreciation or for both, but not for the production of goods or services, for administrative purposes or for sale in the ordinary course of business. Investment property is measured under the acquisition cost method, that is at acquisition cost less any accumulated depreciation and any accumulated impairment losses.

Buildings included in investment properties are depreciated on a straight-line basis over the period of 12.5 to 33.3 years. Land is not depreciated.

1.15. Property, plant and equipment

An item of property, plant and equipment is an asset used for production, provision of services or administrative purposes over a period longer than one year. The acquisition cost consists of the purchase price of the asset and other expenditure incurred in bringing the asset to its operating condition and location.

An item of property, plant and equipment is carried in the balance sheet at its acquisition cost less any accumulated depreciation. Subsequent expenditure incurred for items of property, plant and equipment are recognised as non-current assets when it is probable that future economic benefits associated with the asset will flow to the Group and the cost of the asset can be measured reliably. Other repairs and maintenance costs are recognised as expenses at the time they are incurred.
Depreciation is calculated on a straight-line basis over the following useful lives:

- buildings 10-33.3 years;
- machinery and equipment 3-5 years:
- other items of property, plant and equipment 2.5-5 years;
- right of superficies 50 years;
- land is not depreciated.

At each balance sheet date, the validity of applied depreciation rates, the depreciation method and the residual values applicable to assets is assessed.

Non-current assets are written down to their recoverable amount if the latter is below its carrying amount. The recoverable amount is the higher of the asset's net selling price and its value in use.

1.16. Intangible assets

Intangible assets are recognised in the balance sheet when the asset can be controlled by the company, the expected future benefits attributable to the asset will flow to the company and the cost of the asset can be measured reliably. The acquisition cost of an intangible asset consists of its purchase price and other expenditure directly related to the purchase. Intangible assets are carried in the balance sheet at acquisition cost less any accumulated amortisation and any accumulated impairment losses.

Software and information systems

The costs related to the development of information systems and software which are reported as intangible assets, are depreciated under a straight-line method over their estimated useful lives (2-10 years).

1.17. Finance and operating leases

Leases of property, plant and equipment which transfer all significant risks and rewards of ownership to the lessee are classified as finance leases. All other leases are recognised as operating leases.

Assets and liabilities leased under the finance lease terms are reported in the balance sheet at the lower of fair value of the leased asset and the present value of minimum rental payments. Items of property, plant and equipment leased under the finance lease terms are depreciated over the shorter of the lease term and the useful life.

Finance lease liabilities are reduced by principal payments; interest expenses on lease payments are included within financial expenses in the income statement.

Operating lease payments are reported in the income statement as expenses on an accrual basis over the lease term.

1.18. Financial liabilities

All financial liabilities (supplier payables, borrowings, accrued expenses, bonds issued and other short and long-term borrowings) are initially recorded at their fair value and are subsequently stated at amortised cost, using the effective interest rate method. The amortised cost of the current financial liabilities normally equals their nominal value; therefore current financial liabilities are stated in the balance sheet in their redemption value. To calculate the amortised cost of non-current financial liabilities, they are initially recognised at fair value of the proceeds received (net of transaction costs incurred) and an interest cost is calculated on the liability in subsequent periods using the effective interest rate method.

Financial liabilities are classified as current when they are due to be settled within twelve months after the balance sheet date; or the Group does not have an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date. Borrowings that are due within 12 months after the balance sheet date, but which are refinanced after the balance sheet date as non-current, are recognised as current ones. Also, borrowings are classified as current if the lender had on the balance sheet date the contractual right to demand immediate repayment of the borrowing due to the breach of conditions set forth in the agreement.

1.19. Corporate income tax

According to the Income Tax Act of the Republic of Estonia, legal entities are not subject to income tax on profits earned. Corporate income tax is paid on fringe benefits, gifts, donations, costs of entertaining guests, dividends and payments not related to business operations. Thus there are no differences between the tax bases and the carrying values of assets which would give rise to a deferred income tax asset or liability. Starting from 01.01.2008 the tax rate on dividends payable is 21/79 (in 2007: 22/78; 2006: 23/77) of the amount paid out as net dividends. The corporate income tax arising from the payment of dividends is accounted for as an expense in the period when dividends are declared.

Corporate income tax on profits and deferred income tax expense or income of the subsidiaries located in Latvia and Lithuania as well as corporate income tax on dividends of Estonian companies are reported in the consolidated income statement.

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. Deferred tax assets are recognised in the Group's balance sheet if their future realisation is probable.

Legal entities in Latvia and Lithuania that belong to the Group calculate taxable income and corporate income tax in accordance with the legislation of the Republic of Latvia and the Republic of Lithuania. The profits of entities located in the Republic of Latvia are taxed at the rate of 15%, the profits of entities located in the Republic of Lithuania are taxed at the rate of 15%+3% in 2007 and 15% in 2008 (2006: 15%+4%).

1.20. Borrowings

Borrowings are initially recognised at fair value, net of transaction costs incurred. Borrowings are subsequently stated at amortised cost, calculating interest income on the borrowing in subsequent periods using the effective interest rate method.

Borrowings are classified as current when the borrower does not have a right to pay off the loan later than 12 months after the balance sheet date.

Borrowing costs directly related to the acquisition and construction of a real estate property until the property is ready for use or sale, are capitalised. In other cases, borrowing costs are recognised as an expense in the period in which they are incurred.

1.21. Employee benefits

Termination benefits – Termination benefits are payable when employment is terminated by the Group before the normal retirement date, or whenever an employee accepts voluntary redundancy in exchange for these benefits. The Group recognises termination benefits when it is demonstrably committed to either: terminating the employment of current employees according to detailed formal plan without possibility of withdrawal; or providing termination benefits as a result of another offer made to encourage voluntary redundancy. Benefits due more than 12 months after the balance sheet date are discounted to present value.

Profit-sharing and bonus plans – The Company recognises a liability and an expense for bonuses and profit-sharing, based on formula that takes into consideration the profit attributable to the parent company's shareholders after certain adjustments. The Group recognises a provision where contractually obliged or when there is past practice that has created a constructive obligation.

1.22. Provisions

Provisions are constructive or legal obligations which arise as a result of events occurring before the balance sheet date. Setting up of provisions or increasing existing provisions is recognised as expense in the income statement of the accounting period.

Provisions are measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation which are not included already in the best esimate of the related expenses.

Pursuant to respective building acts, the construction companies of the Group provide 2-year warranties on their buildings. The calculation of warranty provisions is based on management estimates and previous periods' experience with regard to actual warranty expenses.

The expected loss arising from construction contracts is immediately recognised as an expense. A provision is recognised for onerous construction contracts which have not been completed yet (Note 1.24).

1.23. Revenue

Revenue is recognised at the fair value of the consideration received or receivable.

Revenue from construction service is recognised as revenue by reference to the stage of completion of the contract (see Note 1.24) in accordance with IAS 11 *Construction Contracts*. Revenue from own real estate development projects (private dwelling houses, apartments, office premises, etc. that have been built on the registered immovables owned by entities of Merko Ehitus Group) is recognised as revenue in accordance with IAS 18 *Revenue* when significant risks and rewards of ownership of the goods are transferred to the buyer, the receipt of payment is probable and the costs incurred in respect of the transaction can be measured reliably.

When goods are sold or swapped in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue. The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents received or paid. When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents received or paid.

Revenue from the provision of services is recognised based on the stage of completion of the service at the balance sheet date.

Revenue arising from interest and dividends is recognised when it is probable that future economic benefits associated with the transaction will flow to the entity and the amount of the revenue can be measured reliably.

1.24. Construction contracts in progress

Income and expenses of construction contracts in progress have been matched under the stage of completion method. The stage of completion is determined on the basis of the relationship between the actual costs incurred by the balance sheet date and the estimated costs of the contract. The actual costs of the contract consist of direct and certain overhead costs of the construction contact.

If invoices submitted to the customer by the balance sheet date are either higher or lower than the income calculated under the stage of completion method, then the difference is recognised as a liability or as a receivable in the balance sheet.

When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised as an expense immediately and in full.

1.25. Government grants

Government grants are recognised as income over the periods necessary to match them with the related costs, which they are intended to compensate. Government grants received to compensate the operating expenses of the previous period or where there are no additional conditions attached to grants to be addressed in the future, are accounted for as income when the grant is received. Government grants are recognised when there is reasonable assurance that the grant will be received and the Group will comply with all attached conditions.

1.26. Cash and cash equivalents

In the balance sheet and the cash flow statement, cash and cash equivalents comprise highly liquid funds with low variation in value, such as cash on hand, cash in bank accounts and term deposits with maturities of three months or less.
The indirect method has been used for the preparation of the cash flow statement.

1.27. Contingent liabilities

Contingent liabilities are those liabilities the realisation of which is less probable than non-realisation and the amount of which cannot be determined reliably. Contingent liabilities are not recognised in the balance sheet, but they are disclosed in the notes to the financial statements.

1.28. Statutory reserve capital

Reserve capital is formed to comply with the requirements of the Commercial Code. During each financial year, at least one-twentieth of the net profit shall be entered in 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.

1.29. Events after the balance sheet date

The financial statements of the reporting period include material circumstances affecting the assessment of assets and liabilities which became evident between the balance sheet date and the date of preparing the financial statements but that are related to transactions in the accounting period or previous periods. Material events after the balance sheet date not related to transactions in the accounting period or previous periods are not reported in the balance sheet but they are disclosed in the notes to the financial statements.

1.30. Dividends

The distribution of dividends to the Company's shareholders is recognised as a liability in the financial statements in the period in which the dividends are approved by the Company's shareholders.

1.31. Segment reporting

A business segment is a part of the Group engaged in making similar products or providing similar services and whose profitability and risks differ from those of other parts of the Group. The business segments at the Group comprise construction, road construction, construction of communication networks and production of concrete elements. Segment expenses are those which are incurred in the segment's main operations and which can be allocated to the segment reliably and objectively. Such expenses, assets and liabilities have not been allocated to segments that cannot be or are not suitable to be associated with a specific segment. In preparing the financial statements, business segments have been considered as primary segments.

A geographical segment is a part of the Group where operating activities occur in an economic environment in which returns and risks differ from those of other parts of the Group. The main geographical segments at the Group are Estonia, Latvia and Lithuania. In preparing the financial statements, geographical segments have been considered as secondary segments.

The main operating environment of the parent company is Estonia. All business segments of the Group are represented in Estonia. Construction is the main business segment in Latvia and Lithuania. Segment revenue is shown according to geographical segments of markets and segment assets, according to geographical locations of assets.

Note 2 Business and geographical segments

in thousands of kroons

Business segments

2007	**General construction**	**Road construction**	**Concrete elements**	**Group**
Consolidated revenue	5 004 039	506 721	-	5 510 760
Inter-segmental revenue	191	199	-	390
Segment revenue	5 004 230	506 920	-	5 511 150
Segment operating profit	487 697	33 348	-	521 045
Financial income/expenses				69 694
incl. profit/loss from associates and joint ventures (Note 19)	55 577	-	20 863	76 440
Profit before tax				590 739
Corporate income tax				(30 830)
Net profit of the Group				559 909
incl. attributable to equity owners of the parent company				545 049
minority interest				14 860
Segment assets	3 406 435	178 816	-	3 585 251
Associates and joint ventures	215 922	-	57 042	272 964
Unallocated assets				58 416
Total consolidated assets				3 916 631
Segment liabilities	(1 083 479)	(82 223)	-	(1 165 702)
Unallocated liabilities				(701 232)
Total consolidated liabilities				(1 866 934)
Purchase of property, plant and equipment and intangible assets	52 129	21 822	-	73 951
Depreciation and impairment (Notes 22-24)	(18 654)	(10 014)	-	(28 668)

2006	General construction	Road construction	Concrete elements	Group
Consolidated revenue	4 097 263	317 098	-	4 414 361
Inter-segmental revenue	377 656	104 117	-	481 773
Segment revenue	4 474 919	421 215	-	4 896 134
Segment operating profit	596 374	36 497	-	632 871
Financial income/expenses				7 733
incl. profit/loss from associates and joint ventures (Note 19)	(416)	-	17 877	17 461
Profit before tax				640 604
Corporate income tax				(49 913)
Net profit of the Group				590 691
incl. attributable to equity owners of the parent company				581 738
minority interest				8 953
Segment assets	2 772 635	187 047	-	2 959 682
Associates and joint ventures	160 619	-	40 179	200 798
Unallocated assets				54 049
Total consolidated assets				3 214 529
Segment liabilities	(1 033 996)	(63 825)	-	(1 097 821)
Unallocated liabilities				(503 862)
Total consolidated liabilities				(1 601 683)
Purchase of property, plant and equipment and intangible assets	80 654	12 510	-	93 164
Depreciation and impairment (Notes 22-24)	(22 377)	(8 370)	-	(30 747)

Costs, assets and liabilities that cannot be related to a specific asset or it is not practical to do so are considered as unallocated.

Geographical segments

Revenue	Group	
	2007	2006
Estonia	3 385 635	2 794 317
Latvia	1 386 332	1 055 632
Lithuania	738 793	564 412
Total	5 510 760	4 414 361

	Total assets		Purchase of property, plant and equipment	
	31.12.2007	31.12.2006	2007	2006
Estonia	2 022 549	1 700 964	59 117	27 018
Latvia	1 486 220	1 244 312	14 741	65 699
Lithuania	407 862	269 253	93	447
Total	3 916 631	3 214 529	73 951	93 164

Note 3 Revenue

in thousands of kroons

Revenue break-down is presented according to Estonian Classifications of Economic Activities (EMTAK 2008), information which is required under Business Code § 4 p.6.

EMTAK code		Group 2007	Group 2006
	Rendering of construction services		
4120	incl. construction of residential and non-residential buildings	3 565 675	2 551 995
4110	development of building projects	668 913	729 193
4211	construction of roads and railways	468 864	317 098
4221	construction of utility projects for fluids	392 612	308 563
4222	construction of utility projects for electricity and telecommunications	72 992	62 190
4291	construction of water projects	37 863	241 687
4213	construction of bridges and tunnels	37 857	-
4299	Construction of other civil engineering projects n.e.c.	16 993	55 956
		5 261 769	4 266 682
	Real estate activities		
6810	incl. sales of own real estate	246 828	102 407
6820	Renting and operating of own or leased real estate	2 163	45 272
		248 991	147 679
	Total revenue	5 510 760	4 414 361

Note 4 Cost of goods sold

in thousands of kroons

	Group 2007	Group 2006
Construction services	3 191 237	2 592 026
Materials	419 679	369 094
Properties purchased for resale	398 825	215 889
Staff costs	373 901	247 902
Construction mechanisms and transport	106 955	108 629
Design	92 772	72 851
Depreciation and impairment charge	20 596	25 098
Other expenses	127 787	96 072
Total cost of goods sold	4 731 752	3 727 561

Note 5 Marketing costs

in thousands of kroons

	Group 2007	Group 2006
Advertising, sponsorship	12 379	9 015
Staff costs	10 674	9 407
Construction tenders	1 754	900
Transport	1 226	1 268
Depreciation and impairment charge	434	356

Other expenses	6 005	2 444
Total marketing costs	32 472	23 390

Note 6 General and administrative expenses

in thousands of kroons

	Group	
	2007	**2006**
Staff costs	127 856	95 827
Computer equipment and impairment charge	30 977	7 080
Office expenses, communication services	15 494	16 701
Depreciation and impairment charge	7 638	5 293
Transport	8 114	6 820
Other expenses	23 727	17 071
Total general and administrative expenses	213 806	148 792

Note 7 Other operating income

in thousands of kroons

	Group	
	2007	**2006**
Interest income from operating activities	2 844	2 335
Fines and amounts for delay received	723	1 223
Profit from sale of non-current assets	488	122 403
Revenue from government grants (Note 28)	-	20 727
Other income	2 369	1 517
Total other operating income	6 424	148 205

Profit from sale of non-current assets in 2006 include the profit from the sale of multifunctional hall Arena Riga by subsidiary SIA Merks in the amount of 122 053 thousand kroons (Note 23).

Note 8 Other operating expenses

in thousands of kroons

	Group	
	2007	**2006**
Fines, penalties	13 307	1 339
Gifts, donations	3 851	4 674
Foreign exchange loss	325	10
Loss from sales of investment property	212	-
Expenses of arranging ice-hockey world championship	-	22 522
Other expenses	414	1 407
Total other operating expenses	18 109	29 952

Note 9 Financial income

in thousands of kroons

	Group 2007	Group 2006
Interest income	11 016	6 462
Gains from available-for-sale assets	-	618
Financial income from other long-term loans and receivables	-	7
Other financial income	-	1 216
Total financial income	11 016	8 303

Note 10 Financial expenses

in thousands of kroons

	Group 2007	Group 2006
Interest expenses	16 948	14 288
Foreign exchange loss	809	6 064
Other financial expenses	5	1
Total financial expenses	17 762	20 353

Note 11 Corporate income tax

in thousands of kroons

The income tax on the Group's profit before tax differs from the theoretical amount that would arise using the tax rate applicable to profits of the consolidated entities as follows:

2007	Latvia	Lithuania	Estonia	Total
Profit before tax	134 848	24 592	431 299	590 739
Tax rate applicable to profits	15%	18%	0%	
Tax calculated at domestic tax rates applicable to profits in the respective countries	(20 227)	(4 427)	-	(24 654)
Tax calculated on expenses not deductible for tax purposes	(4 594)	(680)	-	(5 274)
Tax calculated on income not subject to tax	8 672	295	-	8 967
Corporate income tax on dividends	-	-	(9 869)	(9 869)
Tax charge	(16 149)	(4 812)	(9 869)	(30 830)
incl. current tax	(15 978)	(1 787)	(9 869)	(27 634)
deferred tax charge (Note 21)	(171)	(3 025)	-	(3 196)

2006

	Latvia	Lithuania	Estonia	Total
Profit before tax	271 450	25 031	344 127	640 608
Tax rate applicable to profits	15%	19%	0%	
Tax calculated at domestic tax rates applicable to profits in the respective countries	(40 717)	(4 756)	-	(45 473)
Tax calculated on expenses not deductible for tax purposes	(49)	(91)	-	(140)
Tax calculated on income not subject to tax	1 295	17	-	1 312
Corporate income tax on dividends	-	-	(5 616)	(5 616)
Tax charge	(39 471)	(4 830)	(5 616)	(49 917)
Incl. current tax	(18 925)	-	(5 616)	(24 541)
deferred tax charged (Note 21)	(20 546)	(4 830)	-	(25 376)

As at 31.12.2007, it is possible to pay out dividends to shareholders from retained earnings in the amount of 1 438 635 thousand kroons and the corresponding income tax would amount to 382 422 thousand kroons. As at 31 December 2006 (taking into account the statutory requirement to increase the statutory reserve capital), it would have been possible to pay out 1 091 409 thousand kroons as dividends, and the corresponding income tax would have amounted to 307 833 thousand kroons.

Note 12 Earnings per share

Basic earnings per share for profit attributable to equity holders of the parent company have been derived by dividing the net profit attributable to shareholders by the weighted average number of shares.

	2007	2006
Net profit attributable to shareholders *(in thousands of kroons)*	545 049	581 738
Weighted average number of ordinary shares *(thousand pcs)*	17 700	17 700
Earnings per share *(in kroons)*	30,79	32,87

In 2006 and 2007, the Group did not have any potential ordinary shares to be issued; therefore the diluted earnings per share equal the basic earnings per share.

Note 13 Dividends per share

Dividends payable are recognised after the approval of profit allocation at the General Meeting of Shareholders. According to the profit allocation proposal, in 2008 dividends are not paid.
In 2007, 123 900 thousand kroons, i.e. 7.0 kroons per share, were paid as dividends and in 2006, 88 500 thousand kroons, i.e. 5.0 kroons per share were paid out as dividends. In both years, AS Merko Ehitus did not need to pay corporate income tax due to the dividends received from subsidiaries (and which were taxable at foreign subsidiary level in prior periods).

Note 14 Cash and cash equivalents

in thousands of kroons

	Group	
	31.12.2007	**31.12.2006**
Cash on hand	116	155
Bank accounts	53 722	437 456
Short-term deposits	151 726	238 532
Total cash and bank	205 564	676 143

As at 31.12.2007, the interest on short-term overnight bank deposits was 4.63% (31.12.2006: 3.37) and the weighted average interest on term deposits was 4.11% (2006: 3.85%). As at 31.12.2007, the average maturity of bank deposits was 6 days (31.12.2006: 25.6 days).

Note 15 Trade and other receivables

in thousands of kroons

	Group	
	31.12.2007	**31.12.2006**
Trade receivables		
accounts receivable	886 967	552 732
allowance for doubtful receivables	(2 111)	(1 370)
	884 856	551 362
Tax prepayments excluding corporate income tax		
value added tax	38 139	32 183
social security tax	12	171
other taxes	1	199
	38 152	32 553
Amounts due from customers for contract works (Note 33)	151 119	135 408
Other short-term receivables		
short-term loans (Note 16)	41 135	34 883
interest receivables	2 075	2 913
receivable from sale of subsidiary	1 000	500
other short-term receivables	2 662	1 049
	46 872	39 345
Prepayments for services		
prepayments for construction services	64 864	86 326
prepaid insurance	2 339	2 245
other prepaid expenses	11 364	6 864
	78 567	95 435
Total trade and other receivables	1 199 566	854 103

Trade receivables by due dates

	Group			
	31.12.2007		**31.12.2006**	
Not overdue	833 330	94.2%	481 231	87.3%
1-30 days overdue	41 505	4.7%	48 006	8.7%
31-60 days overdue	1 000	0.1%	4 047	0.7%
61-90 days overdue	1 180	0.1%	11 433	2.1%
91-120 days overdue	719	0.1%	1 073	0.2%
121-180 days overdue	3 846	0.4%	4 902	0.9%
More than 180 days overdue	3 276	0.4%	670	0.1%
Total trade receivables	884 856	100,0%	551 362	100,0%

Note 16 Loans granted

in thousands of kroons

	Group	
	2007	**2006**
Loans granted to joint ventures		
Loan balance at beginning of the year	24 750	21 325
Granted	6 725	10 950
Collected	(18 750)	(7 525)
Loan balance at end of the year	12 725	24 750
incl. current portion	7 000	24 750
non-current portion 1...5 years	5 725	-
Average effective interest rate 6.0% (2006: 6.5%)		
Loans granted to entities controlled by the parent company		
Loan balance at beginning or the year	12 700	6 565
Granted	110 230	264 286
Reclassification of loan after sale of majority stake in subsidiary	-	2 046
Reclassification of loan granted to related party	-	1 473
Collected	(115 774)	(261 670)
Exchange difference	22	-
Loan balance at end of the year	7 178	12 700
incl. current portion	4 236	8 896
non-current portion 1...5 years	2 942	3 804
Average effective interest rate 4.5% (2006: 4.5%)		
Loans granted to entities controlled by the parent company		
Loan balance at beginning of the year	-	1 973
Collected	-	(500)
Reclassification to loan granted to jointly controlled entities	-	(1 473)
Loan balance at end of the year	-	-

Loans granted to non-related legal entities

Loan balance at beginning of the year	1 177	20 930
Granted	28 737	117
Reclassification from other receivables	-	1 009
Collected	(15)	(16 906)
Reclassification to other receivables	-	(3 973)
Loan balance at end of the year	29 899	1 177
incl. current portion	29 899	1 177
Average effective interest rate 6.0% (2006: 4.0%)		

Loans to non-related individuals

Loan balance at beginning of the year	60	412
Collected	(60)	(352)
Loan balance at end of the year	-	60
incl. current portion	-	60
Average effective interest rate 3.7% 2006: 3.7 %		

Total loans granted

Loan balance at beginning of the year	38 687	51 205
Granted	145 692	275 353
Reclassification of loan granted to subsidiary	-	2 046
Reclassification from other receivables	-	1 009
Collected	(134 599)	(286 953)
Exchange difference	22	-
Reclassification from other receivables	-	(3 973)
Loan balance at end of the year	49 802	38 687
incl. current portion (Note 15)	41 135	34 883
Non-current portion 1…5 years (Note 20)	8 667	3 804

All loans granted are fully performing at the balance sheet date.

The management believes that the credit quality of financial assets which are neither past due nor impaired is very good. The clients of the Group are normally either large local companies or public sector entities with sufficient and known creditworthiness. The Group closely monitors the payment discipline of its customers and monitors the data publicly available on companies' credit discipline.

Note 17 Inventories

in thousands of kroons

	Group	
	31.12.2007	**31.12.2006**
Materials	3 501	4 579
Work-in-progress	1 209 117	567 868
Finished goods	72 434	18 121
Goods for resale		
Land purchased for resale	704 111	723 334
*incl. immovables located on nature preserve areas**	*61 098*	*61 098*
other goods purchased for resale	13	107
	704 124	723 441
Prepayments for inventories		
prepayments for real estate properties	35 653	34 767
prepayments for other inventories	597	7 958
	36 250	42 725

Total inventories	2 025 426	1 356 734

***** There are strict building restrictions on immovables located on nature preserve areas. These immovables can be used for real estate development only by exchanging these with the Government of the Republic of Estonia. According to the Nature Conservation Act, an immovable which is located within the territory of a protected area, special conservation area or species protection site and whose use for its intended purposes is significantly hindered by the protection procedure may be exchanged for an immovable owned by the state based on an agreement between the state and the owner of the immovable, or may be transferred to the state for a consideration equivalent to the usual value of the immovable (§ 19 and 20 of Nature Conservation Act).
The management of the Group is on the opinion that Estonian legislation at the date of signing this annual report allows to exchange those immovables for other, unrestricted immovables (with at least similar value) with the state of Estonia, and consequently the Group's management is not aware of any circumstances refer to impairment of the aforementioned immovables.

The regulation concerning exchanging immovables in the Nature Conservation Act is currently being revised by Riigikogu (the parliament). Proposed changes would create a situation where land owner can require compensation from the state for an immovable whose use for its intended purposes is significantly hindered by the protection procedure only in the form of the purchase of the registered immovable for its usual market price (i.e. the possibility of exchange is removed). If an immovable is not is located, as a whole, within the territory of a protected area, the part of the immovable located within the protected area may be purchased by the state upon agreement with the owner. If the part of the immovable located within the territory of a protected area is larger than two thirds of the total area of the immovable, or if the immovable encompasses the I protected category species protection site or limited management zone of an individual protected natural object, the whole immovable may be purchased by state based on an agreement.

The procedure and bases for evaluating the immovables are planned to be established by a regulation of the Government of the Republic. Therefore it is currently not possible to estimate the effect of amendments to the Nature Conservation Act on the valuation of relevant immovables.

No write-downs were recorded to inventories in the financial year 2007 as well as in the previous period.

Note 18 Shares in subsidiaries

in thousands of kroons

	Participation and voting rights % 31.12.2007	31.12.2006	Location	Area of operation
Subsidiaries of AS Merko Ehitus				
AS Gustaf	75	75	Pärnu	construction
AS Merko Tartu	66	66	Tartu	construction
AS Merko Insenerehitus	100	100	Tallinn	construction
OÜ Merko Ehitustööd	100	100	Tallinn	construction
Eesti Ehitusekspordi OÜ	100	100	Tallinn	construction
Tallinna Teede AS	100	100	Tallinn	road construction
SIA Merks	100	100	Republic of Latvia, Riga	construction
UAB Merko Statyba	100	100	Republic of Lithuania, Vilnius	construction
OÜ Merko Elamu	100	100	Tallinn	real estate
OÜ Põrguvälja Soojus (endise nimega Merko Maja)	100	100	Tallinn	real estate
OÜ Woody	100	100	Tallinn	real estate
OÜ Gustaf Tallinn	80	80	Tallinn	construction
OÜ Karulaugu Kinnisvara (previous name OÜ Maavõlur)	100	100	Tallinn	real estate
OÜ Rae Tehnopark	100	100	Tallinn	real estate

OÜ Maryplus	100	100	Tallinn	real estate
OÜ Metsailu	100	100	Tallinn	real estate
OÜ Pire Projekt	100	100	Tallinn	real estate
OÜ Constancia	100	100	Tallinn	real estate
OÜ Käibevara	100	100	Tallinn	real estate
OÜ Baltic Electricity Engineering	100	100	Tallinn	electricity systems
OÜ Fort Ehitus	75	-	Harjumaa, Viimsi County	construction

In April 2007, AS Merko Ehitus acquired a 75% holding in the private limited company Fort Ehitus for carrying out pole and hydrotechnical works. In August 2007, AS Merko Tartu founded Raadi Kortermaja OÜ (with the share capital of 40 thousand kroons) for real estate development. In September, Tallinna Teede AS acquired the private limited company Tevener, a one-asset-company, the asset of which is land recognised as a non-current asset, and its main activity is extraction of natural resources.
In 2007, the Company received a partial instalment payment in the amount of 500 thousand kroons for the 25% shares of the subsidiary AS Gustaf which was disposed of in 2006.

Acquisition of subsidiaries

	OÜ Fort Ehitus		**OÜ Tevener**	
	Carrying amount	Fair value	Carrying amount	Fair value
Cash and bank	385	385	40	40
Trade receivables	415	415	-	-
Non-current assets	33 003	33 003	1 387	14 960
Current liabilities	(1 177)	(1 177)	-	-
Non-current liabilities	(11 666)	(11 666)	-	-
Net assets	20 960	20 960	1 427	15 000
Acquired holding	75%		100%	
Value of net assets acquired	15 720	15 720	1 427	15 000
Cost	15 000		15 000	
Gain on acquisition	720			
Profit/loss in post-acquisition financial year	(108)			

Cash flows from acquisition of subsidiaries	**OÜ Fort Ehitus**	**OÜ Tevener**	**Total**
Cost	15 000	15 000	30 000
Paid in acquisition in 2007	(15 000)	(15 000)	(30 000)
Cash and cash equivalents in acquisition of subsidiary	385	40	425
Cash flows from acquisition of subsidiaries	(14 615)	(14 960)	(29 575)

As AS Tenever was a one-asset company holding just land, the acquisition of that company was not accounted for as a business combination. The fair value of land included within non-current assets of the subsidiary OÜ Tevener is based on the market value. Before acquisition of OÜ Tevener, there were no economic activities.

At 5 April 2007, AS Merko Ehitus acquired a 75% holding in OÜ Fort Ehitus. From the beginning of the period till acquisition date entity had a revenue in amount 3 269 thousands kroons and profit 604 thousand kroons. Total revenue contributed by acquired entity for the financial period is 21 450 thousand kroons. The gain from the acquisition of the subsidiary Oü Fort Ehitus in the amount of 720 thousand kroons is reported in the line *Other operating income.*

Note 19 Investments into associates and joint ventures

	Participation and voting rights % 31.12.2007	31.12.2006	Location	Area of operation
Associates of AS Merko Ehitus				
AS Tartu Maja Betoontooted	25	25	Tartu	concrete elements
Joint ventures of AS Merko Ehitus				
Normanni Linnagrupi AS	50	50	Tallinn	construction
OÜ Unigate	50	50	Tallinn	real estate
OÜ Tornimäe Apartments	50	50	Tallinn	real estate
Joint ventures of SIA Merks				
PS Merks Terbe Lat	50	50	Republic of Latvia, Riga	construction
SIA Zakusala Estates	50	50	Republic of Latvia, Riga	real estate
Joint venture of AS Merko Tartu				
OÜ Kortermaja	50	50	Tartu	real estate

In 2007, the final instalment payment in the amount of 3352 thousand kroons was paid for the joint venture SIA Zakusala Estates acquired in 2005.

in thousands of kroons	Investment at 31.12. 2006	Changes occurred in 2007			Investment 31.12. 2007
		profit/loss from associates and joint ventures	dividends	currency translation adjustments	
Associates of AS Merko Ehitus					
AS Tartu Maja Betoontooted	40 179	20 863	(4 000)	-	57 042
Total associates	40 179	20 863	(4 000)	-	57 042
Joint ventures AS Merko Ehitus					
Normanni Linnagrupi AS	413	(3)	-	-	410
OÜ Unigate	22	(6)	-	-	16
OÜ Tornimäe Apartments	122	56 133	-	-	56 255
Joint ventures of SIA Merks					
PS Merks Terbe Lat	406	-	(382)	1	25
SIA Zakusala Estates	157 343	(2 749)	-	107	154 701
Joint venture of AS Merko Tartu					
OÜ Kortermaja	2 313	2 202	-	-	4 515
Total joint ventures	160 619	55 577	(382)	108	215 922
Total associates and joint ventures	200 798	76 440	(4 382)	108	272 964

In thousands of kroons	**Investment at 31.12. 2005**	**Changes in 2006**				**Investment at 31.12. 2006**
		acquisition, sale and liquidation	**profit/loss from associates and joint ventures**	**dividends**	**currency translation adjustment**	
Associates of AS Merko Ehitus						
AS Tartu Maja Betoontooted	25 302	-	17 877	(3 000)	-	40 179
AS Telegrupp	3 534	(4 233)	699	-	-	-
Total associates	28 836	(4 233)	18 576	(3 000)	-	40 179
Joint ventures of AS Merko Ehitus						
Normanni Linnagrupi AS	422	-	(9)	-	-	413
OÜ Unigate	92	-	(70)	-	-	22
OÜ Tornimäe Apartments	24	-	98	-	-	122
Joint ventures of SIA Merks						
PS Merks Terbe Lat	12	-	396	-	(2)	406
SIA Zakusala Estates	148 319	11 238	(1 939)	-	(275)	157 343
Joint venture of AS Merko Tartu						
OÜ Kortermaja	1 904	-	409	-	-	2 313
Total joint ventures	150 773	11 238	(1 115)	-	(277)	160 619
Total associates and joint ventures	179 609	7 005	17 461	(3 000)	(277)	200 798

As at 31.12.2007, the difference between the carrying amount of the investment of OÜ Kortermaja and the equity of the investee totalling 2265 thousand kroons (2006: 1847 thousand kroons) is due to the effect from the unrealised gains of mutual transactions.

As at 31.12.2007, the investment into the joint venture SIA Zakusala Estates includes intangible assets in the amount of 147 263 thousand kroons (2006: 147 152 thousand kroons) which are not recognized on the balance sheet of the investee. The intangible asset represents the lease agreement with the City of Riga expiring at 2 June 2051 which gives it a right to use the 126 thousand m^2 registered immovable on Zakusala island in the centre of Riga.

Associates *in thousand kroons*	**Assets 31.12.**	**Liabilities 31.12.**	**Revenue**	**Net profit**
2007				
AS Tartu Maja Betoontooted	308 168	80 000	520 146	83 452
2006				
AS Tartu Maja Betoontooted	272 892	112 176	442 962	71 508

Joint ventures *in thousands of kroons*	**Assets 31.12.**		**Liabilities 31.12.**		**Equity 31.12.**	**Income**	**Expenses**	**Net profit/loss**
	current assets	**non-current assets**	**current liabilities**	**non-current liabilities**				
2007								
Normanni Linnagrupi AS	819	-	-	-	819	2	9	(7)
OÜ Unigate	45 996	-	43 497	2 468	31	3	15	(12)
OÜ Tornimäe Apartments	114 163	-	1 654	-	112 509	331 711	219 446	112 265
PS Merks Terbe Lat	50		-	-	50	-	-	-
SIA Zakusala Estates	4 978	24 648	7 222	7 528	14 876	-	5 498	(5 498)
OÜ Kortermaja	27 316	-	13 756	-	13 560	39 121	33 883	5 238
2006								
Normanni Linnagrupi AS	826	-	-	-	826	56	73	(17)
OÜ Unigate	25 488	-	13 260	12 184	44	-	139	(139)
OÜ Tornimäe Apartments	204 795	-	204 568	-	227	195	17	178
PS Merks Terbe Lat	811	-	9	-	802	884	73	811
SIA Zakusala Estates	11 810	8 870	299	-	20 381	187	4 063	(3 876)
OÜ Kortermaja	54 084	-	14 124	31 638	8 322	27 772	23 474	4 298

Note 20 Other long-term loans and receivables

in thousands of kroons

	Group	
	31.12.2007	**31.12.2006**
Long-term loans (Note 16)	8 667	3 804
Long-term receivable from buyer of subsidiary*	3 625	4 624
Long-term receivables from customers of construction services	2 200	48
Total other long-term loans and receivables	14 492	8 476

* In 2006, AS Merko Ehitus sold 25% of the shares of the subsidiary AS Gustaf. The receivable is discounted at a 5% interest rate.

Note 21 Deferred income tax assets and liabilities

in thousands of kroons

Income tax assets and liabilities arisen at the subsidiaries SIA Merks and UAB Merko Statyba:

31.12.2007

	Latvia	Lithuania	Total
Deferred income tax liability	-	-	-
Deferred income tax assets	2 498	898	3 396
incl. tax loss carryforwards	68	-	68
effect of carrying amount of property, plant and equipment	(613)	-	(613)
effect of stage of completion method	3 043	191	3 234
other	-	707	707
Net deferred income tax assets / liabilities	**2 498**	**898**	**3 396**
Deferred income tax charge of the financial year (Note 11)	171	3 025	3 196

31.12.2006

	Latvia	Lithuania	Total
Deferred income tax liability	-	-	-
Deferred income tax assets	2 669	3 923	6 592
incl. tax loss carryforwards	-	3 062	3 062
effect of carrying amount of property, plant and equipment	2 669	-	2 669
effect of stage of completion method	-	443	443
other	-	418	418
Net deferred income tax assets / liabilities	**2 669**	**3 923**	**6 592**
Deferred income tax charge of the financial year (Note 11)	20 546	4 830	25 376
Reclassification*	(34 600)	-	(34 600)
Net change in deferred tax balance	(14 054)	4 830	(9 224)

* The effect of difference between fair value and carrying amount of real estate inventories (in 2005, in the amount of 34 600 thousand kroons in Latvia) was reclassified from deferred tax liability to actual tax liability in 2006 due to changes in management estimates, and the amount was paid to the State Revenue Service in Latvia in 2006.

In Lithuania, unused tax losses carried forward expire in 4 years and the management considers it likely that the respective tax losses can be utilised against future profits.

Note 22 Investment property

in thousands of kroons

	Land	Buildings	Total
Cost at 31.12.2005	35 634	8 959	44 593
Accumulated depreciation at 31.12.2005	-	(2 087)	(2 087)
Carrying amount at 31.12.2005	35 634	6 872	42 506
Write-off	-	(2 331)	(2 331)
Reclassification	(33 500)	(2 432)	(35 932)
Depreciation charge	-	(343)	(343)
Carrying amount at 31.12.2006	2 134	1 766	3 900
Cost at 31.12.2006	2 134	2 589	4 723
Accumulated depreciation 31.12.2006	-	(823)	(823)
Carrying amount at 31.12.2006	2 134	1 766	3 900
Exchange difference	2	15	17
Sale	-	(212)	(212)
Reclassification	-	3 733	3 733
Depreciation charge	-	(77)	(77)
Carrying amount at 31.12.2007	2 136	5 225	7 361
Cost at 31.12.2007	2 136	5 600	7 736
Accumulated depreciation at 31.12.2007	-	(375)	(375)
Carrying amount at 31.12.2007	2 136	5 225	7 361

As at 31.12.2007, the carrying amount of the investment property does not significantly differ from their fair values (31.12.2006: the carrying amount of the investment property did not significantly differ from their fair values).

In 2007, items of property, plant and equipment were reclassified from construction in progress to investment property in the amount of 3733 thousand kroons.

In 2006, the Group reclassified land in the amount of 33 500 thousand kroons from investment property into inventories, and reclassified buildings to property, plant and equipment in the amount of 2432 thousand kroons. Write-offs in the amount of 2331 thousand kroons relate to the pulling down of useless buildings.

Investment property has not been acquired for the purpose of earning rental income but for capital appreciation or development in the future. Buildings located on the plot of land have been temporarily leased out under the operating lease terms. Rental income receivable, maintenance costs incurred and improvement expenses are immaterial.

Note 23 Property, plant and equipment

in thousands of kroons

	Land	Buildings	Right of super-ficies	Machinery and equipment	Other fixtures	Construction in progress	Prepayments	Total
Cost at 31.12.2005	145	14 872	458	88 070	42 794	260 100	1 270	407 709
Accumulated depreciation at 31.12.2005	-	(2 464)	(76)	(39 188)	(24 276)	(142 701)	-	(208 705)
Carrying amount at 31.12.2005	145	12 408	382	48 882	18 518	117 399	1 270	199 004
Foreign exchange rate changes	-	-	-	-	20	4	-	24
Acquisitions	-	8 042	-	12 893	34 151	29 841	1 510	86 437
Sales	-	(142 592)	-	(586)	(25 137)	-	-	(168 315)
Reclassification	-	143 670	-	(440)	6 740	(146 691)	(2 780)	499
incl. non-current assets held for sale	-	-	-	(733)	-	-	-	(733)
Depreciation charge	-	-	-	(3)	(165)	-	-	(168)
Impairment charge	-	(6 282)	(10)	(9 476)	(11 268)	-	-	(27 036)
Carrying amount at 31.12.2006	145	15 246	372	51 270	22 859	553	-	90 445
Cost at 31.12.2006	145	18 682	458	92 430	51 257	553	-	163 525
Accumulated depreciation at 31.12.2006	-	(3 436)	(86)	(41 160)	(28 398)	-	-	(73 080)
Carrying amount at 31.12.2006	145	15 246	372	51 270	22 859	553	-	90 445
Foreign exchange rate changes	-	-	-	-	57	-	-	57
Acquisitions	15 798	4 695	-	33 766	16 543	5 465	8 230	84 497
Acquisition in business combinations	-	1 106	-	28 757	-	-	1 278	31 141
Sales	-	-	-	(2 181)	(738)	-	-	(2 919)
Reclassification	-	-	-	1 915	1 114	(5 982)	(780)	(3 733)
Write-offs	-	-	-	(250)	(136)	-	-	(386)
Deprecation in income statement	-	(666)	(9)	(14 790)	(10 725)	-	-	(26 190)
Carrying amount at 31.12.2007	15 943	20 381	363	98 487	28 974	36	8 728	172 912
Cost at 31.12.2007	15 943	24 627	458	153 587	64 970	36	8 728	268 349
Accumulated depreciation at 31.12.2007	-	(4 246)	(95)	(55 100)	(35 996)	-	-	(95 437)
Carrying amount at 31.12.2007	15 943	20 381	363	98 487	28 974	36	8 728	172 912

In 2006, the multifunctional hall Arena Riga was sold by the subsidiary SIA Merks which is accounted for in the table above as a sale of buildings. Profit from the sale totalled 122 053 thousand kroons (Note 7).

Information on leased assets is provided in Note 25 and on lease payments in Note 26.

No Property, plant and equipment are pledged as collateral for borrowings.

Note 24 Intangible assets

in thousands of kroons

	Software	Prepayments	Total
Cost at 31.12.2005	2 371	2 847	5 218
Accumulated amortisation at 31.12.2005	(853)	-	(853)
Carrying amount at 31.12.2005	1 518	2 847	4 365
Acquisition	2 059	4 668	6 727
Sale	(46)	-	(46)
Amortisation	(869)	-	(869)
Carrying amount at 31.12.2006	2 662	7 515	10 177
Cost at 31.12.2006	4 368	7 515	11 883
Accumulated amortisation at 31.12.2006	(1 706)	-	(1 706)
Carrying amount at 31.12.2006	2 662	7 515	10 177
Cost	2 004	2 410	4 414
Reclassification	8 112	(8 112)	-
Amortisation	(2 017)		(2 017)
Carrying amount at 31.12.2007	10 761	1 813	12 574
Cost at 31.12.2007	14 443	1 813	16 256
Accumulated amortisation at 31.12.2007	(3 682)	-	(3 682)
Carrying amount at 31.12.2007	10 761	1 813	12 574

Prepayments for intangible assets relate to prospective replacement of the Group's accounting software.

Note 25 Leased assets

in thousands of kroons

	Group	
	2007	**2006**
Assets acquired under finance lease terms		
Machinery and equipment		
Cost	90 195	49 324
Accumulated depreciation	(20 871)	(12 076)
incl. depreciation charge	(8 291)	(4 606)
Carrying amount	69 324	37 248
Assets leased under non-cancellable operating lease terms		
Right of superficies		
Payments made in financial year	-	93
Future lease payments		
payments in next financial year	475	93
payments in 1...5 years	950	372
payments after year 5	9 482	3 806

On the basis of cancellable lease agreements, operating lease payments totalling 11 675 thousand kroons (2006: 8028 thousand kroons) were paid for passenger cars in 2007.

Note 26 Borrowings

in thousands of kroons

	Group	
	2007	**2006**
Finance lease payables		
Present value of lease payments at beginning of the year	25 851	25 098
Received	36 523	11 916
Paid	(14 260)	(11 163)
Present value of lease payments at end of the year	48 114	25 851
incl. current portion	11 879	8 367
non-current portion 2...4 years	36 235	17 484
Interest expense of financial year	3 272	1 316
Minimum future lease payments	51 404	27 402
incl. current portion	13 441	9 868
non-current portion 2...4 years	37 963	17 534
Average effective interest rate 5.7% (2006: 5.0%)		
Base currencies EEK, EUR and LVL		
Loans		
Loan balance at beginning of the year	417 276	292 567
Received	558 348	268 726
Paid	(345 739)	(144 017)
Exchange difference	658	-

Loan balance at end of the year	630 543	417 276
incl. current portion	273 965	275 425
non-current portion 2..5 years	356 578	141 851
Interest cost of reporting period	28 714	12 474
incl. capitalised interest cost	20 975	-
Average effective interest rate 7.0% (2006: 4.5%)		
Base currencies LVL and EUR		
Loans from entities controlled by the parent company		
Loan balance at beginning of the year	-	-
Received	19 035	-
Loan balance at the end of the year	19 035	
incl. current portion	19 035	-
Average effective interest rate 4.9%		
Loans from associates and joint ventures		
Loan balance at beginning of the year	-	-
Received	4 900	-
Loan balance at end of the year	4 900	-
incl. non-current portion 2...5 years	4 900	-
Average effective interest rate 6.0%		
Total loans		
Loan balance at beginning of year	417 276	292 567
Received	582 283	268 726
Paid	(345 739)	(144 017)
Exchange difference	658	-
Loan balance at end of year	654 478	417 276
incl. current portion	293 000	275 425
non-current portion 2...5 years	361 478	141 851
Total borrowings	702 592	443 127
incl. current portion	304 879	283 792
non-current portion 2...5 years	397 713	159 335

Long-term bank loans have floating rates related to EURIBOR or RIGIBOR (Riga Interbank Offered Rate - the index of Latvian interbank credit interest rates). The exposure of the Group's bank borrowings to interest rate changes and the contractual repricing dates at the balance sheet dates are as follows:

	2007	**2006**
6 months or less	354 423	271 458
6-12 months	276 120	145 818
Total bank loans	630 543	417 276

The fair value of borrowings does not differ materially from their carrying amount.
Loan collaterals and pledged assets are presented in Note 31

Note 27 Trade and other payables

in thousands of kroons

	Group	
	31.12.2007	**31.12.2006**
Payables to suppliers	528 856	464 199
Payables to employees	74 892	64 218
Tax liabilities, except for corporate income tax		
value added tax	26 979	19 998
personal income tax	10 720	5 884
social security tax	17 654	13 654
land tax	46	130
unemployment insurance tax	319	206
contributions to mandatory funded pension	527	307
other taxes	570	1 687
	56 815	41 866
Amounts due to customers for contract works (Note 33)	161 725	276 940
Other payables		
interest liabilities	465	-
other payables	21 503	27 290
advance payments received	171 235	206 883
	193 203	234 173
Total trade and other payables	1 015 491	1 081 396

Note 28 Government grants

in thousands of kroons

In 2006, the world championships in ice-hockey took place in the multifunctional hall Arena Riga the owner of which was a subsidiary of SIA Merks. The City of Riga supported the raising of funds for the arrangement of the world championship and the carrying out of competitions with 22 225 thousand kroons in 2005. The grant was used to arrange the world championships in ice-hockey in 2006. The cost of the ice-cleaning machine included within inventories to be given over to the City of Riga equals to the remaining balance of government grant in the amount of 1498 thousand kroons.

	Group	
	31.12.2007	**31.12.2006**
Carrying amount at beginning of the year	1 498	22 225
Utilised portion	-	(20 727)
Balance at end of the year	1 498	1 498

Note 29 Short-term provisions

in thousands of kroons	Group	
	2007	**2006**
Provision for warranty obligation for construction		
Carrying amount at beginning of the year	9 662	8 463
Accrued during the year	13 325	10 692
Utilised during the year	(7 362)	(9 493)
Balance at end of the year	15 625	9 662
Provision for onerous construction contracts		
Residual value at beginning of the year	17 848	-
Accrued during the year	20 541	17 848
Utilised during the year	(5 877)	-
Balance at end of the year	32 512	17 848
Provision for potential cancellation of construction projects		
Residual value at beginning of the year	-	6 664
Accrued during the year	-	(6 664)
Balance at end of the year	-	-
Provision for legal costs and claims filed		
Residual value at beginning of the year	4 054	6 090
Accrued during the year	21 878	1 000
Utilised during the year	(3 146)	(3 036)
Balance at end of the year	22 786	4 054
Other provisions		
Residual value at beginning of the year	1 953	524
Set up	2 480	1 953
Utilised during the year	(2 144)	(524)
Balance at end of the year	2 289	1 953
Total short-term provisions	73 212	33 517

Note 30 Other long-term trade payables

in thousands of kroons	Group	
	31.12.2007	**31.12.2006**
Payables to suppliers	11 091	10 352
Advance payments received	46 332	12 925
Total long-term trade payables	57 423	23 277

In 2007, SIA Merks received initial payment and advance payments for apartments in Skanstes Street, Riga in the amount of 33 407 thousand kroons (2006: 12 925 thousand kroons). The apartments will be completed in 2009.

Note 31 Loan collaterals and pledged assets

The following agreements have been entered into for guaranteeing loans and other obligations:

Between AS Merko Ehitus and Hansabank:
A commercial pledge agreement on movable property in the amount of 140 million kroons (registered under the first, second and fifth orders in the register of commercial pledges). The obligations arising from guarantee contracts and overdraft contracts are guaranteed by the pledge.
In addition, a deposit pledge contract in the amount of 2.5 million kroons has been entered into for guaranteeing the guarantee contract concerning stage I of construction works of Puurmanni traffic network.

Between AS Merko Ehitus and SEB Eesti Ühispank:
A commercial pledge agreement on movable property in the amount of 60 million kroons (registered under the third, fourth and sixth orders in the register of commercial pledges). The obligations arising from the guarantee contract are guaranteed by the pledge.

Between Tallinna Teede AS, Hansabank and SEB Eesti Ühispank:
A commercial pledge agreement on movable property in the amount of 25 million kroons (registered under the first order in the register of commercial pledges), whereby the 14/25 legal share of the commercial pledge belongs to Hansabank and 11/25 to SEB Eesti Ühispank.

Between Tallinna Teede AS and Hansabank:
A commercial pledge agreement on movable property in the amount of 2 million kroons (registered under the second order in the register of commercial pledges). All claims of the banks arising from contracts under the law of obligations have been guaranteed by the pledges.

Between AS Gustaf and Hansabank:
A commercial pledge agreement on movable property in the amount of 6 million kroons for guaranteeing guarantee contracts.

Between OÜ Gustaf Tallinn and Hansabank:
A commercial pledge agreement on movable property in the amount of 3.9 million kroons for guaranteeing guarantee contracts.

Between AS Merko Tartu and SEB Eesti Ühispank:
A commercial pledge agreement on movable property in the amount of 20.0 million kroons. Guarantee contracts entered into are guaranteed by the pledge.

Between SIA Merks and Hansabanka:
A commercial pledge agreement on assets in the amount of 3.0 million Latvian lats (67.3 million kroons). Obligations arising from the guarantee contracts and the loan agreements are guaranteed by the pledge.
Mortgages in the amount of 17.36 million Latvian lats (389.4 million kroons) for 7 registered immovables in Riga have been set as collateral for a loan contract totalling 17.5 million euros (268.3 million kroons).

Between SIA Merks and Nordea Banka:
Mortgages in the amount of 40.5 million Latvian lats (909.2 million kroons) for registered immovables in Riga have been set as collateral for a loan contract totalling 35.0 million euros (785.8 million kroons).

Between UAB Statyba and Hansabankas:
A commercial pledge agreement on movable property in the amount of 6.0 million Lithuanian litas (27.2 million kroons). The obligations arising from overdraft contracts and guarantee contracts are guaranteed by the pledge.

Note 32 Share capital

In 2006 and 2007, no changes occurred in share capital.

As at 31.12.2007, the share capital in the amount of 177 000 thousand kroons consisted of 17 700 thousand registered shares with the nominal value of 10 kroons each.

Additional information is disclosed in note 36 under *Capital management*.

Note 33 Construction contracts in progress

in thousands of kroons

	Group	
	31.12.2007	**31.12.2006**
Costs incurred for construction contracts in progress and corresponding profit	5 570 285	4 016 033
Progress billings submitted	(5 580 891)	(4 157 565)
Amounts due from customers for contract works (Note 15)	151 119	135 408
Amounts due to customers for contract works (Note 27)	(161 725)	(276 940)
Advance payments received for contract works	171 235	86 326

Amounts due from customers for contract works are included in the balance sheet line *Trade and other receivables*. Amounts due to customers for contract work are included in the balance sheet line *Trade and other payables*

Note 34 Related party transactions

in thousands of kroons

In compiling the Annual Report, the following entities have been considered as related parties:

- parent company AS Merko Grupp;
- shareholders of AS Merko Grupp with significant influence through AS Merko Grupp;
- other shareholders with significant influence;
- other subsidiaries of AS Merko Grupp, so-called 'entities controlled by the parent company';
- associates and joint ventures;
- key managers and their close relatives;
- entities under control of persons mentioned above;

Significant influence is presumed to exist when the person has more than 20% of the voting power.

The parent company of AS Merko Ehitus is AS Merko Grupp. As at 31.12.2007 and 31.12.2006, AS Merko Grupp owned 72% of the shares of AS Merko Ehitus. The ultimate controlling party of the Group is Mr Toomas Annus.

Goods and services

	Group	
	2007	2006
Purchased construction services		
Associates and joint ventures	86 123	91 732
Entities controlled by the parent company	8 425	7 858
Total purchased construction services	94 548	99 590
Construction services rendered		
Associates and joint ventures	33 642	118 667
Entities controlled by the parent company	1 576 911	986 301
Management members	10 027	5 970
Total construction services provided	1 620 580	1 110 938
Construction materials purchased		
Other related parties	211	208
Real estate sold		
Entities controlled by the parent company	81 583	31 890

Loans granted to related parties are disclosed in Note 16 *Loans granted.*

Balances with the related parties

	Group	
	31.12.2007	31.12.2006
Trade and other receivables		
Trade receivables		
Associates and joint ventures	16 046	13 678
Entities controlled by the parent company	182 802	141 050
Other related parties	-	18
Short-term loans		
Associates and joint ventures	7 000	24 750
Entities controlled by the parent company	4 236	8 896
Interest receivables		
Associates and joint ventures	649	2 656
Entities controlled by the parent company	-	32
Other short-term receivables		
Entities controlled by the parent company	-	6 890
Other related parties	2	-
Prepayments for services		
Associates and joint ventures	-	1 068

Other long-term loans and receivables		
Long-term loans		
Associates and joint ventures	5 725	-
Entities controlled by the parent company	2 942	3 804
Borrowings		
Short-term loans and bonds		
Entities controlled by the parent company	19 035	-
Trade and other payables		
Payables to suppliers		
Associates and joint ventures	11 098	9 414
Entities controlled by the parent company	326	272
Other related parties	6	7
Prepayments received		
Entities controlled by the parent company	16 094	16 551
Interest liabilities		
Entities controlled by the parent company	272	-
Other payables		
Associates and joint ventures	-	3 365

No allowances for impairment losses have been set up for receivables from related parties in 2007.

Remuneration of the members of the Supervisory and Management Boards and senior executives

In 2007, the members of the Supervisory and Management Boards as well as senior executives of AS Merko Ehitus were paid remuneration totalling 25 355 thousand kroons (2006: 15 171 thousand kroons).

Termination benefits of members of the Supervisory and Management Boards

Upon premature removal or termination of authority of the members of the Supervisory and Management Boards, the Group has the obligation to pay compensation totalling 4410 thousand kroons (2006: 4392 thousand kroons).

Contracts of surety

AS Merko Ehitus provides surety for:

- obligations arising from the loan agreement of the subsidiary AS Merko Tartu to Sampo Bank in the amount of 4841 thousand kroons.
- obligations arising from lease agreements of subsidiaries and consolidation group companies to Balti Autoliisingu AS in the amount of 4158 thousand kroons (31.12.2006: 9883 kroons);
- obligations arising from loan agreements of the joint venture OÜ Unigate to Hansabank in the amount of 1000 thousand kroons (31.12.2006: 1000 thousand kroons).

The fair value of Group's surety contracts is immaterial, therefore no liability has been recorded in the balance sheet as at 31.12.2007 as well as at 31.12.2006.

Note 35 Contingent liabilities

The Group has purchased the following guarantees in the following maximum amounts from financial institutions to cover Group's maximum exposure to third parties if the Group would not be able to fulfil its contractual obligations. The management believes that the likelyhood of additional expenses due to these guarantees is remote.

in thousands of kroons	Group	
	31.12.2007	**31.12.2006**
Performance period's warranty to the customer	309 904	180 617
Tender warranty	23 761	72 352
Guarantee warranty period	55 500	73 295
Prepayment guarantee	68 756	105 478
Sureties (Note 34)*	9 999	26 483
Payment guarantee	5 176	3 743
Letter of credit	11 218	-
Total contingent liabilities	484 314	461 968

* In addition to sureties disclosed in Note 34, the Group has not issued sureties covering the obligations of third parties (31.12.2006: the amount was 8100 thousand kroons).

Performance period's warranty to the customer – warranty provider grants to customer that contractor's obligations arising from construction contract will be adequately completed.
Tender warranty – warranty provider grants to customer arranging the tender process that the tenderer will sign a contract as per tender conditions.
Guarantee for warranty period - warranty provider grants to customer that construction defects discovered during the warranty period will be repaired.
Prepayment guarantee - warranty provider grants to customer that advances will be reimbursed, if contractor fails to deliver goods or services agreed.
Payment guarantee – warranty provider grants to customer payment for goods or services.

On 29 February 2008 a penalty claim was issued against Merko Ehitus branch in Latvia in the amount of 7,5 million kroons. The Group's management believes that this claim is not justified and no provision has been made. The first court hearings will take place in the summer of 2008.

Tax authorities have the right to review the Group's tax records within 6 years after submitting the tax declaration and upon detecting errors, impose additional taxes, interest and fines. The Group's management estimates that there are not any circumstances which might lead the tax authorities to impose additional significant taxes on the Group.

Note 36 Risks

Credit risk

Credit risk relates to a potential damage which would occur if the parties to the contract are unable to fulfil their contractual obligations. In order to lower credit risks, the payment discipline of customers is constantly monitored; construction activities are partly funded by customer prepayments. The company's cash is held in short-term deposits at banks with a high credit rating (Moody's rating A3/P-2 and higher). Cash is mostly held in overnight deposits or term deposits at Hansabank and the banks of the SEB Group. The management estimates that the Group does not have any major credit risks.

Financial assets *in thousands of kroons*	Allocation by due dates 1-12 months	2-5 years	Carrying amount	Collateral
31.12.2007				
Cash and overnight deposits	53 838	-	53 838	-
Term deposits	151 726	-	151 726	-
Trade receivables	884 856	5 825	890 681	-
Receivables recorded based on the stage of completion of construction contracts	151 119	-	151 119	-
Loans granted	41 135	8 667	49 802	30 000
Total	**1 282 674**	**14 492**	**1 297 166**	**30 000**
31.12.2006				
Cash and overnight deposits	437 611	-	437 611	-
Term deposits	238 532	-	238 532	-
Trade receivables	551 362	4 672	556 034	-
Receivables recorded based on the stage of completion of construction contracts	135 408	-	135 408	-
Loans granted	34 883	3 804	38 687	-
Total	**1 397 796**	**8 476**	**1 406 272**	-

Of financial assets, an allowance has been set up for doubtful receivables. Receivables in the amount of EEK 2111 thousand (2006: EEK 1370 thousand) have been written down in full.
According to the industry practice, trade receivables and receivables recorded based on the stage of completion of construction contracts have no collateral.
Of the loans granted, EEK 19 903 thousand (31.12.2006: EEK 37 450 thousand) are loans to companies under joint control and associates of whose economic activities the Company has a good overview and therefore, no collateral is required.

Interest risk

Interest risk arises from interest rate changes in the financial markets as a result of which it may be necessary to revalue the company's financial assets and take into consideration higher financing costs in the future. Most of the Group's bank loans have floating interest rates based on either EURIBOR or the interbank rates of the countries of incorporation of the companies. As the share of interest-bearing liabilities in the Group's capital structure is low (as at 31.12.2007: 18% of the balance sheet total), management considers the effect of changes in the interest rate environment insignificant for the operating results of the Group.

Effect of changes in interest risks on financial expenses.

As at 31.12.2007, the Group's interest-bearing liabilities totalled EEK 702 592.6 thousand, including EEK 10.6 thousand denominated in Estonian kroons, EEK 79 624.0 thousand in Lithuanian litas, EEK 382 230.8 thousand in Latvian lats and EEK 240 727.3 thousand in euros. Loan interest depended on the base interest of 3-12 month interbank money market loans of the respective country of incorporation.
Management expects the European Central Bank to lower the euro base rates over the following 12 months as a result of which Euribor will fall by approximately 50 basis points. However, we expect the increase of base rates on loans denominated in national currencies of the Baltic States by approximately 75 basis points.
Assuming that the volume and structure of borrowings does not change during the year, the following will occur: 1) a decrease/increase of Euribor by -50/+50 basis points will change the Company's interest costs by -/+1195.6 thousand kroons; 2) an increase/decrease of base rate on loans denominated in national currencies by +75/-75 basis points will increase/decrease financing costs by +/-3 476.1 thousand kroons.

Foreign exchange risk

The Group's transactions are carried out in Estonian kroons, Latvian lats and Lithuanian litas. The Estonian kroon, as well as the Latvian lats and Lithuanian litas are pegged to the Euro. The exchange rate of the Latvian lat is 1

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EUR=0.702804 LVL +/-1%. In order to eliminate foreign exchange risk, material foreign contracts and long-term loan agreements are concluded in euros.

Liquidity risk

The Company's solvency represents its ability to settle its liabilities to creditors on time. As at 31.12.2007, the Group's current ratio was 2.4 (2006: 2.0) and quick ratio was 1.0 (2006: 1.1). To complement available current assets and to ensure liquidity and better management of cash flows, the group companies have concluded overdraft agreements with banks for a total facility of EEK 90 million. In addition to overdraft facility, the Company has a current loan facility with the limit of EEK 150 million available from AS Merko Grupp. Management estimates that the Group's capital structure – a high proportion of equity at 52% of the balance sheet total and a low proportion of interest bearing liabilities of 18% of the balance sheet total – ensures the Company's trustworthiness for creditors also during difficult times and significantly improves the feasibility of the extension of existing financial liabilities and raising additional debt.

Financial assets/liabilities *in thousands of kroons*	Allocation by due dates			Total	Carrying amount
	1-3 months	4-12 months	2-5 years		
31.12.2007					
Assets					
Cash and overnight deposits	53 838	-	-	53 838	53 838
Term deposits	151 726	-	-	151 726	151 726
Trade receivables	884 856	-	5 825	890 681	890 681
Prepaid taxes *	40 528	-	-	40 528	40 528
Receivables recorded based on the stage of completion of construction contracts	151 119	-	-	151 119	151 119
Loans and interest	779	42 431	8 667	51 877	51 877
Other short-term receivables	3 662	-	-	3 662	3 662
Total	**1 286 508**	**42 431**	**14 492**	**1 343 431**	**1 343 431**
Liabilities					
Trade payables	528 856	-	11 091	539 947	539 947
Payables to employees	74 892	-	-	74 892	74 892
Tax liabilities	73 533	-	-	73 533	73 533
Loan and finance lease liabilities**	91 535	213 344	397 713	702 592	702 592
Other liabilities	7 991	13 977	-	21 968	21 968
Total	**776 807**	**227 321**	**408 804**	**1 412 932**	**1 412 932**
31.12.2006					
Assets					
Cash and overnight deposits	437 611	-	-	437 611	437 611
Term deposits	238 532	-	-	238 532	238 532
Trade receivables	551 362	-	4 672	556 034	556 034
Prepaid taxes *	38 981	-	-	38 981	38 981
Receivables recorded based on the stage of completion of construction contracts	135 408	-	-	135 408	135 408
Loans and interest	583	37 213	3 804	41 600	41 600
Other short-term receivables	1 549	-	-	1 549	1 549
Total	**1 404 026**	**37 213**	**8 476**	**1 449 715**	**1 449 715**
Liabilities					
Trade payables	464 199	-	10 352	474 551	474 551
Payables to employees	64 218	-	-	64 218	64 218
Tax liabilities	60 734	-	-	60 734	60 734
Loan and finance lease liabilities**	56 758	227 034	159 335	443 127	443 127
Other liabilities	5 458	21 832	-	27 290	27 290
Total	**651 367**	**248 866**	**169 687**	**1 069 920**	**1 069 920**

* Although prepaid taxes do not meet the definition of financial assets, they will offset the amount of negative cash flows from tax liabilities.
** The schedule of expected interest payments cannot be determined with reasonable certainty. In line with property development best practice, the loan obligations to acquire land plots have been assumed with open-end maturities. The repayment of those loan obligations is dependent on the progress of related development projects and on the timing of cashflows generated from those projects upon completion. Consequently the management is on the opinion that even their best estimate on the timing of expected interest payments would not be of reliable accuracy for the users of this financial information and have been omitted.

Capital management

The Commercial Code of the Republic of Estonia specifies the following requirements for the share capital of the companies registered in Estonia:

- the minimum share capital of a public limited company shall be at least EEK 400 000;
- the net assets of a public limited company shall be at least one half of the Company's share capital but not less than EEK 400 000.

The size of share capital or its minimum and maximum are set out in the articles of association of a public limited company whereas the minimum share capital shall equal at least ¼ of maximum share capital.

According to the current articles of association of AS Merko Ehitus, the Company's share capital consists of 17 700 thousand ordinary shares with the nominal value of 10 kroons each and without amending the articles of association of the public limited company, changes can be made to the Company's share capital within the range of EEK 85 - 340 million. As at 31.12.2007, the share capital of AS Merko Ehitus was EEK 177 000 thousand and the consolidated net assets were EEK 2 049 696 thousand, so the Company's equity and share capital were in compliance with the requirements established in the Republic of Estonia.

In capital management, the Company follows the principle of maintaining its trustworthiness, sustainable development and the assets of shareholders through economic cycle pursuant to which it monitors that its equity to assets ratio would at any given time be at least 45% (31.12.2007: 52%, 31.12.2006: 50%) and interest bearing debt to assets ratio would not exceed 25% (31.12.2007: 18%, 31.12.2006: 14%).

Legal risk

At 15 October 2007, the Prosecutors' Office submitted a suspicion of bribery and breach of trust against AS Merko Ehitus and the Chairman of the Company's Supervisory Board Toomas Annus. The suspicion filed is arbitrary and is largely based on incompetent interpretation of risks related to business and industry practices as well as on inability to estimate the effect of time on events and real estate prices. Management estimates that the Company has followed the effective laws of the Republic of Estonia and good industry practice. The theoretical maximum penalty in case of criminal conviction is EEK 250 million and the Company's compulsory liquidation. Management estimates that no *de facto* basis exists for convicting the Company and no provision has been made in this respect (excl provision for lawyers' costs).

Due to different interpretation of contracts, regulations and laws related to Group's principal activities, there is a risk that some buyers, contractors or supervisory authorities evaluate the Company's activities in abiding by a law or a contract on different grounds and dispute the legitimacy of the Company's activities.

As at 31.12.2007, a provision has been set up in the Group in the amount of EEK 22 786 thousand for covering potential claims and legal costs (31.12.2006: EEK 4054 thousand), (Note 29).

Fair value

The carrying amounts of the Group's financial assets and financial liabilities do not significantly differ from their fair values.

Note 37 Number of shares owned by the members of the Supervisory and Management Board and their close relatives

As at 31.12.2007, neither members of the Supervisory Board and Management Board of AS Merko Ehitus nor their close relatives owned shares of Merko Ehitus.

Note 38 Shareholders with more than 5% ownership

	Shares	Ownership %
AS Merko Grupp	12 742 686	71.99
Clients of ING Luxembourg S.A.	909 500	5.14

Note 39 Events after the balance sheet date

At a joint meeting held at 14 March 2008, the Management Board and the Supervisory Board of AS Merko Ehitus adopted a resolution to restructure the Company and separate operating activities from the criminal proceedings related to the land swap. The Company's management estimates that the restructuring the Company is the best way to ensure its sustainable development and protect the interests of shareholders and employees in the long-lasting criminal proceedings related to the land swap.

The delay of the criminal proceedings related to the land swap launched in 2005, the accompanying ambiguity and speculation in the media have started to take a toll on the Company's operations and thus harming the interests of the Company and its shareholders. The Company has entered into advisory agreements with the investment bank GildBankers and law office Tark & CO to evaluate the legal and economic impact related to the adoption and implementation of the process.

At 15 April 2008, the management of AS Merko Ehitus presented the Company's restructuring plan according to which AS Merko Ehitus will be demerged so that core business (e.g. all assets, liabilities and contracts as well as the business name) will be separated and transferred to the new company being set up, except for liquid assets and equity totalling 300 million kroons and contingent liability related to criminal proceedings. As a result of the demerger, each shareholder will receive one share of New Merko for each share of AS Merko Ehitus and the shares of New Merko will be listed on the Tallinn Stock Exchange as soon as possible. The business name of AS Merko Ehitus will also be changed and the Company's shares will continue to be listed on the Tallinn Stock Exchange. The sole member of the Management Board of the company will be Toomas Annus.

The Management Board of AS Merko Ehitus will prepare the demerger plan outlining the details of the demerger, incl. size of share capital of New Merko, members of the Management Board and Supervisory Board, distribution and exchange ratio of the shares of New Merko to be transferred to shareholders, terms of transferring shares, list of assets to be transferred to New Merko and allocation of liabilities accompanying the assets between the companies. In addition, the Management Board will prepare the demerger report explaining the demerger from the legal and economic point of view.

The demerger plan will be presented for approval at the General Meeting of Shareholders of AS Merko Ehitus. At least 2/3 of the voting power represented at the meeting is required to adopt the resolution.

Note 40 Supplementary disclosures on the parent company

The financial information of the parent company comprises separate primary statements of the parent company (income statement, balance sheet, cash flow statement and statement of changes in equity), the disclosure of which is required by the Estonian Accounting Act. The primary financial statements of the parent company have been prepared using the same accounting methods and measurement bases as for the preparation of the consolidated financial statements, except for subsidiaries, associates and joint ventures which are reported at cost in the separate primary financial statements of the parent company.

Income statement

in thousands of kroons

	Parent company	
	2007	**2006**
Revenue	2 466 908	2 111 887
Cost of goods sold	(2 194 892)	(1 834 444)
Gross profit	272 016	277 443
Marketing expenses	(16 439)	(12 591)
Administrative and general expenses	(121 424)	(63 775)
Other operating income	24 683	19 323
Other operating expenses	(14 413)	(4 782)
Operating profit	144 423	215 618
Financial income/expenses	(861)	2 226
Financial income/expenses from investments into subsidiaries	124 079	113 488
Financial income/expenses from investments into associates and joint ventures	4 000	2 499
Net profit for the year	271 641	333 831

Revenue break-down of the parent company is presented according to Estonian Classifications of Economic Activities (EMTAK 2008), information which is required under Business Code § 4 p.6.

EMTAK code		Parent company	
		2007	**2006**
	Rendering of construction services		
4120	incl. construction of residential and non-residential buildings	1 577 180	980 529
4110	development of building projects	205 982	451 609
4211	construction of roads and railways	107 501	99 693
4221	construction of utility projects for fluids	388 160	318 441
4222	construction of utility projects for electricity and telecommunications	53 113	62 327
4291	construction of water projects	29 845	141 372
4213	construction of bridges and tunnels	28 787	-
4299	Construction of other civil engineering projects n.e.c.	16 994	55 999
		2 407 562	2 109 970
	Real estate activities		
6810	incl. sales of own real estate	58 500	-
6820	Renting and operating of own or leased real estate	846	1 917
		59 346	1 917
	Total revenue	2 466 908	2 111 887

Balance sheet

in thousands of kroons

	Parent company	
	31.12.2007	**31.12.2006**
ASSETS		
Current assets		
Cash and cash equivalents	107 000	311 059
Trade and other receivables	964 874	948 507
Prepaid corporate income tax	1 433	1 451
Inventories	373 734	154 132
	1 447 041	1 415 149
Non-current assets		
Investments in subsidiaries	318 069	229 604
Investments in associates and joint ventures	3 540	3 540
Other long-term financial assets	338 763	129 326
Property, plant and equipment	15 681	12 653
Intangible assets	8 801	6 197
	684 854	381 320
TOTAL ASSETS	2 131 895	1 796 469
LIABILITIES		
Current liabilities		
Borrowings	262 391	32 463
Trade and other payables	534 169	617 514
Corporate income tax liability	9	-
Short-term provisions	59 380	18 727
	855 949	668 704
Non-current liabilities		
Other long-term payables	5 690	5 250
TOTAL LIABILITIES	861 639	673 954
EQUITY		
Share capital	177 000	177 000
Statutory reserve capital	17 700	17 700
Retained earnings	1 075 556	927 815
TOTAL EQUITY	1 270 256	1 122 515
TOTAL LIABILITIES AND EQUITY	2 131 895	1 796 469

Statements of changes in equity

in thousands of kroons

Parent company	Share capital	Statutory reserve capital	Retained earnings	Total
Balance as at 31.12.2005	177 000	8 850	691 334	877 184
Net profit for the year	-	-	333 831	333 831
Transfers to reserve capital	-	8 850	(8 850)	-
Dividends	-	-	(88 500)	(88 500)
Balance as at 31.12.2006	177 000	17 700	927 815	1 122 515
Carrying amount of holdings under dominant or significant influence				(233 144)
Carrying amount of holdings under dominant or significant influence under the equity method				704 571
Adjusted unconsolidated equity at 31.12.2006				**1 593 942**
Net profit for the year	-	-	271 641	271 641
Dividends	-	-	(123 900)	(123 900)
Balance as at 31.12.2007	177 000	17 700	1 075 556	1 270 256
Carrying amount of holdings under dominant or significant influence				(321 609)
Carrying amount of holdings under dominant or significant influence if the equity method had been applied				1 067 110
Adjusted unconsolidated equity at 31.12.2007				**2 015 757**

Adjusted unconsolidated retained earnings represent the amount that is available for distribution to the shareholders according to the Estonian Accounting Act.

Cash flow statement

in thousands of kroons

	Parent company	
	2007	**2006**
Cash flows from operating activities		
Operating profit	144 423	215 618
Adjustments:		
depreciation and impairment	6 462	7 648
gain/loss from sale of non-current assets	57	(107)
adjustment of revenue from construction contracts under stage of completion method	19 786	(102 843)
interest income from operating activities	(24 585)	(17 913)
change in provisions	49 203	9 697
Change in trade receivables related to operating activities	(220 877)	(214 673)
Change in inventories	(219 603)	(60 913)
Change in trade payables related to operating activities	(6 242)	147 513
Interest paid	(7 513)	(931)
	(258 889)	(16 904)
Cash flows from investing activities		
Investments into subsidiaries	(65 807)	(69 834)
Proceeds from sale of subsidiaries	500	25 039
Proceeds from sales of associates	-	1 847
Proceeds from sale of other financial assets	-	3 004
Purchase of property, plant anda equipment	(5 459)	(7 501)
Proceeds from sale of property, plant and equipment	151	155
Purchase of intangible assets	(3 332)	(4 570)
Loans granted	(283 278)	(303 095)
Loan repayments received	161 502	510 324
Interest received	18 223	20 379
Dividends received	128 079	88 579
	(49 421)	264 327
Cash flows from financing activities		
Borrowings	259 651	33 242
Repayments of borrowings	(30 436)	(5 165)
Finance lease principal payments	(1 063)	-
Dividends paid	(123 900)	(88 500)
	104 252	(60 423)
Net increase / decrease in cash and cash equivalents	(204 058)	187 000
Cash and cash equivalents at beginning of the period	311 059	124 033
Currency translation adjustment	(1)	26
Cash and cash equivalents at end of the period	107 000	311 059

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INDEPENDENT AUDITOR'S REPORT

(Translation of the Estonian original)*

To the Shareholders of AS Merko Ehitus

We have audited the accompanying consolidated financial statements of AS Merko Ehitus and its subsidiaries (the Group) which comprise the consolidated balance sheet as of 31 December 2007 and the consolidated income statement, consolidated statement of changes in equity and consolidated cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory notes.

Management Board's Responsibility for the Financial Statements

Management Board is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the European Union. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

PRICEWATERHOUSECOOPERS

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 2007, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the European Union.

Urmas Kaarlep
AS PricewaterhouseCoopers

Tiit Raimla
Authorised Auditor

30 April 2008

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* *This version of our report is a translation from the original, which was prepared in Estonian. All possible care has been taken to ensure that the translation is an accurate representation of the original. However, in all matters of interpretation of information, views or opinions, the original language version of our report takes precedence over this translation.*

PROFIT ALLOCATION PROPOSAL
in kroons

Retained earnings	1 281 092 636
Net profit for 2007	545 049 316
Total retained earnings as at 31.12.2007	**1 826 141 952**

Due to the need to ensure the liquidity of the company and maintain the investment ability in deteriorating economic environment, the Management Board proposes that no dividends would be distributed.

Tõnu Toomik	Chairman of the Management Board	15.04.2008
Alar Lagus	Member of the Management Board	15.04.2008
Veljo Viitmann	Member of the Management Board	15.04.2008
Andres Agukas	Member of the Management Board	15.04.2008
Tõnu Korts	Member of the Management Board	15.04.2008

SIGNATURES OF THE MANAGEMENT BOARD AND SUPERVISORY BOARD TO THE 2007 ANNUAL REPORT

The Management Board of AS Merko Ehitus has prepared the management report, consolidated financial statements and the profit allocation proposal for 2007.

Tõnu Toomik	Chairman of the Management Board	15.04.2008
Alar Lagus	Member of the Management Board	15.04.2008
Veljo Viitmann	Member of the Management Board	15.04.2008
Andres Agukas	Member of the Management Board	15.04.2008
Tõnu Korts	Member of the Management Board	15.04.2008

The Supervisory Board has reviewed the Annual Report which consists of the management report and the financial statements prepared by the Management Board and which also includes the auditor's report and the profit allocation proposal, and approved it for presentation at the General Meeting of Shareholders.

Toomas Annus	Chairman of the Supervisory Board	30.04.2007
Teet Roopalu	Member of the Supervisory Board	30.04.2007
Jaan Mäe	Member of the	30.04.2007

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