Annual report 2013
Arco Vara AS

ARCO VARA

Annual report

(Translation of the Estonian original)

ARCO VARA AS

Beginning of financial year:	1 January 2013
End of financial year:	31 December 2013

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Core activities:	Real estate activities (EMTAK 6800) Construction of buildings (EMTAK 41000) Civil engineering (EMTAK 42000) Specialised construction activities (EMTAK 43000)
Supervisory board:	Hillar-Peeter Luitsalu, Toomas Tool, Aivar Pilv, Stephan David Balkin, Arvo Nõges, Rain Lõhmus, Allar Niinepuu
Management board:	Tarmo Sild
Auditor:	AS PricewaterhouseCoopers

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Directors' report

ARCO VARA GROUP

Arco Vara AS (hereafter also 'the parent company' or 'the Company') and other entities of Arco Vara group (hereafter together 'the group') are engaged in various aspects of the real estate business. Until the end of year 2013, the group's three business lines – services, development and construction had been organised into corresponding divisions. Since year 2014, the group has two continuing business lines: Service division and Development division. The group has no plans on independent construction activities in next few years.

The Service division is engaged in real estate brokerage, valuation, management and consulting as well as in short-term investment in residential real estate. The Service division offers to the group additional value by generating analytical data on market demand and supply, also behaviour of potential clients. Analytical data allows to make better decisions on purchase of land plots, planning and designing, also on timing the start of construction.

The Development division develops complete living environments and commercial real estate. Fully developed housing solutions are sold to the end-consumer. In some cases the group is developing also commercial properties until they start generating cash flow for two possible purposes: for the support of the groups' cash flows or for resale. The group is currently holding completed commercial properties that generate rental income.

The Construction division provided general construction and environmental engineering services, operating as a general contractor and construction manager as well as a subcontractor. In 2013, the provision of construction services was finished and in February 2014, the group sold its construction company Arco Ehitus OÜ. Arco Vara is still responsible for completing possible warranty works, together with Arco Ehitus. The construction business line is presented in the annual report as discontinued operation, in accordance with IFRS 5.

At the end of 2013, the group comprised 23 companies (31 December 2012: 23). At 31 December 2013, the group had interests in one joint venture (31 December 2012: 2) and one associate (31 December 2012: 1).

The group regards Estonia, Latvia and Bulgaria as its home markets and in the Development division particularly Tallinn, Riga and Sofia.

The goal and core values

Common goal for all Arco Vara companies is:

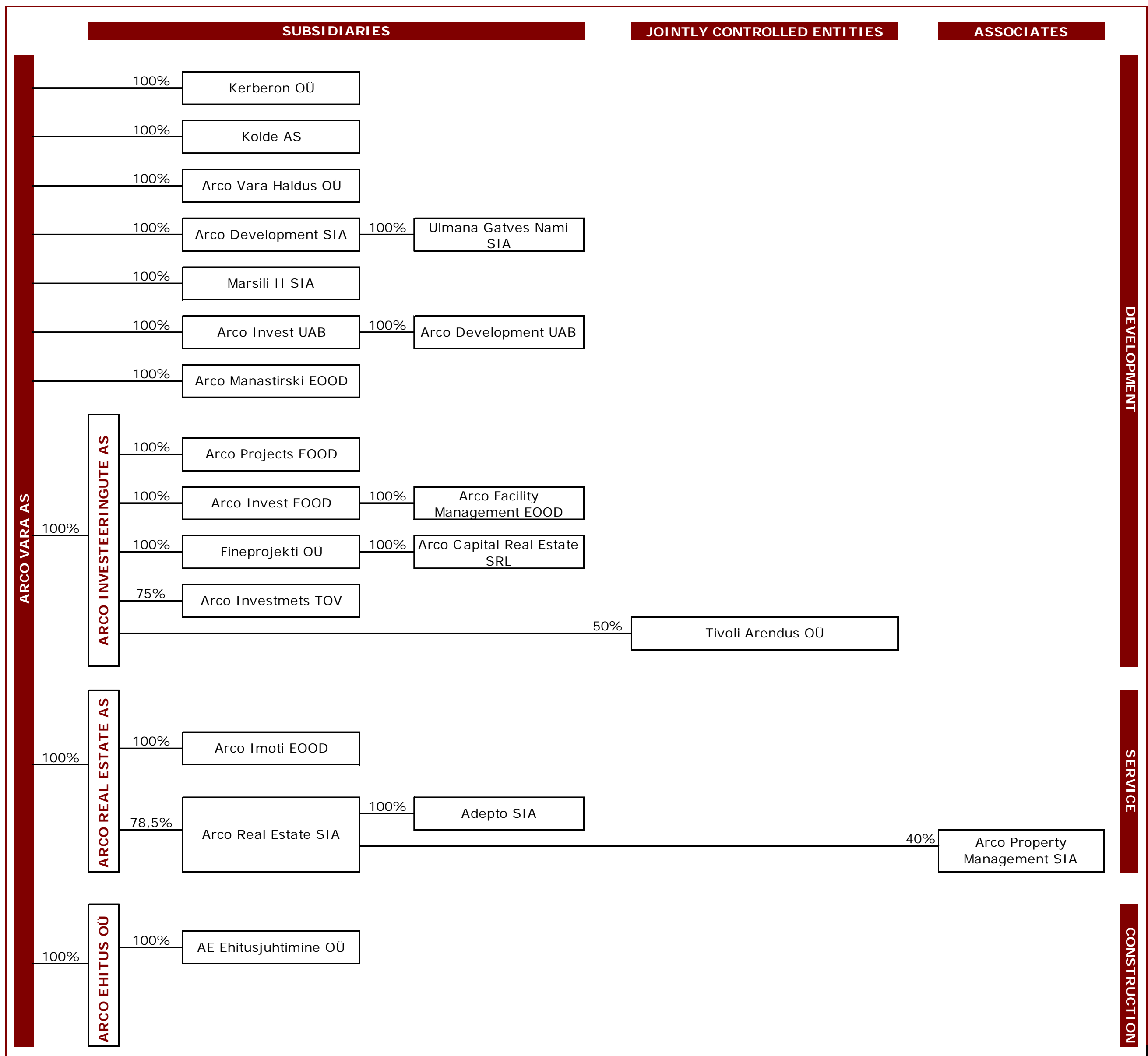
1) to provide clients with trustworthy real estate services which are based on quality information and integrated real estate products of high value in use, being innovative in the same time;
2) to gain stable and high return on equity for the shareholders, which beats the competiton in real estate business and justifies investing and holding Arco Vara shares;
3) and to create the best conditions for self-realization in real estate industry for the people working for the group.

Arco Vara's **core values** include:

Partnership – our client is our partner
Reliability – we are reliable, open and honest
Professionalism – we deliver quality
Consideration – we value our clients as individuals
Responsibility – we keep our promises

GROUP STRUCTURE

As at 31 December 2013



Key performance indicators of Arco Vara group

KEY PERFORMANCE INDICATORS

- The group's revenue for 2013 from continuing operations was 10.7 million euros, declined by 2% compared to previous year. Revenue of Development division declined by 0.5 million euros (-6%) and revenue of Service division increased by 0.3 million euros (+13%) compared to previous year.
- The group ended the year 2013 with an operating profit from continuing operations of 4.5 million euros, significant part on that had reversal of provisions and revaluation of assets and liabilities with total amount of 3.3 million euros. In 2012, the group incurred an operating loss of 15.9 million euros including loss in total amount of 15.6 million euros from recognition of provisions and revaluation of assets and liabilities.
- In 2013, the group had net loss from discontinued operation (construction business line) in amount of 0.1 million euros (2012: 0.3 million euros). Revenue from discontinued operations was 3.5 million euros in 2013 (2012: 9.8 million euros).
- The group ended the year 2013 with net profit of 3.4 million euros. Net loss for 2012 was 18 million euros.
- Equity to assets ratio has been recovered substantially during 2013. As at 31 December 2013, the ratio was 27% (31 December 2012: 11%).
- The loan burden (net loans) of the group has been decreased to 14.1 million euros as at 31 December 2013 (31 December 2012: 17.1 million euros). Average interest rate of loans is declined by 0.5 percentage points in a year to a level of 6.0% as at 31 December 2013.
- In 2013, the group sold 83 apartments, plots and commercial areas (2012: 81) in its own development projects.

EUR, millions	**2013**	2012
Revenue from continuing operations	10.7	10.9
Operating loss from continuing operations	4.5	-15.9
Net profit/loss from continuing operations	3.5	-17.7
Net loss from discontinued operations	-0.1	-0.3
Net profit/loss for the year	3.4	-18.0
EPS (in euros)	0.72	-3.79
Total assets at period-end	25.2	31.2
Invested capital at period-end	21.7	22.1
Net loans at period-end	14.1	17.1
Equity at period-end	6.9	3.4
Average loan term (in years, at period-end)	0.3	2.0
Average interest rate of loans (per year, at period-end)	6.0%	6.5%
ROIC (rolling, four quarters)	20.7%	neg
ROE (rolling, four quarters)	66.7%	neg
ROA (rolling, four quarters)	12.6%	neg
Number of staff at period-end	178	139

FORMULAS USED

Earnings per share (EPS) = net profit attributable to owners of the parent / (weighted average number of ordinary shares outstanding during the period – own shares)
Invested capital = current interest-bearing liabilities + non-current liabilities + equity (at end of period)
Net loans = current interest-bearing liabilities + non-current liabilities – cash and cash equivalents – short-term investments in securities (at end of period)
Equity to assets ratio = equity at end of period / total assets at end of period
Average equity = past four quarters' equity at end of period / four
Return on equity (ROE) = past four quarters' net profit / average equity
Return on assets (ROA) = past four quarters' net profit / average total assets
Average invested capital = past four quarters' current interest-bearing liabilities, non-current liabilities and equity / four
Return on invested capital (ROIC) = past four quarters' profit before tax and interest expense / average invested capital
Number of staff at period end = includes persons working for the group under employment or authorization contract

CONTINUING OPERATIONS

Revenue and profit

EUR, millions	2013	2012
Revenue		
Development	8.1	8.6
Service	2.8	2.6
Eliminations	-0.2	-0.3
Total revenue	**10.7**	**10.9**
Operating profit/loss		
Development	5.1	-14.9
Service	0.2	0.3
Eliminations	-0.3	0.2
Unallocated income and expenses	-0.5	-1.5
Total operating profit/loss	**4.5**	**-15.9**
Interest income and expense	-1.0	-1.6
Income tax expense	0.0	-0.2
Net profit/loss	**3.5**	**-17.7**

Cash flows

In millions of euros	2013	2012
Cash flows from operating activities	0.3	2.3
Cash flows from investing activities	1.6	0.8
Cash flows used in financing activities	-2.8	-3.5
Net cash flows	**-0.9**	**-0.4**
Cash and cash equivalents at beginning of period	1.8	2.2
Changes in cash and cash equivalents	-0.1	0.0
Cash and cash equivalents at end of period	0.8	1.8

In recent years, the main factor that has caused negative net cash flow for the group is the settlement of bank loans - principal and interest payments totalled 5.8 million euros in 2013 and 4.9 million euros in 2012.

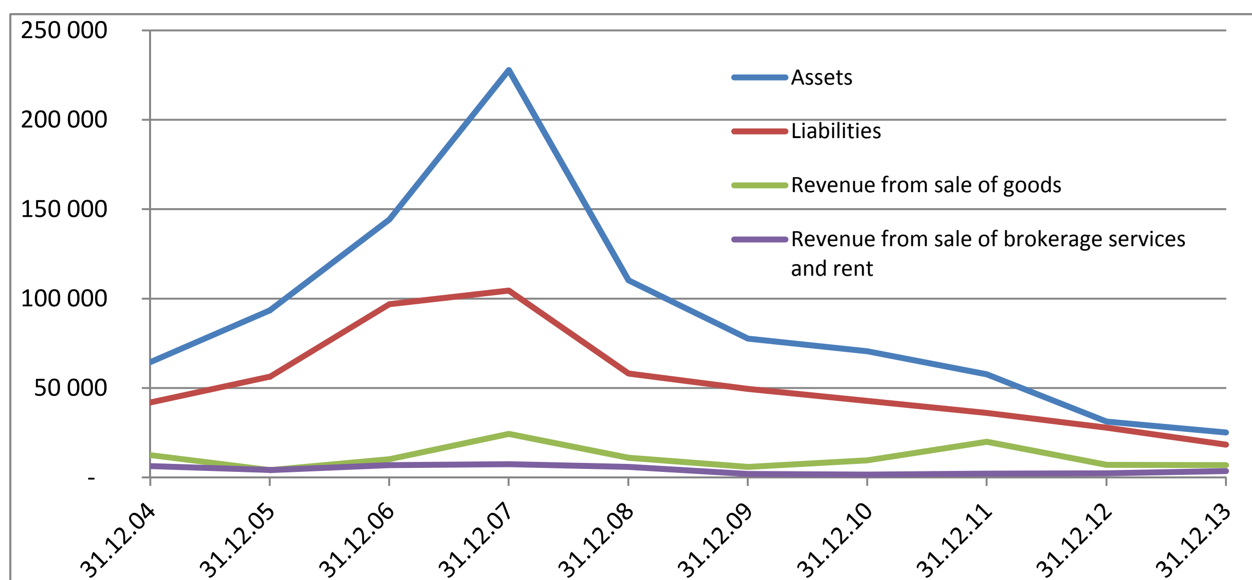
Group chief executive's review

The year 2013 was a successful year for Arco Vara real estate group.

Real estate development is a business with a long-lasting cycle, where an average of at least four years passes from obtaining a plot of land, receiving construction permits, designing and construction to selling the final product or renting it. This time may be shorter if the land plot is obtained with construction rights and the project. The time may also be longer, since each development is individual with its own risks and possibilities. What is important is that the result of each concluded year depends on the basis created in previous periods, and the work done during last year promotes the result of following years.

The success of 2013, in short, is that the group resolved all problems related to assets and liabilities obtained in previous years. Each of these problems alone threatened the sustainability of the group. Secondly, the group restarted development activities with its own resources and without increasing net debt burden. We got significant units in our assets to earn money again starting different real estate development cycles and at the same time we also continued to earn money with our Service division units in Estonia, Latvia and Bulgaria.

Arco Vara group activities during year 2004 – 2013 can be summarized with the following chart:



Th graph shows that until the end of 2007 the group had been actively purschasing different assets and revaluing the assets up. The assets were partly obtained with the help of debt, the growth in liabilities simultaneously with the growth of assets shows it. It should be mentioned conserning debt that mostly the debt was short-term and could have been serviced only by refinancing the loans or reselling assets. In 2007, the group received additional 70 million euros from IPO achieving the peak of the group's assets. After the IPO and at the same time with the real estate crisis, was started the cycle which is illustrated by devaluations of assets, the biggest of which occurred in 2008, and unprofitable sale of assets concurrently with the repayment of debt. And probably the group sold most liquid assets first, because by the end of 2012 and the start of 2013, the group had reached a point where the majority of assets (Bulgarian development projects, Ahtri 3 and Tivoli project) were frozen or actual development activities had stopped, at the same time interest obligations from a total of 18.1 million euros continued to increase daily and the amount of disposable (not blocked) cash was less than half a million euros.

The graph above shows also, that the group had in 2004 - 2013 quite stable revenue from real estate services as well as from the sale of own production, mostly apartments. Unfortunately, the previously mentioned activities where secondary, far behind the attention and energy that was given to assets and debt: acquisition of different land plots and real estate objects with debt which was followed by the sale of the same assets to settle the debt. It should be mentioned, that since the year 2007, the group have paid only loan interest in total amount of over 12 million euros. Most of assets, which carried interest obligation after the IPO, we do not find anymore in the balance sheet of the group.

All quarters of 2013 as well as the year as a whole ended with net profit, even though the goal set in 2012 was to gain operating profit first. In other words, the primary goal was to cover the immediate production costs of products and services with their sales and also cover general operating costs of the group. Such a goal was the baseline requirement for survival – considering how the group has been making a loss every year since IPO in 2007 with one exception. The goal was reached and more, we also managed to reach net profit beyond operating profit, i.e. discharge all interest obligations and increase the value of the group. Our equity capital increased from 3.4 million euros at the end of 2012 to 6.8 million euros at the end of 2013.

Below, we reveal more about last year's activities, starting from cleaning the balance sheet and moving from there through restoring development activities and strengthening the service division to future plans.

Cleaning the balance sheet

At the start of the year, the group faced four essential challenges, each of which had the potential to destroy or irrecoverably distort the parent company. In Bulgaria, those were Madrid and Manastirski projects and in Estonia, Tivoli project, Ahtri 3 project and the sustainability of Arco Ehitus. All challenges were resolved positively for the group.

Madrid Blvd and Manastirski Livadi

The Madrid project is a multi-purpose 8-storey building with the total area of approx. 24,000 m2, involving apartments, office and commercial premises and 160 underground parking spaces in Sofia city centre. The Manastirski project is a three-stage apartment development on an immovable of 8,000 m2 in a residential area of suburban Sofia, the 1st stage of which (8-storey block C with 74 apartment units) was fully constructed and out of the 2nd and 3rd stages (145 and 74 apartment units respectively), the foundation and basic structure of underground parking lot had been constructed. The projects had been consolidated into one 100% subsidiary of Arco Vara group, Arco Invest EOOD, and they had a total of 15.7 million euros in debt obligations to Piraeus bank.

Both in Madrid building and the 1st stage building of Manastirski, the sales transactions of apartments and delivery of apartments to buyers had stopped in the 3rd quarter of 2012, due to the requirement of the funding Piraeus bank that as prerequisite of relieving apartments from construction loan, loan must be returned in a larger sum per sold square metre of apartments than Arco Invest EOOD, the seller of apartments, was receiving as final payments from apartment buyers who concluded a preliminary contract. In other words, the bank's request and right pursuant to earlier loan agreements was to receive complete repayment of construction loans from the developer faster compared to the receipt of sales revenue of all apartments. As not all apartments were covered with preliminary sales contracts and the rented premises of Madrid building were also not for sale, the bank's claim could only have been fulfilled by an additional capital boost of approximately 3 million euros into Arco Invest EOOD by the parent company. However, there were neither the means nor the need for it in the management's opinion, considering the group's general interests for ensuring positive rate of return of equity capital.

The situation was additionally complicated by dissatisfaction of buyers who had concluded the preliminary contract and paid the prepayment due to the seller delaying the delivery of ownership and possession of apartments, even though everyone could see that the apartments were physically completed. Also, in late 2012 an important buyer withdrew from an earlier block deal for Madrid apartments, resulting in the loss of over 2 million euros in sales revenue. The buyer paid the contractual penalty properly.

The group resolved the situation in two stages, firstly concluding a refinancing contract with the bank for Madrid and Manastirski loans in March 2013. The refinancing lowered the interest rate of loans by 1.5%, its impact on the annual decrease of interest expenses of the group was at least 200,000 euros. Refinancing also enabled to complete the sales transactions of apartments, perform the obligations to buyers and decrease loan obligations by over 2 million euros with the revenue received from final payments. In the second stage in August 2013, the group returned the Manastirski construction loan to the bank before the prescribed time, by which the entire mortgage on Manastirski project was relieved. It became possible to separate Manastirski project from Arco Invest EOOD and place it independently in a new 100% subsidiary Arco Manastirski EOOD. This in turn enabled to continue development activities in Bulgaria, which we will address in greater detail in the part regarding the restart of development activities.

As we stated in the stock notice of 11.03.2013, Arco Invest EOOD took the obligation to return 1.8 million euros to the bank within the year 2014, due to which the need to restructure loans may arise again in the future, depending on product sales results and other circumstances. As of the date of this report, there is indeed a situation where the sale of remaining apartments of Madrid building has been slow and Arco Invest EOOD has been unable to further decrease the principal amount of loan. Negotiations with the bank are ongoing to refinance the remaining construction loan into a long-term investment loan. Considering that the Madrid building as a whole (business and commercial premises, GLA of 7,400 m2) produces positive lease cash flow of approx. 1 million euros per year, which is sufficient to cover interest expenses as well as moderately decrease the principal amount, the company's goal is refinancing and if successful, also the complete furnishing and leasing out the remaining 34 Madrid apartments (GSA 3,800 m2). Arco Projects EOOD has furnished already and letting out, short-term or long term, 11 apartments out of 34 with the annual return of over 4% from the assets carrying value.

In the case of failed negotiations, it can be predicted that the Madrid building is sold in execution proceeding and the loan is collected from Arco Invest EOOD and in the case of certain met prerequisites, also from Arco Investeeringute AS, which is the 100% parent company of Arco Invest EOOD. The parent company of the group and any significant subsidiary of the group do not guarantee this loan contract, nor have they provided securities.

Tivoli project

The Tivoli project is an apartment development project in Tallinn, Kadriorg, consisting of several immovables under one detailed plan with the area of 48,588 m2, providing the construction of approx. 700 apartment units. The immovables belonged to joint venture Tivoli Arendus OÜ, owned 50/50 by Arco Investeeringute AS and development partner based on Russian capital, International Invest Project (IIP), represented by Ms Natalija Levina. In 2011, IIP and its related company Kylemore also funded Tivoli Arendus OÜ in repaying the remaining loan of 5.4 million euros received earlier from SEB Bank. The interest rate of loans provided by IIP was significantly higher from the bank loan and with ongoing capitalization of interest, the debt of Tivoli Arendus OÜ to the partner exceeded 7.4 million euros as of the end of 2012, increasing by approx. 800,000 euros per year. The term of realizing the entire project pushed on to at least five years, calculating an optimistic 140 apartments per year for sales speed.

Arco Vara AS provided the surety for the loan obligation of Tivoli Arendus to IIP in up to 5.65 million euros and due to the slow speed of Tivoli project, the management of Arco Vara created an additional appropriation in the balance sheet of late 2012 to the sum of 1 million euros. It was not possible to refinance the IIP loan in a credit institution because this would

essentially have been a loan to obtain the Tivoli land and the banks' credit policy in 2013 as well as at the time of this report does not enable such large loans for obtaining land without equity capital. The IIP loan basically functioned as the developer's equity capital, being only subordinated to Swedbank bank loan taken for construction. The loan of Arco Investeeringute AS to Tivoli Arendus to the sum of 2.9 million euros was in turn subordinated to IIP loan, i.e. Arco Investeeringute AS would have been the last to get money back from Tivoli project as the creditor.

Here it must be stressed that Tivoli Arendus did not have solvency problems for the entire duration of the project, IIP had constantly ensured ongoing funds. The question for the group was that returning the loan to IIP at the end of the project may eventually have turned out to be beyond the capability of Tivoli Arendus OÜ and Arco Vara AS may have had to pay extra for the project.

The slow speed of Tivoli project was in turn connected with AS Nordecon failing to properly perform the design and construction project. For the construction of stage 1, Tivoli Arendus OÜ had concluded a design and construction agreement with Nordecon on 22.05.2012 to 10.3 million euros and it was behind schedule. The builder also provided Tivoli Arendus with project documents which did not conform to the agreement and tried to establish solutions which did not conform to the initial task of the contracting entity. As the situation did not improve despite the attention drawn to the issues, Tivoli Arendus cancelled the construction agreement with Nordecon on 01.02.2013. On 10.09.2013, Tivoli Arendus OÜ submitted a claim for compensation for damages to AS Nordecon in the sum of 1.8 million euros. AS Nordecon has filed an action against Tivoli Arendus for a claim of 174,000 euros. Disputes are still ongoing as of the day of this report.

On 13.03.2013, IIP, the creditor of Tivoli Arendus OÜ, cancelled the loan contracts of Tivoli Arendus and requested that Tivoli Arendus OÜ and Arco Vara AS pay a total of 8 million euros. Swedbank also cancelled the loan contract for construction.

For above reasons, the best possible choice for the group was to withdraw from Tivoli project with minimal losses. According to an agreement with the partner, Tivoli immovables were set up for public auction on 12 April 2013 with the starting price 8 million euros. The first auction attempt failed. The second attempt with the starting price of 7.8 million euros took place on 10.06.2013 and it was successful. The buyer was IIP and the sale resulted in complete deletion of the debt of Tivoli Arendus to the partner. Withdrawing from the project enabled Arco Vara AS to delete the appropriation of one million euros created to cover its surety and not bear any financial losses.

As of the date of this report, the group still has 50% ownership in Tivoli Arendus OÜ. The value of ownership depends on the solution of ongoing dispute between Tivoli Arendus OÜ and AS Nordecon. No company of the group is providing surety for any obligations of Tivoli Arendus OÜ.

Ahtri 3 project

The Ahtri 3 project is an immovable sized 13,991 m2 in Tallinn city centre, covered with one detailed plan, providing the construction of over 50 thousand m2 of commercial, entertainment and business premises above ground and over 20 thousand m2 below ground. The immovable belonged to Arco HCE OÜ, which is a related company with the 50/50 shareholding of Arco Investeeringute AS and OÜ Ahtrimaa.

Arco HCE had invested over 20 million euros in obtaining and developing the immovable. In 2007, Arco HCE OÜ had taken out a loan of 12 million euros from Danske Bank to develop the immovable, the loan's term was in November 2012. The loan from Danske Bank was provided with a surety on 1.9 million euros by Arco Investeeringute AS and OÜ Ahtrimaa, a subsidiary of US Invest.

Negotiations of Arco HCE and its shareholders with Danske Bank for extending the loan contract failed and in January 2013, the bank initiated execution proceedings to sell the immovable as well as to collect surety from shareholders Arco Investeeringute AS and OÜ Ahtrimaa. Arco HCE challenged the execution proceedings in court in reference to investments already made to develop the immovable and the complication and duration of the development process of the immovable, which could not be completed for the initial term of the loan contract. Arco HCE and its shareholders achieved the stoppage of execution proceedings with a court ruling. Subsequently, the bank issued a bankruptcy petition against Arco Investeeringute AS, OÜ Ahtrimaa and Arco HCE, which Arco HCE and its shareholders challenged.

Court proceedings took place throughout the year 2013. At the same time, during the first, second and third quarter, parties negotiated to refinance the loan contract or sell the immovable to one or both partners or to third parties which had placed purchase offers. The situation was revaluated according to changes in the external environment.

By the end of November 2013, we reached a satisfactory solution for the group, by which Arco Investeeringute AS sold its shareholding in Arco HCE to OÜ Ahtrimaa, the group also sold its small neighbouring immovables (land for roads) to the same buyer. Arco HCE performed its obligations to Danske Bank, the bankruptcy proceedings against Arco Investeeringute AS was terminated and the group deleted its appropriation of 1.9 million euros formed to cover the surety of Danske Bank. The cash flow of the group in exiting the Ahtri 3 project was also positive.

Arco Ehitus

Arco Ehitus OÜ was a 100% subsidiary of Arco Vara AS until 14.02.2014, when we sold its shareholding out of the group for 10 thousand euros, turning a profit. Arco Ehitus employed nearly 30 people in early 2013 and two construction contracts were in works: the construction of Paide water treatment plant and the construction of Kuusalu water and sewerage pipelines. The volume of construction works remaining (unfinished) for the start of 2013 was 3.5 million euros and new tenders were not signed and were not searched for.

By the start of 2013, over ten claims, actions or bankruptcy petitions had been filed against Arco Ehitus due to unresolved disputes of previous years to a total sum of over one million euros. Regrettably, the financially larger share of it was in bad faith or were based on arguable circumstances. In one case, a criminal matter was initiated with the petition of Arco Ehitus

in regards to a possible fraud exceeding 70 thousand euros in calculating amounts of material supplied for construction. The criminal matter has not been resolved as of the end of 2013.

The initial goal and interest of the group in regards to Arco Ehitus was to properly perform all ongoing contracts and avoid the collection of performance bonds of construction contracts from the parent company. The amount of performance bonds exceeded 1.4 million euros at the start of the year. The second goal of the group was to support the determination of substantiated claims of various debtors in Arco Ehitus and the determination and collection of debt claims by Arco Ehitus. Therein, the group had to consider that different associations of the group also had unsatisfied debt claims against Arco Ehitus. The first goal was reached completely.

The second goal was reached partially. Over the year, the group thoroughly resolved several debt disputes of Arco Ehitus, whether by paying the debt from the resources of Arco Ehitus, for Arco Ehitus or by way of buying up the debt claim, or by realising assets of an association of the group to cover the debt of Arco Ehitus. Disputes where agreement was not reached or where Arco Ehitus does not approve of the claim are in proceedings in court. One criminal matter initiated by Arco Ehitus in is progress.

As of the date of the report, the group has sold the shareholding of Arco Ehitus. An overview of the balance sheet structure of Arco Ehitus at the time of sale is provided in the stock notice of 17.02.2014. The group has no interest to continue activities in the field of environmental construction, which we have repeatedly referred to since the start of 2013. However, the group’s construction activities in realising its own developments cannot be precluded in the future.

Restoration of development activities

Cleaning the balance sheet of non-producing or damaging assets was necessary to save equity capital remaining in the group, but it was not the only goal. As Arco Vara is a real estate company with 22 years of history and a well-known trademark, restoration of development activities and future-bound, profitable business operations are even more important.

The management sees the group’s future as a developer through a complete development cycle, where (i) the first stage is selecting an idea for product and predicting demand on the market; (ii) the second stage is creating a stock of lands consisting of immovables with suitable location (a “land bank”) and constantly adding to it; (iii) obtaining construction rights (detailed plan, etc.) for a development product suitable for an immovable in the land bank pursuant to local law; (iv) designing the product and use of innovative solutions; (v) marketing; (vi) construction and (vii) sale and presale, with starting point no later than beginning of construction.

As of the start of 2013, the group had an excellent sales system in each country of operation, consisting of real estate agents of the service division, and we began a more methodical future-centric approach in selecting development products and predicting the market demand. There was no land bank that enabled immediate development activities, except for the Tivoli, Ahtri 3 and Manastirski projects, which were unsuitable for development as of the start of the year for reasons described above. The Latvian development of Bisumuiza apartments had stopped due to lack of finances. The only development activities were taking place by T53 Maja OÜ in completing the apartment building with 14 apartments at Tehnika 53, and as of the start of 2013, AS Kolde had also not sold 6 apartments in Tallinn, apartment building of Helme Street (Kodukolde project).

Started projects

The management selected the initiation or restarting of development activities at following sites as strategic priorities:

1) Riga, completion of apartment buildings at Bisumuiza 1 (14 + 14 apartments, gross sold area (GSA) over 1,900 m2) because the building’s shells had already been finished but the completion of the construction contract was stopped in the summer of 2012 due to lack of financing. Revenue received by the developer in difficulties, Arco Development SIA, upon realising half-finished house shells would have been smaller than completing them and selling as finalised product that meets the demands of the Latvian market.

   The completion contract of the next to last apartment building was concluded and construction began in February 2013. As of the end of the year, 12 apartments out of 14 were sold and the apartments are not encumbered with loan obligations of third persons. As of the date of this report, the completion of the final apartment building has also begun with the group’s own funds and the goal is to sell all apartments by the end of 2014.

   Bisumuiza’s penultimate apartment building as at 30 May 2013.

2) Obtaining the immovable in Tallinn, Paldiski mnt 70c and initiating a detailed plan for constructing at least 300 apartments with gross sold area (GSA) of nearly 27 thousand m2 from the year 2015. Consolidating the immovable from three co-owners was necessary for obtaining it.

The detailed plan was initiated by the end of 2013. As of the date of the report, the proceedings progress according to plan and local authority had approved the detail planning. The immovable's owner AS Kolde has a bank loan to 1.4 million euros due to obtaining the immovable.

3) Initiating the detailed plan in Tallinn, immovables at Liimi 1b and Lehiku tee 21, 23, which belong to the group, with the goal of starting construction on the immovables in 2016 at the latest. The immovables were obtained by OÜ Kerberon as one stage of restructuring the group. The immovable of Liimi 1b is located in Mustamäe, intended purpose is commercial land, the area is 4,847 m2 and is in co-ownership with regulated possession with third person Balti Kinnisvara Portfell. The gross leased area (GLA) of office building expected with the plan exceeds 6 thousand m2. Lehiku tee 21, 23 is located in Pirita, has the area of 5,688 m2 and in sole ownership of the group. The purpose of the land plots is residential, business and public land and expected GSA is close to 1,000 m2. As of the end of the year, the detailed plan of Liimi 1b was initiated and the detailed plan of Lehiku project was being initiated. No loan obligations have been undertaken to develop the immovables.

Manastirski stage II as at 14 November 2013

Manastirski stage II as at 9 April 2014

4) In Sofia, designing the 2nd stage of Manastirski and starting construction, for which it was necessary to restructure the assets and obligations of Arco Invest EOOD, found Arco Manastirski EOOD (see above) and return the bank loan related to Manastirski before the prescribed time. The project's volume is 145 units of apartments and business premises with gross sold area (GSA) of over 12,500 m2 above ground. The design of Manastirski 2nd stage was funded by the group with its own funds. For returning the Piraeus loan before prescribed time, Arco Vara conducted an issue of debt instrument in August 2013 to 750 thousand euros with the interest rate 14% per year. The debt instruments have the surety of mortgage set on construction rights of Manastirski 3rd stage. For complete financing of construction activities, Arco Manastirski EOOD concluded a loan agreement with UniCredit bank to up to 4.4 million euros. The surety of the loan is a mortgage on construction rights of Manastirski 2nd stage, apartments and parking spaces. Arco Manastirski EOOD concluded the construction agreement after a competition on 12.11.2013. Construction activities started on 15.11.2013 and will last for 11 months. As of the end of the year, preliminary sales of apartments exceeded 20% of area on sale and as of the date of this report, preliminary sales exceed 40% of area to be sold. The sale of apartments, business premises and parking spaces (i.e. delivery of ownership in return to final payment and delivery of possession) is planned to begin in the final quarter of 2014.

5) In Sofia, obtaining Manastirski 3rd stage in the land bank of the group without any problems so that it would be immediately suitable for continued development. Activities necessary to reach the goal are the same as for Manastirski 2nd stage and they were also successfully completed. As of the end of the year, the owner of Manastirski 3rd stage is Arco Manastirski EOOD.

As of the date of the report, the above development projects are still in progress.

Funding of developments

All above activities were funded by the group's own funds, an additional 750,000 euros were included with the issue of debt instruments of Arco Vara AS, 1.4 million euros required to obtain Paldiski road 70c with a loan from LHV and capital required for Manastirski construction with a loan from UniCredit.

The group's own funds for restarting development activities were received from two main sources:

1) Profitable sale of the market OÜ Pärnu Turg in February 2013. With the sale of the market, the group decreased its debt burden by 772 thousand euros. Although the management increased the value of the market in the balance sheet of the end of 2012, the market was sold at an even higher price than its balance sheet price and the group earned calculated profit of 98 thousand euros from the sale.

2) Sale of Hills plot in Lithuania, Vilnius, sized 6,500 m2, to subsidiary of Merko group. The management did not change the balance sheet value of Hills plot as of the end of 2012. Considering that Arco Vara has no development and sales team in Lithuania for independent realisation of the plot's potential, and considering that the final price for the deal offered after negotiations was 600 thousand euros, the result can be deemed satisfying. The sale decreased the group's loan burden by 310 thousand euros.

In the case of both sources of own funds, it must be noted that the decision to realise them enabled the group to continue its main activity and also focus geographically. The management considered the start-up of the above five developments

to be of more importance to the group as a whole than maintaining the passive real estate position of Pärnu market and Lithuania, and the supervisory board agreed with the management.

The group also realised all apartments in Helme Street and Tehnika 53 in Estonia, with gross sales revenue of 2,564 thousand euros, and returned bank loans taken to finance the construction in the total amount of 800 thousand euros. The sale of immovables owned by subsidiary of the group, Marsili II SIA, also continued in Latvia in the Baltezers-5 project. 5 plots were sold over the year, sales revenue amounted to 135 thousand euros and related bank loans were decreased by 94 thousand euros.

Passive immovables

In addition to the above, the group owns land in Estonia (Tallinn and Tartu cities, Viimsi, Saue and Harku rural municipalities) and Latvia (Riga city, Adazhi region), which did not receive significant effort and expenses for development in 2013 due to low potential for the near future of the immovables. The management assesses the condition and potential of this land on an ongoing basis and it is possible that in 2014, active effort will be put into certain immovables to change or initiate detailed plan, obtain designing conditions or exchange immovables.

Activities of the service division

In early 2013, the service division consisted of four units:

1) Arco Real Estate AS – provides real estate mediation and valuation service in Estonia;
2) Arco Real Estate SIA – provides real estate mediation and valuation service in Latvia;
3) Arco Imoti EOOD – provides real estate mediation and valuation service in Bulgaria, and
4) Arco Facility Management EOOD – which provides real estate maintenance and administration service in Sofia.

During the year, the group also started two more units:

5) Arco Vara Haldus OÜ (former T53 Maja OÜ) – provides real estate maintenance and administration service in Tallinn;
6) Arco Projects EOOD – which adopted a total of 11 apartments into use in Sofia, the Madrid Blvd building during the year and is leasing them short- and long-term.

Providing real estate services is strategically important to the group for three reasons: (i) firstly, it enables to be in intense contact with the market's expectations and the supply of the entire market, and receive a large amount of data, the abstract analysis of which allows to make better decisions for the group's development activities, and (ii) secondly, a personal sales system allows to better predict and realise the sales speed and prices of developing products, and (iii) thirdly, providing real estate agency and valuation services generates rather stable positive cash flow and increases awareness of the Arco brand on all target markets. The operation volumes and team of the service division are stably growing, which is nothing but good news.

Looking ahead

The group's goal is to maintain the role of one of the biggest residential real estate developers on its three main markets. The company primarily focuses on the real estate markets of Tallinn (400 thousand residents), Riga (700 thousand residents) and Sofia (1,250 thousand residents). Our developments are mainly directed at city residents earning average wages, who buy their new homes with the help of a bank loan. The company's 22 years of experience have proven that high-quality and low-priced residential spaces find buyers both in an economic boom as well as in deep recession. We are convinced that the 2.5 million people living in our three target markets ensure stable demand for residential real estate and the group can realise a total of at least 150 apartments per year on all markets and achieve 20% per year as long-term average rate of return for equity capital.

We believe that the structure of Arco Vara group, which merges direct analysis of the real estate market with mediation activities and real estate development, allows to react to all changes on the market quickly and efficiently and provide the best solutions for clients. In order to use this competitive edge, we are intensively investing in increased capacity of data processing since 2013. To better predict market developments, we have set the goal to map the wishes of home buyers and predict the movements of the house market and dynamics of clients' wishes as accurately as possible. As we have experience in different countries, we have the option of using best practices of each market in our markets of operations.

Strategy 2014 - 2016

The group's strategy until the year 2016 is:

1) Focusing on three residential markets: Estonia, Latvia, Bulgaria.
2) Starting a stable production cycle: obtaining land or buildings to be renovated, obtaining construction rights, designing and construction activities, and sales. The group does not obtain land for the purpose of speculations or long-term investments.
3) Focusing only on cities with a stable or increasing population. Although the total population of Estonia, Latvia and Bulgaria is decreasing due to emigration and low birth rate, the population continues to move to Tallinn (approx. 400 thousand people), Riga (approx. 700 thousand people) and Sofia (approx. 1,300 thousand people) in upcoming years.

4) Focusing on year-round need for residential space of local working-age population. I.e. investments are mostly not made in tourism, residential permit tourism, seasonal visits or products for the high-end market, because those markets are highly volatile.

5) Using the transaction and client database of the entire service division over the years and extending its area of use to the whole development cycle.

6) The development activities and supply volume of the group are based on the total number of households (homeowners) on each target market and the number of new homeseekers added to the market annually, as well as on data regarding their income. We work with the assumption that the active and solvent group of homeseekers starts from the age of 22 and ends with the age of 45. In the case of other age groups, residential space has likely already been obtained or no longer being planned, or there is no solvency.

7) Achieving cooperation with a credit institution which is interested in increasing the loan portfolio of residential spaces. One euro loaned into development should in the case of sale of the development product turn into a loan of two euros granted to the buyer for obtaining and furnishing the home.

8) Primarily focusing on average or volume developments (starting from 50 units depending on the size of market) and investment of equity capital starting from 2 million euros. In the case of volume developments, competition is scarcer and supply more stable compared to small developments where depending on the current state of real estate market, the market may be overcrowded and it is impossible to match good production and final price which is reasonable for the consumer. Labour costs per square metre of small development are also relatively bigger compared to volume development and there are fewer chances of standardisation.

9) The expected annual productivity of equity capital for each new development project must be at least 20%. For this purpose, the following must be conservatively estimated and in every possible case, tied with previous factual experience in compiling the business plan: realisation time and costs:

    a. obtaining costs of the immovable;
    b. time and costs of obtaining construction right (detailed plan, etc.);
    c. likely volume of construction rights and distribution of intended purpose;
    d. expenses and time of preparing the immovable (joining with utility networks, costs of developing infrastructure and landscaping on the immovable;
    e. time and costs of designing;
    f. construction costs and timing the construction as well as the connection of construction costs to solutions of designing;
    g. marketing period and costs;
    h. duration of sales period;
    i. ratio of the project's equity capital and foreign capital;
    j. price of foreign capital;
    k. cash flow of the project.

10) Using the competitive edge as a publicly traded company and a 22-year-old brand. More trust by the consumers allows to start preliminary sales earlier and improve the cash flows of the development project compared to a situation where the buyer only trusts to buy a finished item.

SERVICE DIVISION

In 2013, the sales revenue of the service division was 2,829 thousand euros, with 9% growth compared to the previous year. Sales revenue increased primarily in Latvia and Bulgaria where the annual increase of turnover exceeded 30%. At the same time, the turnover of the Estonian real estate agency decreased by 6%.

Revenue of real estate agencies

	2013	2012	Change, %
In thousand of euros			
Estonia	1, 444	1,539	-6%
Latvia	1, 005	770	31%
Bulgaria	380	288	32%
Total	**2, 829**	**2,597**	**9%**

The turnover growth of Latvian and Bulgarian agencies was caused both by general increased activity on the market and strongly seizing the market by increasing the number of employees.

The growth of turnover of the Latvian real estate agency, Arco Real Estate SIA, increased largely thanks to real estate investments in the Republic of Latvia. Active investments in real estate were related to the decision of Latvia to issue a residence permit to each investor of at least 71 thousand euros (in Riga, at least 142 thousand euros), which enables the applicant to use Schengen visa. The uncertainty at the end of the year regarding the continuation of this policy strongly altered investment behaviour and enabled a nearly twofold increase of turnover of mediation services. As of the end of the year, ARE SIA employs 78 people (68 of whom are real estate agents and valuators), which makes Arco Real Estate SIA the company with most employees in the group, providing 44% of all employees in the group.

The sales revenue of the Bulgarian real estate agency, Arco Imoti EOOD, increased stably throughout the year, only dipping somewhat in September and October. The annual increase in sales revenue was an impressive 32%. The number of employees has grown together with the growth of turnover, reaching 22 people as of the end of 2013, of whom 16 were real estate agents and valuators.

Despite the decrease of turnover in absolute numbers as well as relatively, the largest and most efficient service division is the Estonian real estate agency Arco Real Estate AS. As of the end of the year, Arco Real Estate AS employed 59 people (55 of those were real estate agents and valuators), forming 33% of employees in the group. Turnover per person (by only real estate agents and valuators) was 29 thousand euros.

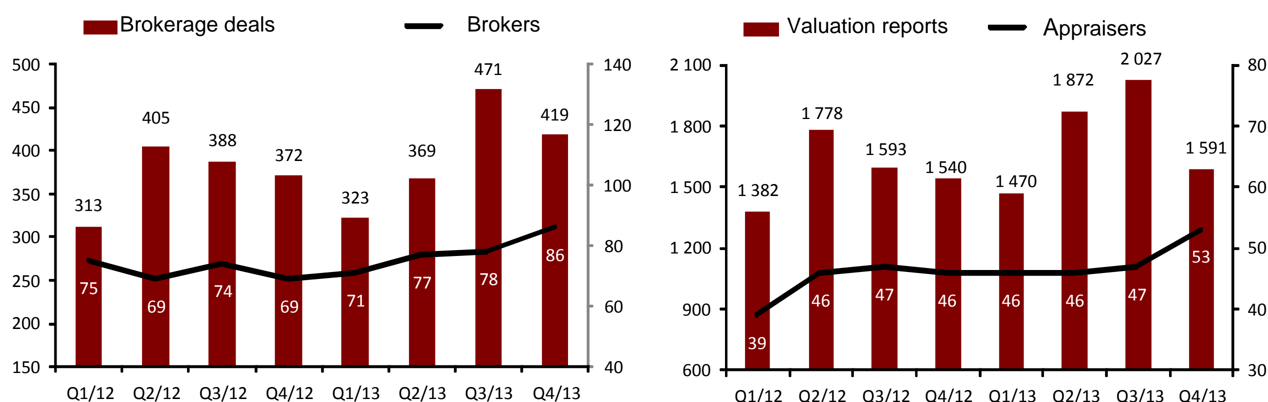
All three real estate agencies finished the year 2013 with net profit: the net profit of the Estonian agency was 156 thousand euros (in 2012: 280 thousand euros), the net profit of the Latvian agency was 81 thousand euros (in 2012: 12 thousand euros) and the net profit of the Bulgarian agency was 25 thousand euros (in 2012: 6 thousand euros). The result of the Estonian agency in 2012 was significantly affected by revaluations of assets and obligations, resulting in total profit of 148 thousand euros. Therefore, the profitability of the Estonian agency has not decreased in 2013 either.

Number of brokers and appraisers

As at 31 December	2013	2012	Change, %
Eesti	55	44	25%
Läti	68	60	13%
Bulgaara	16	11	45%
Kokku	**139**	**115**	**21%**

Revenue per employee

In 2013
In thousand of euros
29
16
28
22



In addition to mediation and valuation service, the service division also provides real estate management service (in all three countries, as well as accommodation service in Bulgaria).

In 2013, a separate real estate management company Arco Vara Haldus OÜ was founded in Estonia, formed by renaming the existing company T53 Maja OÜ in September 2013. The company's goal is to create a sufficient client base among owners of business and residential real estate and start to provide real estate management service. The company only started to provide more active management service in 2014, due to which the company had no sales revenue from management services outside of the group in 2013.

The turnover of Arco Facility Management, operating in Bulgaria, Sofia, was 108 thousand euros in 2013 (in 2012: 65 thousand euros). The company's main field of activity is providing real estate management service, so far primarily in the group's own development projects in Sofia: on Madrid Blvd and Manastirski Livadi.

Arco Projects EOOD is renting out apartments in Sofia, the Madrid office building for short- and long-term use. As of the end of the year, the company uses 4 apartments and its turnover was 24 thousand euros. The company started its operations in the summer of 2013.

DEVELOPMENT DIVISION

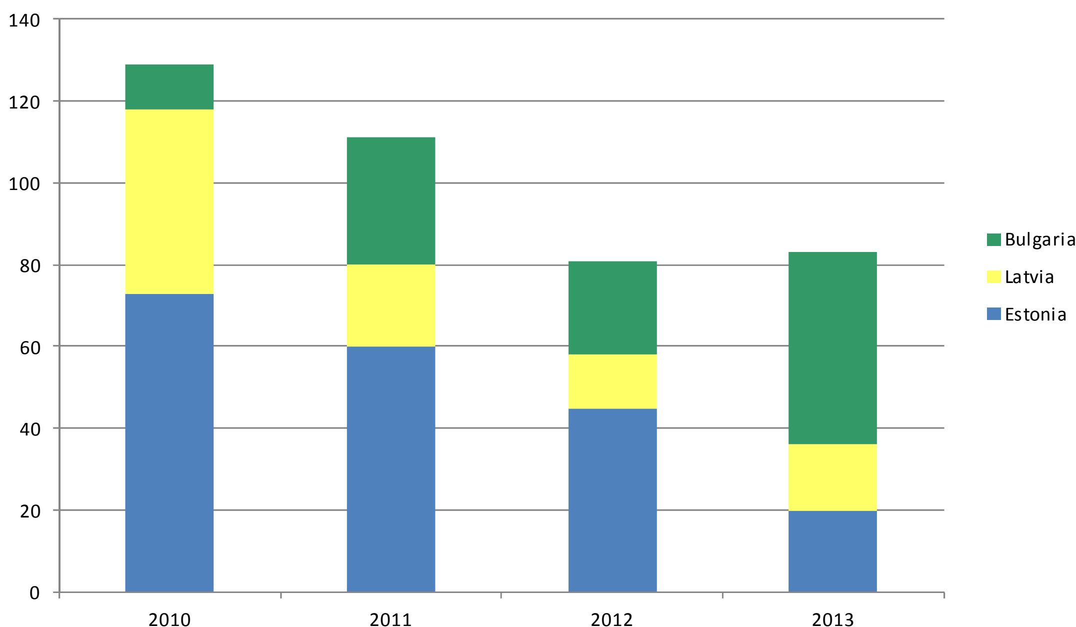
The sales revenue of the year 2013 from the sale of immovables developed by the group itself was a total of 6,937 euros in 4 countries, which is 1% less than in 2012. The year 2013 also contained leaving the Lithuanian market and realising the immovable there. The appended table gives an overview of the sale of development projects by countries.

Revenue from sale of properties (real estate)	**2013**	2012	Change, %
In thousands of euros			
Bulgaria	2,995	2,199	36%
Estonia	2,564	4,234	-39%
Latvia	778	599	30%
Lithuania	600	0	100%
Total	**6,937**	**7,032**	**-1%**

In 2013, the group sold a total of 83 apartments, plots and business premises in three countries it operates in (81 in the year 2012). The sales focus is moved from Baltic States to Bulgaria, there in 2013 were sold 47 apartments and business premises in total (23 in 2012). In Estonia, 20 immovables were sold in 2013 (45 in 2012) and in Latvia, 16 apartments and plots (13 in 2012). The appended table gives an overview of sales results of the development division by immovables in 2013.

No of properties sold	**2013**
Estonia, Tallinn	**20**
Tehnika street 53	*14*
Helme street 16, project Kodukolde	*6*
Latvia, Riga	**16**
Kometas street, project Bisumuiza-1	*11*
Baltezers-5 land plots	*5*
Bulgaria, Sofia	**47**
Madrid Blvd project	*8*
Manastirski Livadi project	*39*
Total	**83**

Total number of sold apartments, plots and business areas by location in years 2010 - 2013.



Sales speed has decreased fastest in Estonia, where 20 apartments were unsold as of the end of 2012 and by the end of 2013, those were all sold. In 2013 and 2014, new immovables suitable for residential development have been actively sought, resulting in one residential development with 30 apartments being added to the land bank.

If the planned development activities continue, the group will have a land bank in Tallinn and Harju County by the end of 2014 which allows to build approximately 350 apartments in the next few years. Presuming that the group can involve sufficient capital, the goal is to increase land bank in Estonia to build up to 500 apartments, which would ensure a stable base for continuing the development activity with apartments in the next 4 years.

The group is selling 20 residential plots in Latvia, Baltezers. The average sales speed of plots of the last three years has been 5 sold plots per year. In addition, there are 4 unsold apartments in the apartment building at Kometas 2 and 14 unsold apartments in the apartment building of Kometas 4, which is an incomplete shell, both located in Riga, Bisumuiza-1 residential area. As of the date of the financial report, finishing works are ongoing in the apartment building of Kometas 4, which will be completed in June 2014. The group has no land bank suitable for apartment construction in Latvia. The group is working towards having a land bank in Latvia that would enable the development of at least 100 apartments.

In Bulgaria, the group has a land bank in the form of Manastirski Livadi D-block, which enables to build an apartment building with approximately 70 apartments (GSA 6 thousand m2). The group's long-term goal is to create a land bank for all three countries which enables the development of at least 1,000 apartments. At present, the group has a land bank suitable for constructing about 450 apartments.

As of the end of 2013 and the financial report, 2 apartments and 34 parking spaces have not been sold in the apartment building of Manastirski Livadi C-block. Madrid complex contains 23 unsold apartments and 29 parking spaces.

As of the end of 2013, 4 people were employed in the development division.

Find out more about the projects at: www.arcorealestate.com/arendus.

SUMMARY TABLE OF ARCO VARA'S PROJECTS AS AT 31 DECEMBER 2013

Country	Passive m²	In preparation m²	Under construction m²	In stock m²	Cash flow m²	TOTAL m²
Estonia	**446,555**	**79,498**	**0**	**70,446**	**0**	**596,499**
of which building	*0*	*40,331*	*0*	*0*	*0*	*40,331*
of which land plot	*446,555*	*39,167*	*0*	*70,446*	*0*	*556,168*
Latvia	**2,450**	**110,951**	**960**	**39,888**	**0**	**154,249**
of which building	*0*	*0*	*960*	*210*	*0*	*1,170*
of which land plot	*2,450*	*110,951*	*0*	*39,678*	*0*	*153,079*
Bulgaria	**6,651**	**0**	**15,842**	**3,829**	**7,349**	**33,671**
of which building	*6,651*	*0*	*15,842*	*3,829*	*7,349*	*33,671*
of which land plot	*0*	*0*	*0*	*0*	*0*	*0*
TOTAL	**455,656**	**190,449**	**16,802**	**114,163**	**7,349**	**784,419**

Note: The development and success of the group's development projects depend largely on external factors, particularly on the adoption of plans and the issue of construction permits by the local governments and the planning authorities. Expectations of the projects' realisation may also change over time in connection with changes in the market situation and the competitive environment. Management estimates the value of the projects portfolio on an ongoing basis and is prepared to sell any project or part of a project at any time, depending on the results of the cost-benefit analysis.

Passive – development projects that have not reached the preparation or construction phase.
In preparation – development projects in the phase of market research, marketing, detailed plan process or design work. In the case of apartment development, the area presented is the gross above-ground building right.
Under construction – development projects for which financing has been obtained and which are under construction.
In stock – completed development projects, apartments or plots on sale.
Cash flow – completed development projects that generate regular cash flow.

PEOPLE

At the end of 2013, the group employed 178 people compared with 139 at the end of 2012. The number of employees includes also people providing services under authorization contracts, mostly brokers and appraisers. Employee remuneration expenses from continuing operations for 2013 totalled 2.5 million euros (2012: 2.7 million euros).

In 2013, the remuneration of the member of the management board and the members of the supervisory board of the group's parent company including social security charges amounted to 174 thousand euros. In 2012, the corresponding figure was 230 thousand euros. The management board of Arco Vara AS has one member. Since 22 October 2012, the chief executive officer/member of the management board of Arco Vara AS has been Tarmo Sild.

Similarly to previous years, in 2013 management upheld all of the group's traditions. Staff events included in a country-wide Arco Vara briefing day, corporate summer days and a Christmas party, as well as the selection of the best employees of the year.

SHARE AND SHAREHOLDERS

The Company has issued a total of 4,741,707 shares. At 31 December 2013, the Company had 1,778 shareholders (31 December 2012: 1,883) and the share price closed at 1.40 euros, 11,39% decrease from the previous year-end.

The following charts reflect movements in the price and daily turnover of the Arco Vara share in 2013.

In euros (EUR)

Changes in share price compared with the benchmark index OMX Tallinn in 2013

Index/equity	1 January 2013	31 December 2013	+/-%
OMX Tallinn	734.20	817.72	+11.38
ARC1T	EUR 1.58	EUR 1.40	-11.39

Major shareholders at 31 December 2013	No of shares	Interest %
AS Baltplast	920,000	19.4%
Gamma Holding OÜ	470,105	9.9%
HM Investeeringud OÜ	450,000	9.5%
Alarmo Kapital OÜ	374,188	7.9%
Lõhmus Holdings AS	312,378	6.6%
LHV Pensionifond L	310,000	6.5%
OÜ Rimonne Baltic	234,000	4.9%
Firebird Republics Fund LTd	205,064	4.3%
Central Securities Depository of Lithuania	140,171	3.0%
LHV Pensionifond XL	110,445	2.3%
Other shareholders	1,215,356	25.6%
Total	**4,741,707**	**100%**

Holdings of members of the management and supervisory boards at 31 December 2013	Position	No of shares	Interest, %
Toomas Tool (OÜ Baltplast)	member of the supervisory board	920,000	19.4%
Arvo Nõges (Gamma Holding OÜ)	member of the supervisory board	470,105	9.9%
Hillar-Peeter Luitsalu (HM Investeeringud OÜ, connected persons)	chairman of the supervisory board	459,377	9.7%
Tarmo Sild and Allar Niinepuu (Alarmo Kapital OÜ)	member of the management board / member of the supervisory board	374,188	7.9%
Rain Lõhmus (Lõhmus Holdings AS)	member of the supervisory board	312,378	6.6%
Stephan David Balkin	member of the supervisory board	-	-
Aivar Pilv	member of the supervisory board	-	-
Total		**2,536,048**	**53.5%**

DESCRIPTION OF THE MAIN RISKS

Credit risk

Credit risk exposure is the greatest at the Construction and Development division. Accordingly, counterparties' settlement behaviour is monitored on ongoing basis, quarantines and collaterals are also used.

Liquidity risk

The group's free funds are placed on current accounts or short-term deposits with the banks operating in Estonia, Latvia and Bulgaria. Owing to high refinancing risk, cash flow management is critical. The group's cash and cash equivalents balance is constantly smaller than the balance of loans that require refinancing in the next 12 months. At 31 December 2013, the weighted average duration of interest-bearing liabilities was only 0.3 years mainly due to stopping by the group scheduled loan principal repayments to Piraeus bank. As a result whole loan amount could become redeemable prematurely. At the end of 2013, the group's cash and cash equivalents totalled 0.8 million euros and term deposits with maturities from 3 month to 2 years totalled 0.3 million euros. Out of the above balance 0.7 million euros was under the group's own control and the rest was in accounts with restricted withdrawal opportunities (mostly accounts of designated purpose where withdrawals require the banks' consent). Liquidity and refinancing risks continue to be the most significant risks for the group.

Interest rate risk

The base currency of most of the group's loan agreements is the euro and the base interest rate is 3 or 6 month EURIBOR. As a result, the group is exposed to developments in international capital markets. At the moment, the group does not use hedging instruments to mitigate its long-term interest rate risk. In 2013, the group's interest-bearing liabilities decreased by 3.9 million euros to 14.9 million euros at 31 December 2013. In 2013, interest payments on interest-bearing liabilities totalled 1.0 million euros. Compared with 31 December 2012, the weighted average interest rate as at 31 December 2013 decreased from 6.5% to 6.0%, mainly thanks to a decrease in the interest rates negotiated on refinancing the bank loans of the group's Bulgarian development company.

Currency risk

Purchase and sales contracts are mostly signed in local currencies: euros (EUR), Latvian lats (LVL) and Bulgarian levs (BGN). Real estate sales are nominated in euros due to that company has low currency risk asset- liability structure. The group is not protected against currency devaluations. Most liquid funds are held in short-term deposits denominated in euros. Devalution risk will decrease since 2014 because Republic of Latvia transferred to euro on 1 January 2014.

Corporate governance report

The shares of Arco Vara AS were listed in the main list of the Tallinn Stock Exchange on 21 June 2007. As a listed company, Arco Vara AS (hereinafter also “Company”) observes the laws and regulations that are effective in Estonia, the rules and recommendations of the Tallinn Stock Exchange, and its own core values.

The annual report of Arco Vara AS includes its corporate governance report in which management confirms the Company’s compliance with the Corporate Governance Recommendations (‘the CGR’) of the Tallinn Stock Exchange. Any instances of non-compliance with the CGR are disclosed and explained.

This annual report has been prepared in accordance with the guidance of the CGR. The corporate governance report is a separate section of the directors’ report, which is part of the Company’s annual report.

I General meeting

The Company’s highest governing body is the general meeting of its shareholders. The powers of the general meeting and the procedure for calling general meetings and passing resolutions are set out in the Company’s articles of association.

In 2013, the Company called one annual general meeting and one extraordinary general meeting. The annual general meeting was called in accordance with § 297 subsection 2 of the Commercial Code as the annual general meeting that was called for 18 June 2013 did not have the necessary quorum stipulated § 297 subsection 1 of the Commercial Code and therefore was unable to adopt resolutions.

Annual general meeting

The annual general meeting was held on 1 July 2013 at 11 a.m. at Paadi 5 in Tallinn, in *Lääne-Euroopa* meeting room of Hotel Euroopa.

Notice of the annual general meeting was given in the information system of the Tallinn Stock Exchange and on the Company’s website on 18 June 2013. The notice was published in the national daily newspaper *Postimees* on 21 June 2013. The notice included information on where materials concerning the general meeting had been made available, where shareholders could submit their questions and a direct link to information on the agenda and relevant documents on the Company’s website. The information was published in Estonian and in English.

The proposals of the supervisory board were published in the notice of the annual general meeting. On the agenda of the annual general meeting was the following:

- approving the annual report for 2012.
- issuing a convertible bond (regarding the option deriving from the manager’s service contract)
- new principles of rewarding the Supervisory Board of Arco Vara AS
- appointment of Auditor

The following decisions were adopted at the annual general meeting:

- To approve the year 2012 annual report of Arco Vara AS and to covert the net loss for the year ended on 31 December 2012 of 18,034,755 euros to retained earnings.
- To increase the share capital of Arco Vara AS conditionally by issuing one convertible bond with the nominal value of 1,000 euros in accordance with the attached conditions of the convertible bond.
- to pay the members of the Supervisory Board 500 euros (net amount) for every participated meeting but not more that 1,000 euros (net amount) per month. To make the payment of the reward dependent on the signing of the minutes of the meetings of the Supervisory Board. Not to compensate the travel and living expenses of the members of the Supervisory Board.
- To appoint an auditor for one year (until the next annual general meeting of shareholders) and appoint AS PricewaterhouseCoopers such auditor. To pay the auditor for auditing the 2013 annual report according to an agreement to be signed between Arco Vara AS and AS PricewaterhouseCoopers.

The meeting was chaired by Hannes Vallikivi, who is neither the chairman of the Company’s supervisory board nor a member of the Company’s management board. The meeting was attended by 18 shareholders whose votes represented 77,09%% of total voting power. The meeting was conducted in Estonian and the chair of the meeting made sure it was conducted smoothly. The meeting was also attended by the member of the management board of Arco Vara AS, Tarmo Sild, who gave an overview of the company’s performance in 2012.

Extraordinary general meetings

The extraordinary general meeting was held on 5 August 2013 at 11.03 a.m. at Paadi 5 in Tallinn, in *Lääne-Euroopa* meeting room of Hotel Euroopa.

Notice of the extraordinary general meeting was given in the information system of the Tallinn Stock Exchange and on the Company’s website on 1 July 2013 and in the national daily newspaper *Postimees* on 11 July 2013. The notice included information on where materials concerning the meeting had been made available, where shareholders could submit their

questions and a direct link to information on the agenda and relevant documents on the Company's website. The information was published in Estonian and in English.

The management board made a proposal to the extraordinary general meeting, which was published in the notice of the extraordinary general meeting and was as follows:

- to elect Allar Niinepuu as member of the supervisory board of Arco Vara AS. The new member will assume its powers as of the adoption of the resolution of the general meeting.

The following decision was adopted at the general meeting:

- to elect Allar Niinepuu as the new member of the supervisory board.

The meeting was chaired by the management board member of Arco Vara AS Tarmo Sild. The meeting was attended by 18 shareholders whose votes represented 50.22% of total voting power. The meeting was conducted in Estonian and the chair of the meeting made sure it was conducted smoothly.

The resolutions and minutes of all general meetings held in 2013 as well as other relevant materials were made available on the Company's website. Information on the agenda items of all annual and extraordinary general meetings as well as questions submitted by the shareholders before the meetings and answers to those questions are available online at least until the information on the next general meeting is published on the Company's website.

II Management board

Since 4 September 2009 the management board of Arco Vara AS has had one member. Since 22 October 2012, the CEO (and only member of the management board) of Arco Vara AS is Tarmo Sild.

On assignment, three-year service contact was concluded with the member of the management board. The member of the management board is not concurrently a member of the management board or supervisory board of any other listed company.

When the member of the management board assumed office, service contract was signed which sets forth the powers, obligations and responsibilities of the member of the management board and also regulates the disbursement of his basic remuneration. Remuneration is agreed taking into account the management board member's duties and activities and the Company's current financial performance and future prospects. Under the service contract, Tarmo Sild is entitled to termination benefits equal to his five months' basic board member remuneration. The management board member has an incentive scheme that is linked to the Company's securities in connection to which the shareholders decided on the annual general meeting on 1 July 2013 to increase the share capital of Arco Vara AS conditionally by by issuing one convertible bond with the nominal value of 1,000 euros.

In 2013, the remuneration of member of the management board member Tarmo Sild (for the period 1 January 2013 to 31 December 2013) amounted to 88 thousand euros (includes social security tax). In 2013, the member of the management board was not paid any bonuses (except for the convertible bond issued according to the management board member's incentive scheme) or termination benefits.

The member of the management board has notified the Company of his interests and involvement in the governing bodies of the following companies that are not part of the group:

- Tarmo Sild – member of the management board of AS IuteCredit Europe, MFV Lootus OÜ, Aia Tänav OÜ, Alarmo Kapital OÜ and OÜ Catsus.

Holding certain ownership interests and being involved in the governing bodies of other companies does not constitute breach of the prohibition on competition. Under the service contract, the member of the management board may not breach the prohibition on competition. In addition, the Company's internal regulations provide that no member of the management board or staff may demand or accept for personal gain money or any other benefits from third parties in connection with their work and may not grant unlawful or unjustified benefits or discounts to third parties.

III Supervisory board

The supervisory board is responsible for planning and organising the operation of the Company and overseeing the activities of the management board. Members of the supervisory board of Arco Vara AS are elected by the general meeting.

Under the CGR, half of the members of the supervisory board of a listed company have to be independent. In the event of an odd number of members of the supervisory board, the number of independent members may be smaller by one.

In 2013, there were several changes in the composition of the Company's supervisory board. At the beginning of 2013, the members of the supervisory board were Richard Tomingas, Hillar-Peeter Luitsalu, Aivar Pilv, Toomas Tool, Stephan Balkin, Rain Lõhmus and Arco Nõges. On 10 June 2013 member of the supervisory board Richard Tomingas presented his notice to resign from the supervisory board. On the extraordinary general meeting on 5 August 2013 Allar Niinepuu was elected as the member of the supervisory board. Since 5 August 2013 the supervisory board consists of the following members - Hillar-Peeter Luitsalu, Aivar Pilv, Toomas Tool, Stephan David Balkin, Rain Lõhmus, Arvo Nõges ja Allar Niinepuu.

Members of the supervisory board elect the chairman of the supervisory board from among themselves. Since 21 January 2008 since 10 June 2013 the chairman of the supervisory board was Richard Tomingas. On the meeting of the supervisory board that took place on 10 June 2013 the members of the supervisory board elected Hillar-Peeter Luitsalu to be the new chairman of the supervisory board.

Until 30 June 2013 the remuneration of a member of the supervisory board was 959 euros per month (the net amount paid). The remuneration was approved by the general meeting with a resolution adopted on 17 December 2009. Members of the supervisory board are not eligible for any additional remuneration or termination benefits and the remuneration of the chairman of the supervisory board does not differ from that of other members of the supervisory board. On the general meeting on 1 July 2013 the remuneration system was changed and it was decided that in the future the members of the supervisory board are paid remuneration in the amount of 500 euros (the net amount paid) for each participated meeting but not more than 1000 euros (the net amount paid) per month. The payment of the remuneration was made dependent on the signing of the minutes of the meetings of the supervisory board. Additionally it was decided not to compensate the travel and living expenses of the members of the supervisory board.

In 2013, the supervisory board had 12 meetings. Members of the supervisory board attended the meetings as follows:

- Arvo Nõges attended 12 meetings;
- Hillar-Peeter Luitsalu attended 10 meetings;
- Richard Tomingas attended 8 meetings (while he was a member of the supervisory board in 2013 8 meetings took place);
- Rain Lõhmus ja Aivar Pilv attended 8 meetings;
- Toomas Tool attended 4 meetings;
- Stephan David Balkin attended 2 meetings;
- Allar Niinepuu attended 1 meeting (while he was a member of the supervisory board in 2013 2 meetings took place).

IV Cooperation of the management and supervisory boards

In line with the Company's articles of association and historical practice, the management and supervisory board cooperate closely. The management and supervisory board hold joint meetings for discussing matters related to the Company's strategy and exchange information about the Company's strategic development on an ongoing basis. At the meetings, the member of the management board informs the supervisory board about any deviations from the Company's plans and objectives and the reasons for those deviations. During the period under review the member of the management board attended all meetings of the supervisory board.

The members of the supervisory board do not take part in everyday management of the Company but the manager updates the supervisory board on regular basis regarding planning the operations of the Company and business activities. In addition the supervisory board is able to turn to the manager at any time with additional questions and/or inquiries. In information exchange, all parties observe the rules approved by the supervisory board for keeping and disclosing inside information, making transactions with Arco Vara AS shares and segregating the functions of the management and supervisory boards. It has become customary that at the meetings of the supervisory board the managers provides the members of the supervisory board an overview of important issues and developments related to the Company.

V Disclosure of information

Since the flotation of its shares on the Tallinn Stock Exchange, Arco Vara AS has disclosed information in accordance with the rules of the Tallinn Stock Exchange, the laws of the Republic of Estonia and the principle that all shareholders should be treated equally.

Arco Vara AS discloses information in the information system of the Tallinn Stock Exchange and on its website at www.arcorealestate.com in Estonian and in English. On the website, the information intended for shareholders is in the "Investor Relations" menu. The Company discloses on its website all facts, forecasts and estimates that are disseminated to financial analysts or other parties. Disclosed information includes inter alia information connected to the general meetings and general information about the Company. General and more specific information about the Company can be found in different menus of the corporate website. The information is logically structured and easy to find.

On the website the Company has posted its financial calendar for the period April 2012 to April 2014.

The Company's website does not include information on shareholder agreements on concerted exercise of shareholder rights because no such agreements have been concluded.

The Company has not organised presentations to investors and analysts directly before the release of a financial report and has never disclosed inside information or unreleased financial data at meetings with analysts or investors.

VI Financial reporting and auditing

The consolidated financial statements of Arco Vara AS are prepared in accordance with International Financial Reporting Standards as adopted by the European Union. Quarterly financial statements are prepared in accordance with IAS 34 Interim Financial Reporting and they are designed to be read in conjunction with the Company's most recent consolidated annual financial statements.

The consolidated financial statements of Arco Vara AS are audited. The auditor is elected and appointed once a year, at the annual general meeting. On 1 July 2013 the annual general meeting appointed AS PricewaterhouseCoopers as auditor of the Company.

For better risk assessment and management, most group entities prepare a budget for the next financial year, which is approved by the entity's supervisory board or general meeting. The group's consolidated budget is approved by the supervisory board of Arco Vara AS. Execution of and adherence to approved budgets is monitored by the Company's controller and, where necessary, additional internal audit services are purchased from qualified professionals.

To ensure high-quality financial reporting and to counteract the risks related to financial reporting, the Company has created the position of a financial controller. The financial controller participates actively in the preparation of the consolidated annual and interim reports. The consolidated financial statements are prepared using uniform group-wide cross-border financial accounting and reporting software. Consolidation procedures have largely been automated and are performed monthly. Monthly reporting is presented to the managements of relevant entities and monthly consolidated reporting is presented to the group's management.

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Consolidated financial statements

Consolidated statement of comprehensive income

	Note	**2013**	2012
In thousands of euros			
Continuing operations			
Revenue from rendering of services		3,791	3,899
Revenue from sale of real estate		6,937	7,032
Total revenue	5.7	**10,728**	**10,931**
Cost of sales	8	-7,450	-14,241
Gross profit		**3,278**	**-3,310**
Other income	9	404	889
Marketing and distribution expenses	10	-278	-267
Administrative expenses	11	-1,676	-2,467
Other expenses	9	-196	-5,430
Gain on sale of subsidiary	12	98	0
Gain/loss on transactions involving joint ventures	12	2,897	-5,272
Operating profit/loss		**4,527**	**-15,857**
Finance income	13	22	81
Finance costs	13	-994	-1,726
Profit/loss before tax		**3,555**	**-17,502**
Income tax	14	0	-251
Net profit/loss from continuing operations		**3,555**	**-17,753**
Discontinued operations			
Loss from discontinued operations	32	-128	-281
Profit/loss for the period		**3,427**	**-18,034**
attributable to owners of the parent		*3,410*	*-17,964*
attributable to non-controlling interests		*17*	*-70*
Total comprehensive income/expense for the period		**3,427**	**-18,034**
attributable to owners of the parent		*3,410*	*-17,964*
attributable to non-controlling interests		*17*	*-70*
Basic earnings per share (in euros)	15	**0.72**	**-3.79**
- of which continuing operations		0.75	-3.73
- of which discontinued operations		-0.03	-0.06
Diluted earnings per share (in euros)	15	**0.66**	**-3.79**
- of which continuing operations		0.69	-3.73
- of which discontinued operations		-0.03	-0.06

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Consolidated statement of financial position

As at 31 December	Note	2013	2012
In thousands of euros			
Cash and cash equivalents	17	818	1,775
Receivables and prepayments	18	656	3,094
Inventories	19	10,780	11,701
Assets belonging to sales group	32	847	0
Total current assets		**13,101**	**16,570**
Investments in equity-accounted investees		1	1
Receivables and prepayments	18	252	0
Investment property	20	11,331	14,097
Property, plant and equipment	21	459	540
Intangible assets		13	21
Total non-current assets		**12,056**	**14,659**
TOTAL ASSETS		**25,157**	**31,229**
Loans and borrowings	22	12,589	16,838
Payables and deferred income	23	1,746	6,645
Provisions	24	172	3,084
Liabilities belonging to sales group	32	1,488	0
Total current liabilities		**15,995**	**26,567**
Loans and borrowings	22	2,308	1,231
Payables and deferred income	23	0	64
Total non-current liabilities		**2,308**	**1,295**
TOTAL LIABILITIES		**18,303**	**27,862**
Share capital	25	3,319	3,319
Statutory capital reserve	25	2,011	2,011
Other reserves	15	60	0
Retained earnings		1,452	-1,958
Total equity attributable to owners of the parent		**6,842**	**3,372**
Equity attributable to non-controlling interests		12	-5
TOTAL EQUITY		**6,854**	**3,367**
TOTAL LIABILITIES AND EQUITY		**25,157**	**31,229**

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Consolidated statement of cash flows

	Note	**2013**	2012
In thousands of euros			
Cash receipts from customers		10,516	11,442
Cash paid to suppliers		-7,058	-6,429
Taxes paid		-1,976	-2,252
Taxes recovered		189	471
Cash paid to employees		-846	-1,030
Other cash payments and receipts related to operating activities		-218	-140
Net cash flow of discontinued operations		-317	277
NET CASH FROM OPERATING ACTIVITIES		**290**	**2,339**
Purchase of property, plant and equipment	21	-34	-24
Proceeds from sale of property, plant and equipment		118	9
Proceeds from sale of investment property		80	0
Proceeds from sale of a subsidiary	6	1,610	1,160
Acquisition of a subsidiary		0	-12
Loans provided		-48	-315
Repayment of loans provided		0	2
Placement of security deposits		-263	0
Release of security deposits		258	0
Interest received		7	14
Other payments related to investing activities		0	-90
Net cash flow of discontinued operations		-56	-6
NET CASH FROM/USED IN INVESTING ACTIVITIES		**1,672**	**738**
Proceeds from loans received	22	3,046	1,391
Settlement of loans and finance lease liabilities	22	-4,809	-3,384
Interest paid		-964	-1,478
Other payments related to financing activities		-75	-31
Net cash flow of discontinued operations		0	-9
NET CASH USED IN FINANCING ACTIVITIES		**-2,802**	**-3,511**
NET CASH FLOW		**-840**	**-434**
Cash and cash equivalents at beginning of period	17	1,775	2,209
Decrease in cash and cash equivalents		**-840**	**-434**
Decrease in cash and cash equivalents through sale of a subsidiary	6	-37	0
Cash and cash equivalents reclassified to sales group assets	32	-80	0
Cash and cash equivalents at end of period	17	818	1,775

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Consolidated statement of changes in equity

	Equity attributable to owners of the parent					Non-controlling interests	**Total equity**
	Share capital	Statutory capital reserve	Other reserves	Retained earnings	Total		
In thousands of euros							
Balance as at 31 December 2011	**3,319**	**2,011**	**0**	**16,306**	**21,636**	**-447**	**21,189**
Acquisition of non-controlling interests	0	0	0	-300	-300	512	**212**
Total comprehensive expense for the period	0	0	0	-17,964	-17,964	-70	**-18,034**
Balance as at 31 December 2012	**3,319**	**2,011**	**0**	**-1,958**	**3,372**	**-5**	**3,367**
Total comprehensive income for the period	0	0	0	3,410	3,410	17	**3,427**
Formation of equity reserve (note 15)	0	0	60	0	60	0	**60**
Balance as at 31 December 2013	**3,319**	**2,011**	**60**	**1,452**	**6,842**	**12**	**6,854**

Further information on share capital is provided in note 25.

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Notes to the consolidated financial statements

1 General information

These consolidated financial statements of Arco Vara AS and its subsidiaries as at and for the year ended 31 December 2013 were authorised for issue by the chief executive officer/member of the management board on 17 April 2013. Under the Commercial Code of the Republic of Estonia, final approval of the annual report prepared by the management board and approved by the supervisory board rests with the shareholders' general meeting. The consolidated financial statements are part of the annual report that has to be approved by the shareholders, and they serve as a basis for adopting a resolution for covering the loss. Shareholders may decide not to approve the annual report, which has been prepared by the management board and approved by the supervisory board, and may demand that a new annual report be prepared.

Arco Vara AS is a company incorporated and domiciled in Estonia whose registered office is at Jõe 2B, Tallinn, Estonia. At the end of 2013, the group employed 178 people (31 December 2012: 139 people). The core business lines of the group are described in note 5 and discontinued operations in note 32. In addition to Estonia, the group operates through its subsidiaries in Latvia, Lithuania and Bulgaria.

The structure of the group as at 31 December 2013 is presented in note 34.

2 Statement of compliance and basis of preparation

The consolidated financial statements of Arco Vara AS and its subsidiaries have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU. The consolidated financial statements have been presented and submitted for approval in conformity with the requirements of the Estonian Accounting Act and the Estonian Commercial Code.

The consolidated financial statements are presented in thousands of euros, unless indicated otherwise.

The consolidated financial statements have been prepared under the historical cost convention, unless explained otherwise in note 4 *Significant accounting policies*.

Use of accounting estimates and judgements

The preparation of consolidated financial statements in conformity with IFRS as adopted by the EU requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities, income and expenses, and the disclosure of contingent assets and contingent liabilities.

Although estimates and underlying assumptions are reviewed on an ongoing basis and they are based on historical experience and expectations of future events that are believed to be reasonable under the circumstances, actual results may differ from the estimates.

Information about management's critical judgements and estimates that have a material effect on the amounts reported in the financial statements is provided below.

Classification of real estate

Items of real estate (properties) are classified as inventories, investment properties and items of property, plant and equipment both on initial recognition and on any subsequent reclassification based on management's intentions regarding their further use. Realization of management's plans depends, among other factors, on resolutions adopted by other parties (e.g. changes in the designated purpose of the land, approval of detailed design plans, issue of construction permits, etc).

Properties which are acquired for development and subsequent sale as living environments, single residential buildings, or residential plots and properties which are acquired for resale in the ordinary course of business are classified as inventories.

Properties which are held to earn operating lease rentals or for capital appreciation and properties which are held over an extended period for an undetermined future use are classified as investment property.

Properties which are being developed for future use as commercial or business environments that will be leased out under operating leases and commercial and business properties which are being extensively reconstructed or renovated are also classified as investment properties.

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Estimation uncertainty

The estimates made by management are based on historical experience and the information that has become available by the date the financial statements are authorised for issue. There is a risk that the estimates applied at the reporting date in respect of assets and liabilities and associated income and expenses need to be revised in the future. The key sources of estimation uncertainty that have a significant risk of causing material adjustments to the consolidated financial statements are discussed below.

Measurement of loans and receivables

The group's loans and receivables include mostly trade receivables and loans provided. Loans and receivables are measured based on management's best estimates. The measurement principles applied are disclosed in note 4 *Significant accounting policies*. Changes in market conditions or the customers' financial position may cause management to significantly revise its estimates. Further information on risks that may affect the carrying value of loans and receivables is presented in note 26.

Estimation of the net realisable value of inventories

The group has a number of items of real estate (properties) that have been classified as inventories. The net realisable values of all significant properties classified as inventories were measured as at 31 December 2013 and 31 December 2012 in order to determine whether:

1) the net realisable value of any item had decreased below its carrying amount;

2) any impairments recognised in prior periods needed to be reversed.

The net realisable values of the properties were measured in the same way as the fair value of investment properties is measured, i.e. by using the following methods:

- the discounted cash flow analysis;
- comparison method;
- residual value method.

Valuation methods are described in more detail in notes 4 and 19.

Determination of the fair value of investment properties

At each reporting date, investment properties are measured at their fair values. In addition to management's estimates, where necessary, the fair value of investment properties is measured based on valuation reports issued by independent real estate appraisers. This means that in the case of significant investment properties, where necessary, parallel appraisals are commissioned from independent appraisers. In determining the fair value of its investment properties as at 31 December 2013 and 31 December 2012, the group did not request valuation reports from independent appraisers. Fair value is mainly determined by using two basic techniques - the discounted cash flow method and comparison method. Valuation methods are described in more detail in notes 4 and 20.

Determination of the stage of completion of construction contracts

The revenue and expenses associated with long-term construction contracts are recognised by reference to the stage of completion method. The stage of completion of a contract is determined as the proportion that the contract costs incurred for work performed until the reporting date bear to the estimated total contract costs. If the amount of progress billings as at the reporting date differs from the revenue determined by reference to the stage of completion method, the difference is recognised in the statement of financial position as a payable or a receivable. When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised as an expense immediately. A key input for determining the stage of completion of a contract at the reporting date is management's estimate of the contract's future contract costs and revenues. At the end of 2013, the group had finished with the activities in construction business line.

Recognition and measurement of provisions and reassessment of provisions made in previous periods

A provision is recognised in the statement of financial position when the group has a present obligation arising from a past obligating event deriving from a contract, legislation or an established pattern of the group's past practice, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation although the timing or amount of the arising liability are uncertain. The amount recognised as a provision is management's best estimate of the expenditure required to settle the obligation and the time the obligation should be settled. The best estimate of the expenditure required to settle a present obligation is the amount that the group would rationally be expected to pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. Expenses related to provisions are recognised as an expense in the period in which they arise. At each reporting date, management assesses the need for recognising additional provisions or adjusting or reversing existing provisions.

3 *Changes in accounting policies and presentation of information*

The consolidated financial statements are prepared in accordance with the principles of consistency and comparability, which means that the group consistently applies the same accounting and presentation policies. Accounting policies and presentation are changed only when this is required by new or revised International Financial Reporting Standards (IFRS)

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as adopted by the EU and their interpretations or when a new accounting policy or presentation practice represents the group's financial position, financial performance and cash flows more faithfully.

Change in presentation of information in the statement of cash flows

From 2013 the group presents its statement of cash flows using the direct method whereby major classes of gross cash receipts and gross cash payments are disclosed. Until the end of 2012, cash flows from operating activities were reported using the indirect method. Comparative information for year 2012 has been aligned with the changed presentation.

Adoption of new or revised standards and interpretations

The following new or revised standards and interpretations became effective for the group from 1 January 2013:

IFRS 13, Fair Value Measurement, effective for annual periods beginning on or after 1 January 2013. The standard aims to improve consistency and reduce complexity by providing a revised definition of fair value, and a single source of fair value measurement and disclosure requirements for use across IFRS-s. Additional information was disclosed in this annual report as a result of the standard.

New accounting pronouncements

Certain new or revised standards and interpretations have been issued that are mandatory for the group's annual periods beginning on or after 1 January 2014, and which the group has not early adopted.

IFRS 10 Consolidated financial statements replaces all of the guidance on control and consolidation in IAS 27 "Consolidated and separate financial statements" and SIC-12 "Consolidation - special purpose entities". IFRS 10 changes the definition of control so that the same criteria are applied to all entities to determine control. This definition is supported by extensive application guidance. The Group is currently assessing the impact of the standard on its financial statements.

IFRS 12, Disclosure of Interest in Other Entities, effective for annual periods beginning on or after 1 January 2014. The standard applies to entities that have an interest in a subsidiary, a joint arrangement, an associate or an unconsolidated structured entity. IFRS 12 sets out the required disclosures for entities reporting under the two new standards: IFRS 10, Consolidated financial statements, and IFRS 11, Joint arrangements, and replaces the disclosure requirements currently found in IAS 28 "Investments in associates". IFRS 12 requires entities to disclose information that helps financial statement readers to evaluate the nature, risks and financial effects associated with the entity's interests in subsidiaries, associates, joint arrangements and unconsolidated structured entities. To meet these objectives, the new standard requires disclosures in a number of areas, including (i) significant judgements and assumptions made in determining whether an entity controls, jointly controls, or significantly influences its interests in other entities, (ii) extended disclosures on share of non-controlling interests in group activities and cash flows, (iii) summarised financial information of subsidiaries with material non-controlling interests, and (iv) detailed disclosures of interests in unconsolidated structured entities. The group is assessing the impact of the standard on the financial statements.

The other new or revised standards or interpretations, which became effective in the financial year starting 1 January 2013 or are not yet effective, are not expected to have a material impact on the group

4 Significant accounting policies

Business combinations and basis of consolidation

The consolidated financial statements comprise the financial statements of Arco Vara AS and its subsidiaries, combined line by line, and the group's interests in joint ventures and associates, accounted for using the equity method. The financial statements of all group entities coincide with the calendar year. group entities use in all material respects uniform accounting policies and measurement bases. Where necessary, the accounting policies and measurement bases of group entities are adjusted for consolidation to ensure consistency with the policies adopted by the group.

A subsidiary is an entity that is controlled by the parent. Control is the power to govern the financial and operating policies of an entity under a statute or an agreement or by some other means so as to obtain benefits from its activities. Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity.

Subsidiaries are consolidated from the date the control commences until the date the control ceases.

In preparing the consolidated financial statements, all receivables, liabilities, income, expenses, cash flows and unrealised profits and losses arising from transactions between the parent and its subsidiaries are eliminated in full. Unrealised losses are eliminated only to the extent that there is no evidence of impairment.

A non-controlling interest, i.e. the portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, is separately presented in the consolidated statement of financial position (within equity) and the consolidated statement of comprehensive income.

Acquisitions of subsidiaries and interests in joint ventures are accounted for using the acquisition method whereby the assets acquired and liabilities and contingent liabilities assumed ('net assets') are recognised and measured at their acquisition-date fair values. For each business combination, the group decides whether to measure the non-controlling interests in the acquiree at either fair value or the non-controlling interests' proportionate share in the recognised amounts of the acquiree's identifiable net assets. If the aggregate of the consideration transferred, the amount of any non-controlling interest in the acquiree and the acquisition-date fair value of the group's previously held equity interest in the acquiree exceeds the group's interest in the net of the acquisition-date amounts of identifiable assets acquired and the liabilities

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assumed, the difference is recognised as goodwill. When a bargain purchase is made and the fair value of the net assets acquired exceeds the above aggregate amount, the resulting gain is recognised in profit or loss immediately. Acquisition-related costs are recognised as expenses as incurred.

Transactions with non-controlling interests (changes in the group's ownership interests in subsidiaries) that do not result in a loss of control over a subsidiary are accounted for as equity transactions. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity.

When the parent loses control of a subsidiary, it derecognises the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts and the carrying amount of any non-controlling interests in the former subsidiary. Any investment retained in the former subsidiary is subsequently accounted for as an investment in an associate or a joint venture or an investment in other financial assets, measured at its fair value at the date the control was lost. Any difference between the consideration received and the aggregate of the derecognised net assets and the investment recognised is recognised in profit or loss in the period in which it arises.

Investments in associates and 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 control exists when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control.

Investments in associates and joint ventures are accounted for using the equity method whereby the investment is initially recognised at cost, i.e. at the fair value of the consideration paid for it on acquisition, and its carrying amount is adjusted to recognise the investor's share of the profit or loss of the associate or joint venture after the date of acquisition. In preparing the consolidated financial statements, the group's share of unrealised gains and losses on transactions between the group and its associates and joint ventures are eliminated unless there is evidence of impairment.

When the group's share of losses of an associate or joint venture exceeds the carrying amount of its investment in the associate or joint venture (i.e. the investment together with any long-term loan receivables that in substance form part of the group's investment), the carrying amount of the investment is reduced to zero and additional losses are not recognised unless the group has incurred legal or constructive obligations on behalf of the associate or joint venture and at the reporting date it is evident that the associate or joint venture is unable to meet its commitments. In such cases additional losses are provided for and recognised to the extent that the group has incurred obligations on behalf of the investee.

Segment reporting

Reportable segments are identified and segment information is reported on the same principle as the group's structural units are grouped for internal accounting and reporting purposes (management accounting and budgeting). Segment reporting complies with internal reporting submitted to the group's chief operating decision maker. The group has identified the parent company's chief executive officer/member of the management board as its chief operating decision maker. The chief executive officer/member of the management board reviews the group's operating results by business line, whereby an operating segment is a component of the group that provides clearly distinguishable products or services and operates as an independent profit centre.

Segment revenue is revenue that a segment earns from sales to external customers or other segments of the group. Segment expenses are expenses resulting from the operating activities of a segment that are directly attributable to the segment, including expenses from transactions with external suppliers and other segments of the group. Segment expenses do not include finance costs and investment expenses, the group's general administrative expenses and other expenses that arise at the group level. The costs incurred at the group level are allocated to a segment only if they relate to the segment's operating activities and they can be attributed to the segment on a reasonable basis.

Unrealised profits and losses which arise within the group from transactions performed between its segments are not allocated to any segment but are reported as eliminations of inter-segment profits and losses. Unrealised profits and losses that arise from transactions between the group's head office and the segments and which can be allocated to a segment on a reasonable basis are included in the segment's operating profit.

Segment assets are assets that are employed by a segment in its operating activities and that are directly attributable to the segment. Segment assets include, for example, current assets, investment properties, property, plant and equipment and intangible assets used in a segment's operating activities. Segment assets do not include assets used for the group's general needs or which cannot be directly allocated to the segment.

Segment liabilities are liabilities that result from the operating activities of a segment and that are directly attributable to the segment. Segment liabilities include, for example, trade and other payables, accrued expenses, advances from customers, warranties provisions and other liabilities related to the segment's products and services. Segment liabilities include also loans and finance lease liabilities arisen from financing activities.

Unallocated items comprise revenue and expenses and assets and liabilities which have not been allocated to any segment under the above principles.

Foreign currency transactions

All group entities prepare their financial statements in the currency of the primary economic environment in which they operate (their functional currency), i.e. in the local currency. The functional currency of the group's parent company and Estonian subsidiaries is the euro. The presentation currency of the consolidated financial statements is the euro. Foreign

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currency is any currency other than the functional currency. A transaction in foreign currency is recorded by applying the foreign exchange rate of the European Central Bank ruling at the date of the transaction. Monetary assets (cash, cash equivalents and receivables) and monetary liabilities (loans and borrowings, payables and other monetary liabilities) denominated in foreign currency at the reporting date are retranslated to euros at the exchange rates of the European Central Bank ruling at the reporting date. Foreign exchange gains and losses are recognised in finance income and finance costs respectively in the period in which they arise. A non-monetary item denominated in foreign currency that is measured in terms of historical cost is recorded using the exchange rate of the European Central Bank ruling at the date of the original transaction. A non-monetary item denominated in foreign currency that is measured at fair value is recorded in the functional currency using the exchange rate of the European Central Bank ruling at the date the fair value was determined.

When the functional currency of a subsidiary differs from the parent's functional currency, the financial statements of the subsidiary (e.g. in Latvia, Lithuania and Bulgaria) are translated for consolidation purposes using the central exchange rate of the currency against the euro, which is why translation does not give rise to any significant exchange differences. All relevant countries, i.e. Latvia, Lithuania and Bulgaria, have pegged their currency to the euro. The Latvian lats has the widest permitted fluctuation corridor – its exchange rate may differ from the fixed central exchange rate by up to 1%.

Revenue

Revenue is measured at the fair value of the consideration received or receivable. Revenue is recognised to the extent that it is probable that the economic benefits will flow to the group and the revenue can be measured reliably.

Revenue from the sale of real estate

Sales of real estate (including real estate development projects: buildings, apartments, etc built on properties belonging to group companies) are recognised when all significant risks and rewards related to the properties have been transferred to the buyer and the group has no obligation to perform significant additional work. In general, a sale is deemed to have occurred when the real right contract (the contract by which title is transferred) has been signed. Payments made by customers before the signature of the real right contract are recognised as deferred income.

Revenue from long-term service contracts

The revenue and expenses arising from long-term service contracts (including construction contracts) are recognised using the stage of completion method. The stage of completion of a service is determined as the proportion that the costs incurred until the reporting date bear to the estimated total costs of the transaction. If the amount of progress billings as at the reporting date differs from the revenue determined by reference to the stage of completion method, the difference is recognised in the statement of financial position as a payable or a receivable.

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

Revenue from the rendering of other services

Revenue from the rendering of other services arises when the service has been rendered. Revenue from brokerage services is recognised when the brokerage transaction has been concluded. Rental income from investment properties is recognised on a straight-line basis over the lease term. Revenue from intermediation of utilities services (payments for electricity, heating, water supply, etc) is offset against the costs of purchasing those services.

Cash and cash equivalents and the statement of cash flows

Cash and cash equivalents comprise cash and short-term (with a term of up to 3 months from the date of acquisition) highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in market value. Such assets are cash, demand deposits and term deposits with a maturity of up to three months.

In the statement of cash flows, cash flows from operating activities are reported using the direct method. Cash flows from investing and financing activities are reported using the direct method, i.e. by disclosing separately gross cash receipts and gross cash payments.

Financial assets

Financial assets are classified to different categories and designated to the appropriate category upon initial recognition.

The group classifies its financial assets to the following categories:

1) loans and receivables;

When a financial asset is recognised initially, it is measured at cost, which is the fair value of the consideration given for it. Acquisition costs are any costs that are directly attributable to the acquisition of the asset, including fees and commissions paid to agents, advisers, brokers and dealers, as well as any non-recoverable levies, taxes and duties.

A regular way purchase or sale of financial assets is recognised using trade date accounting. The trade date is the date on which the group commits itself to purchase or sell a financial asset (e.g. the date on which the agreement is signed). A regular way purchase or sale is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established by regulation or convention in the marketplace concerned.

Loans and receivables

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After initial recognition, loans and receivables are measured at amortised cost using the effective interest method. The effective interest rate is found for the entire expected life of a financial asset, taking into account any premiums or discounts on acquisition and any directly attributable transaction costs.

If there is objective evidence, which indicates that an impairment loss on a financial asset carried at amortised cost has been incurred (e.g. significant financial difficulty of the debtor, default or delinquency in settlement, etc), the carrying amount of the financial asset is written down to its recoverable amount. The recoverable amount is the present value of the estimated future cash flows discounted at the asset's original effective interest rate. Impairment losses on financial assets related to operating activities are charged to administrative expenses and impairment losses on financial assets related to investing activities are charged to finance costs. Financial assets that are individually significant are assessed for impairment on an individual basis.

If a receivable that has been written down is collected or any other event occurs which reverses an impairment loss that has been recognised, the reversal is recognised by reducing the line item in the statement of comprehensive income within which the impairment loss was originally recognised.

Interest income on loans and receivables is recognised within finance income.

Inventories

The group's inventories include mostly land and buildings that have been acquired or are being developed for housing development. Finished goods and work in progress are initially recognised at their cost of conversion. The cost of conversion includes all direct and indirect production costs incurred in bringing the inventories to their present location and condition. Other inventories are initially recognised at cost. The cost of inventories includes all direct and indirect costs incurred in bringing the inventories to their present location and condition. Indirect costs that are included in the cost of items of real estate classified as inventories include borrowing costs incurred in financing the construction of the assets. Capitalisation of borrowing costs commences when borrowing costs and expenditures for development of inventories have been incurred and development activities have been undertaken. Borrowing costs are capitalised during the active development stage. Capitalisation of borrowing costs ceases when the asset is complete (usually when the building has been granted a permit of use) or its development has been suspended for an extended period.

The cost of inventories is assigned using the weighted average cost formula except that the cost of registered immovable properties and apartments treated as movable properties is assigned by specific identification of their individual costs.

In the statement of financial position, inventories are measured at the lower of cost and net realisable value. Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. Inventory write-downs to net realisable value are recognised in the cost of sales.

Investment property

Investment property is property (land or a building or both) held to earn rentals or for capital appreciation, rather than for use in the production or supply of goods or services of for administrative purposes. In addition, investment property includes properties which are held over an extended period for an undetermined future use. Properties being constructed or developed for future use as investment properties (commercial buildings) and buildings treated as movable properties (commercial buildings under reconstruction and renovation) are carried as investment properties.

An investment property is measured initially at its cost. Directly attributable transaction costs are included in the initial measurement. Transaction costs that are directly attributable to acquisition include notary's fees, stamp duties, advisors' fees and other transaction costs without which the purchase transaction could probably not have been performed. After initial recognition, investment properties are measured using the fair value model. The fair value of investment property reflects market conditions at the reporting date.

In addition to estimates made by management, the fair value of investment property is determined, where necessary, based on the valuations performed by qualified independent appraisers. This means that in the case of significant investment properties valuation reports are also commissioned, if necessary, from independent real estate appraisers. Fair value is determined using the following methods:

- Discounted cash flow analysis. The discounted cash flow method is used to determine the value of investment properties that generate stable rental income and properties whose fair value, according to management's assessment, cannot be determined reliably under the comparison method (for example, inactive property market in the location of the property being valued, absence of comparable transactions or an extensive period between a comparable transaction and the date of valuation). In order to calculate the present value of a property's future cash flows, the appraiser has to forecast the property's future rental income (including rental per 1 square metre and the occupancy rate) and operating expenses. Depending on the terms of the lease (whether and how easily the lease can be terminated by the lessee), the appraiser will base the projections on either the property's existing cash flows or the market's current average cash flows for similar properties. The present value of the future net cash flow is found by applying a discount rate which best reflects the current market assessments of the time value of money and the risks specific to the asset. The discount rate is selected based on the market's average capital structure.
- Comparison method. The comparison method is applied to properties that do not generate rental cash flow and are held for future development or capital appreciation. Under this method, the market value of a property is determined by reference to the price per square metre agreed in transactions performed with similar properties. As the transactions selected for comparison are practically never identical with the property being valued, their

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prices are adjusted to reflect differences in time, location, size and detailed design plan. Where necessary, another valuation technique is applied (e.g. the discounted cash flow analysis) if management believes that the latter can measure the fair value of the property more reliably.

- Residual value method. The method is applied to determine the value of a property that requires development or reconstruction in a situation where the comparison method cannot be applied due to the absence of a suitable basis for comparison. The method is applied on the assumption that the buyer is willing to pay for a property an amount equal to the value of the property after its development or reconstruction less its estimated development or reconstruction costs and a reasonable profit margin.
- Existence of a sales contract under the law of obligations (a presale contract). In the case of properties which at the reporting date have been sold based on a contract under the law of obligations but in respect of which the real right contract has not been signed (title has not transferred), fair value is determined by reference to the sales price of the property in the contract under the law of obligations. The sales price agreed in the contract under the law of obligations is used for determining the fair value of a property only when the group has reasonable assurance that the related real right contract will be concluded under the same terms and conditions (e.g. the buyer has made a substantial prepayment for the property by the reporting date or the real right contract is concluded after the reporting date but before the date management approves the financial statements for issue).

Gains and losses arising from changes in the fair value of investment property are recognised in profit or loss in the period in which they arise (in other income and other expenses respectively).

An investment property is derecognised on disposal or when the property is permanently withdrawn from use and no future economic benefits are expected from its disposal. Gains and losses arising from the retirement or disposal of investment property are recognised in profit or loss in the period of retirement or disposal (in other income and other expenses respectively).

Transfers to and from investment property are made when there is a change in use. From the date of transfer, an asset is accounted for using the policies applied to the class of assets to which it has been transferred. For a transfer from investment property to inventories or property, plant and equipment, the property's deemed cost for subsequent accounting is its fair value at the date of transfer.

When an item of property, plant and equipment is transferred to investment property, any positive difference between the fair value and carrying amount of the property at the date of transfer is recognised in the revaluation reserve in equity. Any negative difference is recognised as an impairment loss. When a property is transferred from inventories to investment property, any difference between fair value and carrying amount is recognised in profit or loss, within other income or other expenses as appropriate.

According to the requirements set out in IFRS 13 the fair value measurement methods are the following:

- quoted prices (unadjusted) in an active market for identical assets (Level 1);

- inputs other than quoted prices included within Level 1 that are observable for the asset, either directly or indirectly (Level 2);

- unobservable inputs for the asset (Level 3).

Fair value of the group's investment property is measured using level 3 inputs. Additional information on used estimates is presented in note 20.

Property, plant and equipment

Assets are classified as items of property, plant and equipment when their useful life extends beyond one year.

An item of property, plant and equipment is initially recognised at cost. The cost of an item of property, plant and equipment comprises its purchase price and any costs directly attributable to its acquisition. The cost of items of real estate, which are carried as items of property, plant and equipment, includes borrowing costs incurred in financing their construction. For the principles of capitalising borrowing costs, see the policy *Inventories*.

After recognition, an item of property, plant and equipment is carried at cost less any accumulated depreciation and any accumulated impairment losses.
If an item of property, plant and equipment consists of significant parts that have different useful lives, the parts are accounted for separately and assigned depreciation rates that correspond to their useful lives.

Subsequent expenditure on an item of property, plant and equipment (e.g. the costs of replacing a part of an item) is added to the carrying amount of the item, provided that it meets the following criteria: (a) it is probable that future economic benefits associated with the item will flow to the group; and (b) the cost of the item can be measured reliably. The carrying amounts of the parts that are replaced are derecognised. All other subsequent expenditures related to items of property, plant and equipment are recognised as an expense in the period in which they are incurred.

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Items of property, plant and equipment are depreciated on a straight-line basis. Each item of property, plant and equipment is assigned a depreciation rate that corresponds to its useful life. Asset classes are assigned the following annual depreciation rates:

- Buildings and structures 2–18%
- Plant and equipment 8–20%
- Vehicles 15–25%
- Other equipment and fixtures and tools 20–40%

Items of property, plant and equipment are depreciated until their residual value increases to an amount equal to their carrying amount. The residual value is the estimated amount that the group would currently obtain from the disposal of the asset if the asset were already of the age and in the condition expected at the end of its useful life.

Depreciation methods, depreciation rates and residual values are reviewed at least at each financial year-end.

The carrying amounts of items of property, plant and equipment are reviewed for impairment when there is evidence that the carrying amount of an asset may exceed its recoverable amount. Impairment testing is described in more detail below (see the policy *Impairment of property, plant and equipment and intangible assets*).

The carrying amount of an item of property, plant and equipment is derecognised on disposal or when no future economic benefits are expected from its use or disposal. Gains and losses arising from the derecognition of items of property, plant and equipment are recognised in profit or loss, within other income and other expenses respectively, in the period in which the item is derecognised.

Items of property, plant and equipment that are available for immediate sale and whose sale within the next 12 months is highly probable are reclassified to non-current assets held for sale. Non-current assets held for sale are presented separately from other assets in the statement of financial position and their depreciation is discontinued. A non-current asset held for sale is measured at the lower of its carrying amount and fair value less costs to sell.

Intangible assets

An intangible asset is recognised when it is controlled by the group, future economic benefits from the asset are expected to flow to the group and its cost can be measured reliably. Intangible assets comprise computer software that is not an integral part of the related hardware.

Intangible assets are initially measured at cost. Following initial recognition, intangible assets are measured at cost less any accumulated amortisation and any accumulated impairment losses.

The group's intangible assets comprise assets with finite useful lives only. Intangible assets with finite useful lives are amortised on a straight-line basis over their estimated useful lives (generally three to six years). Amortisation expense is recognised in profit or loss for the period, in the expense category consistent with the function of the underlying asset. The amortisation periods and amortisation methods of intangible assets with a finite useful life are reviewed at each financial year-end. Changes in the expected useful life of an asset and the pattern in which the asset's future economic benefits are expected to be consumed are accounted for as changes in accounting estimates and are applied prospectively.

Impairment of property, plant and equipment and intangible assets

The group assesses at each reporting date whether there is any indication that an item of property, plant and equipment or an intangible asset may be impaired. If any such indication exists, the asset's recoverable amount is estimated.

The recoverable amount of an asset is the higher of the fair value of the asset or its cash-generating unit less costs to sell and value in use. In measuring value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For the purpose of impairment testing, assets are grouped into the smallest identifiable groups that generate cash inflows that are largely independent of the cash inflows from other assets or asset groups (cash-generating units).

An impairment loss is recognised when the carrying amount of an asset or a cash-generating unit exceeds the recoverable amount of that asset or cash-generating unit. Impairment losses are recognised in profit or loss in the period in which they are incurred. The impairment loss for a cash-generating unit is recognised by reducing the carrying amounts of the items of property, plant and equipment or intangible assets belonging to the unit *pro rata*.

Financial liabilities

Financial liabilities (trade and other payables, loans and borrowings and accrued expenses) are initially recognised at their fair value less any transaction costs directly attributable to their acquisition. After initial recognition, financial liabilities are measured at amortised cost using the effective interest rate method.

Interest expenses on financial liabilities are recognised in finance costs on an accrual basis except that interest expenses on financing the development of assets (real estate projects carried as inventories, investment properties, and items of property, plant and equipment) are capitalised and added to the carrying amount of the asset as borrowing costs.

A financial liability is classified as current when it is due to be settled within 12 months after the reporting date or the group does not have an unconditional right to defer settlement of the liability for more than 12 months after the reporting date. Financial liabilities which are due to be settled within 12 months after reporting date are classified as current even if an

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agreement to refinance on a long-term basis is completed after the reporting date and before the financial statements are authorised for issue. When a contract is breached on or before the reporting date with the effect that the liability becomes payable on demand, the liability is also classified as current.

A financial liability is removed from the statement of financial position when it is discharged or cancelled or expires.

Employee benefits

Short-term employee benefit obligations are measured on an undiscounted basis and are expensed as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus plans if the group has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

Termination benefits are recognised as an expense when the group is demonstrably committed, without a realistic possibility of withdrawal, to a detailed formal plan to either terminate employment before the normal retirement date or to provide termination benefits as a result of an offer made to encourage voluntary redundancy. Termination benefits for voluntary redundancies are recognised as an expense when the group has made an offer of voluntary redundancy, it is probable that the offer will be accepted and the number of acceptances can be estimated reliably.

Share-based payments

The share options granted to the group's CEO/member of the management board are recognised as equity-settled consideration for services rendered to the Group. Owing to the complexity of determining the fair value of services received, the fair value of the services rendered by the CEO/member of the management board is measured by reference to the fair value of the equity instruments granted.

The cost of equity-settled share-based payment transactions is recognised as an expense with a corresponding increase in equity over the period in which the employee provided services until the date of vesting of equity instruments. At each balance sheet date, the Group recognises expenses related to share-based payments based on an estimate of the number of equity instruments expected to vest. Any change in the cumulative remuneration expense from the date of the current reporting period is recognised in profit or loss for the period.

The grant of share options is conditional on the length of the employee's employment in the group's between the grand date of the options and the end of the vesting period. Vesting conditions, other than market conditions, are not taken into account when estimating the fair value of the share options at the measurement date. Instead, vesting conditions are taken into account by adjusting the number of equity instruments included in the measurement of the transaction so that, ultimately, the amount recognised for services received as consideration for the equity instruments granted is based on the number of equity instruments that will eventually vest. Hence, on a cumulative basis, no amount is recognised for services received if the equity instruments granted do not vest because of the failure to satisfy a vesting condition, e.g. when the counterparty fails to complete a specified service period.

If the share options are exercised by the CEO/member of the management board the group will issue new share, which will be redeemed by the CEO/member of the management board for 0.7 euros per shares. The fair value of share options accumulated in equity will be transferred to retained earnings at the exercise date.

Provisions and contingent liabilities

A provision is recognised in the statement of financial position only when the group has a present legal or constructive obligation as a result of a past event, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.

Other possible commitments that may transform into obligations under certain circumstances (which have not yet occurred) are disclosed as contingent liabilities in the notes to the consolidated financial statements.

Present obligations arising from past events which according to management's judgement will not realise or cannot be measured reliably are also disclosed as contingent liabilities.

Financial guarantee contracts

A financial guarantee contract is a contract that requires the issuer of the guarantee to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the terms of a debt instrument. On initial recognition, a financial guarantee contract is measured at its fair value at the date of issue of the guarantee. After initial recognition, financial guarantee contracts are measured at the higher of: (a) the originally recognised amount less amortisation; and (b) the amount determined as described in the section on measurement of provisions.

Leases

A lease that transfers substantially all the risks and rewards incidental to ownership of the leased asset to the lessee is classified as a finance lease. All other leases are classified as operating leases.

As a lessee, the group recognises finance leases at the commencement of the lease term as assets and liabilities at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments. If the group does not obtain ownership of the leased asset by the end of the lease term, the asset is depreciated over the lease term or its estimated useful life. Lease payments are apportioned between the finance charge and the reduction of the outstanding liability. A constant periodic rate of interest is applied throughout the lease term.

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Assets subject to operating leases are recognised in the lessor's statement of financial position. Operating lease payments received and made are recognised as income and expenses respectively on a straight-line basis over the lease term.

Statutory capital reserve

According to the Estonian Commercial Code, the statutory capital reserve of a company has to amount to at least 10% of its share capital. Accordingly, the Company transfers at least 5% of its net profit for the year to the capital reserve until the required level has been achieved. The capital reserve may not be distributed as dividends but it may be used for covering accumulated losses if the latter cannot be covered with unrestricted equity, and for increasing share capital through a bonus issue.

Income tax

Income tax assets and liabilities and income tax expense and income comprise current and deferred items. Current tax is recognised as a short-term asset or liability and deferred tax is recognised as a long-term asset or liability.

Parent company and subsidiaries registered in Estonia

Under the Estonian Income Tax Act, in Estonia companies do not have to pay income tax on their earnings (profit for the year). Instead, income tax is levied on profit distributions (dividends). The amount of tax payable is calculated as 21/79 of the net amount of dividends distributed in Estonia. The income tax payable on a dividend distribution is recognised as the income tax expense of the period in which the dividends are declared.

Because of the specific nature of the taxation system, deferred income tax liabilities and assets do not arise for companies registered in Estonia. The contingent tax liability reflecting the obligation that would arise on the distribution of retained earnings as dividends is not recognised in the statement of financial position.

Latvian, Lithuanian and Bulgarian subsidiaries

In Latvia, Lithuania and Bulgaria the profit earned by companies is subject to income tax. The tax rate in Latvia and Lithuania is 15% and in Bulgaria 10% of taxable income. Taxable income is identified by adjusting profit before tax for the temporary and permanent differences permitted by the local tax laws.

In the case of foreign subsidiaries, deferred income tax assets and deferred income tax liabilities are recognised for all temporary differences between the carrying amounts and tax bases of assets and liabilities. A deferred tax asset is recognised to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilised.

Discontinued operations and sales group assets and liabilities

Sales group assets and liabilities are measured at the lower of carrying amount and fair value (less sales costs).

Investments in subsidiaries and joint ventures in the parent company's unconsolidated primary financial statements presented in accordance with the Estonian Accounting Act

The parent company's unconsolidated primary financial statements (note 35) represent supplementary information that is presented in accordance with the requirements of the Estonian Accounting Act and they do not constitute separate financial statements as defined in IAS 27.

In the parent's unconsolidated primary financial statements, investments in subsidiaries and joint ventures are measured using the cost method whereby an investment is initially recognised at cost, i.e. at the fair value of the consideration paid for it on acquisition and after initial recognition it is carried at cost less any impairment losses.

Investments are tested for impairment by measuring their recoverable amounts whenever there is any indication of impairment. Impairment losses are recognised in the statement of comprehensive income.

Dividends received and receivable from subsidiaries and joint ventures are recognised as income when the right to receive payment has been established.

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5 Segment information

The group has the following reportable segments:

Service – real estate services: real estate brokerage, valuation, management and short-term investment in real estate.

Development – real estate development: development of residential and commercial environments.

Inter-segment transactions are conducted at market prices and priced on the same basis as transactions with external counterparties. A significant proportion of inter-segment transactions is generated by the Service segment that sells real estate brokerage services to the Development segment. Unallocated items include primarily income, expenses, assets and liabilities of the group's parent.

Revenue and operating profit/loss by operating segment

Segment	Development		Service		Unallocated items		Eliminations		Consolidated	
	2013	2012	2013	2012	2013	2012	2013	2012	2013	2012
In thousands of euros										
External revenue	8,091	8,604	2,632	2,326	5	1			10,728	10,931
Annual change	*-6%*	*-62%*	*13%*	*12%*					*-2%*	*-56%*
Inter-segment revenues	17	35	197	271			-214	-306	0	0
Total revenue	**8,108**	**8,639**	**2,829**	**2,597**	**5**	**1**	**-214**	**-306**	**10,728**	**10,931**
Operating profit/loss	**5,062**	**-14,917**	**251**	**363**	**-442**	**-1,477**	**-344**	**174**	**4,527**	**-15,857**
Of which inventory write-downs and reversals of inventory write-downs, net	*299*	*-5,844*	*0*	*0*	*0*	*0*			*299*	*-5,844*
Fair value adjustments to investment property, net	*-113*	*-3,824*	*0*	*-256*	*0*	*0*			*-113*	*-4,080*
Depreciation, amortisation and impairment losses	*53*	*-344*	*-15*	*-16*	*-2*	*-2*			*36*	*-362*
Gain/loss on reassessment of other assets and liabilities	*98*	*-390*	*0*	*364*	*43*	*-79*			*141*	*-105*
Gain on sale of a subsidiary	*98*	*0*	*0*	*0*	*0*	*0*			*98*	*0*
Profit/loss from joint ventures and subsidiaries	*2,897*	*-5,272*	*0*	*0*	*0*	*0*			*2,897*	*-5,272*

Assets and liabilities by operating segment

Segment	Development		Service		Construction [1]		Parent company		Consolidated	
	31 Dec 2013	31 Dec 2012	31 Dec 2013	31 Dec 2012	31 Dec 2013	31 Dec 2012	31 Dec 2013	31 Dec 2012	31 Dec 2013	31 Dec 2012
In thousands of euros										
Assets	23,456	27,605	557	486	847	2,310	297	828	25,157	31,229
Liabilities	15,324	23,382	557	623	1,488	2,746	934	1,111	18,303	27,862

[1] - As at 31 December 2013, presented in statement of financial position as sales group assets and liabilities

External revenue by location

Segment	Development		Service		Parent company		Consolidated	
	2013	2012	2013	2012	2013	2012	2013	2012
In thousands of euros								
Estonia	2,620	4,746	1,405	1, 412	5	1	4,030	6,159
Bulgaria	4,093	3,258	253	158	-	-	4,346	3,416
Latvia	778	600	974	756	-	-	1,752	1,356
Lithuania	600	0	-	-	-	-	600	0
Total	**8,091**	**8,604**	**2,632**	**2, 326**	**5**	**1**	**10,728**	**10,931**

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Operating profit/loss of Development and Service segment by location

Segment	Development		Service	
	2013	**2012**	**2013**	**2012**
In thousands of euros				
Estonia	3,356	-6,584	145	343
Bulgaria	1,645	-7,770	24	6
Latvia	38	-561	82	14
Lithuania	23	-2	-	-
Total	**5,062**	**-14,917**	**251**	**363**

Properties (real estate) by location - Comprises properties developed for sale in the category of inventories, prepayments for inventories, investment properties, and land and buildings classified as property, plant and equipment (notes 19, 20 and 21). Properties belong to the assets of Development segment. As an exception, Estonian service segment has properties in carrying amount of 153 thousand euros as at 31 December 2013 (193 thousand euros as at 31 December 2012).

As at 31 December	**2013**	2012
In thousands of euros		
Bulgaria	16,539	18,113
Estonia	3,980	4,977
Latvia	1,959	2,486
Lithuania	0	575
Total	**22,478**	**26,151**

6 Acquisition and sale of subsidiaries

Scope of consolidation and changes in the group's ownership interests

At 31 December 2013, Arco Vara group comprised 23 consolidated entities (31 December 2012: 23). In addition, at 31 December 2013 the group had investments in one joint venture (31 December 2012: 2) and one associate (31 December 2012: 1). Joint venture is domiciled in Estonia and the associate is domiciled in Latvia.

The structure of the group is presented in note 34.

Sale of a subsidiary in 2013

On 1 March 2013, Arco Investeeringute AS divested its 100% interest in the subsidiary Pärnu Turg OÜ to Bellvory Turg OÜ. The group's sales gain on the transaction amounted to 98 thousand euros. As a result of the divestment, the group's assets decreased by 2,067 thousand euros and its loan liabilities declined by 772 thousand euros (of which 325 thousand euros was paid just before the sale). The group's annual revenue will decrease by around 300 thousand euros.

Effect of the sale of subsidiary on the group's statement of financial position	**2013**
In thousands of euros	
Decrease in cash	-37
Decrease in receivables	-30
Decrease in investment property (note 20)	-2, 000
Decrease in loan borrowings (note 22)	447
Decrease in other liabilities	108
Cash receipts from the sale	1, 610
Total effect on the group's net assets (note 12)	**98**

Increase in interests in group entities in 2012

Through a transaction finalised on 5 September 2012, the Latvian entity Arco Development SIA in which Arco Vara AS's subsidiary Arco Investeeringute AS had a 70% stake was divided into two companies - Arco Development SIA and Newcom SIA. By the transaction, Newcom SIA acquired some of the assets and liabilities that used to belong to Arco

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Development SIA. Under the division agreement, Arco Investeeringute AS became the sole owner of Arco Development SIA and the former non-controlling shareholder Viktors Savins became the sole owner of the new entity Newcom SIA. The transaction was undertaken to allow the non-controlling shareholder exit from the investment in Arco Development SIA. As a result of the division of assets, the group's stake in Ulmana Gatves Nami SIA increased from 70% to 100% and Arco Development SIA's 50% stake in the joint venture AD Saulkrasti SIA was transferred to Newcom SIA. The effect of the transaction on the group's statement of financial position is following.

Effect of increase in interest in the subsidiary on the group's statement of financial position	**2012**
EUR, thousands	
Decrease in inventories	-334
Decrease in receivables	-143
Decrease in liabilities	689
Total effect on the group's net assets	**212**

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Notes to the consolidated statement of comprehensive income

7 Revenue

	2013	2012
In thousands of euros		
Sale of real estate	6,937	7,032
Brokerage services	2,560	2,205
Rental services	1,001	1,338
Property management services	110	156
Construction services	0	106
Other revenue	120	94
Total revenue	**10,728**	**10,931**

8 Cost of sales

	2013	2012
In thousands of euros		
Cost of real estate sold	-5,620	-6,180
Personnel expenses	-1,596	-1,473
Property management costs	-407	-533
Vehicle expenses	-21	-29
Depreciation, amortisation and impairment losses	-11	-9
Construction services purchased	-3	-79
Inventory write-down and reversals of write down (note 19)	299	-5,844
Other costs	-91	-94
Total cost of sales	**-7,450**	**-14,241**

9 Other income and expenses

Other income

	2013	2012
In thousands of euros		
Income on reassessment of liabilities[1]	160	601
Gain on reversal of property, plant and equipment devaluation (note 21)	72	0
Gain on sale of investment property (note 20)	60	13
Gain on sale of property, plant and equipment	3	2
Miscellaneous income	109	273
Total other income	**404**	**889**

[1] The figure for 2012 includes income of 553 thousand euros from a forgiven loan.

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Other expenses

In thousands of euros	**2013**	2012
Loss on changes in the fair value of investment property (note 20)	-113	-4,080
Late payment interest and penalty charges	-43	-36
Write-down of receivables and prepayments[1]	-19	-587
Loss on sale and impairment of other non-current assets	-1	-7
Loss on sale of investment property	0	-712
Miscellaneous expenses	-20	-8
Total other expenses	**-196**	**-5,430**

[1] In 2012, the largest write-downs include a write-down of 283 thousand euros relating to an amount due for a company sold in 2010 and write-downs of 297 thousand euros relating to prior period prepayments.

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10 Marketing and distribution expenses

In thousands of euros	**2013**	2012
Advertising expenses	-159	-155
Personnel expenses	-54	-43
Brokerage fees	-7	-26
Market research	-13	-4
Other marketing and distribution expenses	-45	-39
Total marketing and distribution expenses	**-278**	**-267**

11 Administrative expenses

In thousands of euros	**2013**	2012
Personnel expenses	-870	-1,147
Office expenses	-434	-435
Legal and consulting fees	-246	-306
Vehicle expenses	-36	-78
Depreciation, amortisation and impairment losses	-27	-353
Impairment losses on receivables	0	-119
Other expenses	-63	-29
Total administrative expenses	**-1,676**	**-2,467**

12 Gain on transactions involving subsidiaries and joint ventures

In thousands of euros	**2013**	2012
Gain on sale of subsidiary	98	0
Provision expenses related to sureties given to joint venture obligations (notes 24 and 29)	0	-1,959
Gain on reversal of provisions related to sureties given to joint venture obligations (notes 24 and 29)	2,917	0
Allowances made to receivables from joint ventures	-20	-3,313
Total	**2,995**	**-5,272**

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13 Finance income and costs

Finance income

	2013	2012
In thousands of euros		
Interest income	22	81
Total finance income	**22**	**81**

Finance costs

	2013	2012
In thousands of euros		
Interest expense	-828	-1,428
Foreign exchange loss	-5	-8
Other finance costs	-161	-290
Total finance costs	**-994**	**-1,726**

Interest expense consists mainly of interest expense on loans taken for acquiring and building real estate projects. Interest expense on loans taken for financing development projects in progress is capitalised. In 2013, capitalised interest expenses totalled 59 thousand euros (2012: 110 thousand euros).

14 Income tax

	2013	2012
In thousands of euros		
Income tax expense from Bulgarian subsidiaries	0	-1
Change in deferred income tax expense	0	-250
Total income tax expense/income	**0**	**-251**

As at 31 December 2011, the group's Bulgarian subsidiary Arco Invest EOOD recognised a deferred income tax asset of 250 thousand euros as an item to be used against the income tax payable on the profit of subsequent years. As at 31 December 2012, the same deferred tax asset was written down.

As at 31 December 2013, the group's contingent income tax assets at its Bulgarian and Latvian subsidiaries totalled 3,453 thousand euros (31 December 2012: 3,281 thousand euros). The contingent tax assets, which are accounted for off the statement of financial position result mostly from losses incurred in 2008 to 2013. The assets can be used against the entities' future income tax liabilities.

15 Earnings per share

Basic earnings per share are calculated by dividing profit or loss attributable to ordinary equity holders of the parent by the weighted average number of ordinary shares outstanding during the period. Diluted earnings per share are calculated by taking into account the effects of all dilutive potential ordinary shares.

	2013	2012
Weighted average number of ordinary shares outstanding during the period	4,741,707	4,741,707
Number of ordinary shares potentially to be issued at the end of year	390,000	0
Net loss attributable to equity holders of the parent (in thousands of euros)	3,410	-17,964
Basic earnings per share (in euros)	**0.72**	**-3.79**
- of which continuing operations	0.75	-3.73
- of which discontinued operations	-0.03	-0.06
Diluted earnings per share (in euros)	**0.66**	**-3.79**
- of which continuing operations	0.69	-3.73
- of which discontinued operations	-0.03	-0.06

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According to the decision of the annual general shareholders' meeting of Arco Vara AS, held on 1 July 2013, one convertible bond was issued with the nominal value of 1,000 euros. The convertible bond will give to the chief executive of the group's parent company the right to subscribe up to 390,000 ordinary shares of Arco Vara AS for 0.7 euros per share during the year 2016. As at 31 December 2013, was created an equity reserve in amount of 60 thousand euros for the option associated with the bond. See also note 29.

16 Operating lease expenses

In the reporting period, the group used office premises, vehicles and office equipment under operating leases.

Operating lease expenses on	2013	2012
In thousands of euros		
Premises	141	176
Vehicles	26	67
Office equipment	22	23
Total	**189**	**266**

Future lease rentals payable under non-cancellable operating leases are as follows:

Future operating lease rentals payable As at 31 December	2013	2012
In thousands of euros		
No later than 1 year	90	128
Later than 1 year and no later than 5 years	10	396
Later than 5 years	0	179
Total	**100**	**703**

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Notes to the consolidated statement of financial position

17 Cash and cash equivalents

Cash and cash equivalents comprise cash on hand, cash in bank accounts and term deposits with a maturity of less than three months.

As at 31 December	**2013**	2012
In thousands of euros		
Cash on hand and demand deposits	818	1,764
Term deposits	0	11
Total cash and cash equivalents	**818**	**1,775**

Out of the group's year-end cash and cash equivalents balance 139 thousand euros (31 December 2012: 872 thousand euros) was in accounts with a designated purpose limited to the cash flows of specific projects (mostly receipts from customers, direct project development costs and loan and interest payments to banks).

18 Receivables and prepayments

Short-term receivables and prepayments

As at 31 December	**2013**	2012
In thousands of euros		
Trade receivables		
Receivables from customers	164	2,214
Allowance for doubtful trade receivables	-22	-463
Total trade receivables	**142**	**1,751**
Other receivables		
Loans provided	33	580
Term deposits (with maturities from 3 to 12 months)	23	19
Miscellaneous receivables	163	202
Total other receivables	**219**	**801**
Accrued income		
Interest receivable	0	230
Prepaid and recoverable taxes	127	112
Other accrued income	9	12
Total accrued income	**136**	**354**
Prepayments	**159**	**188**
Total short-term receivables and prepayments	**656**	**3,094**

Long-term receivables

As at 31 December	**2013**	2012
In thousands of euros		
Term deposits (with maturities more than 1 year)	240	0
Prepayments	12	0
Total long-term receivables and prepayments	**252**	**0**

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Allowance for doubtful trade receivables

As at 31 December	2013	2012
In thousands of euros		
Balance at beginning of year	**-463**	**-130**
Receivables considered doubtful during the year	-1	-467
Receivables considered irrecoverable during the year	442	134
Balance at end of year	**-22**	**-463**

19 Inventories

As at 31 December	2013	2012
In thousands of euros		
Properties purchased and being developed for resale	10,762	11,090
Materials and finished goods	5	92
Prepayments for inventories	13	519
Total inventories	**10,780**	**11,701**

In 2013, the group reversed prior period inventory write-downs of 302 thousand euros.

In 2013, the net realisable values of some inventories decreased below their carrying amounts and the group wrote them down by 3 thousand euros (2012: 5,844 thousand euros). See also note 8.

For information on inventories pledged as loan collateral, see note 27.

Projects under development, which are classified as inventories, have been measured using the comparison method, the residual value method and the discounted cash flow method. In 2013 and also in 2012, the value of the group's inventories was determined by internal experts. Estimates used in valuations are based on real market prices and the group's recent experience with comparable assets. As at 31 December 2013, inventories in total amount of 5,045 thousand euros did not require a write-down or reversal of write-down (2012: 2,530 thousand euros).

As at 31 December	2013	2012
In thousands of euros		
Measured using the residual value method	6,612	6,804
Measured using the comparison method	4,003	1,461
Measured using the discounted cash flow method	-	3,277
Other	165	159
Total inventories	**10,780**	**11,701**

As at 31 December 2013, the total carrying value of inventories carried at cost was 5 thousand euros (at 31 December 2012: 92 thousand euros) and total carrying value of inventories measured at net realisable value was 10,775 thousand euros (at 31 December 2012: 11 609 thousand euros).

As at 31 December 2013, the total carring value of land plots in inventories, where the group started detail planning procedures in 2013 or is planning to start active development in 2014, is 3 430 thousand euros. The estimated developmet period is up to 2 years in smaller projects and up to 9 years in Paldiski road 70C project. In Paldiski road 70C, is planned to build up to 13 apartment buildings on 5 stages following the principle: not starting constraction of new stage before buildings of previous stage are sold out.

20 Investment property

Investment properties comprise commercial buildings that have been leased out and properties that have development potential but whose future use is still uncertain.

In thousands of euros	
Balance at 31 December 2011	**21,252**
Net loss on changes in fair value (note 9)	-4,080
Reclassification from inventories	992
Reclassification from property, plant and equipment (note 21)	8
Sales	-4,075

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Balance at 31 December 2012	**14,097**
Net loss on changes in fair value (note 9)	-113
Reclassification to inventories	-630
Sales	-2,023
Balance at 31 December 2013	**11,331**

In March 2013, Arco Investeeringute AS sold its subsidiary Pärnu Turg OÜ. The assets of Pärnu Turg OÜ included an investment property at Suur-Sepa 18 in Pärnu, where the “old” Pärnu market operates. At the date of sale, the carrying amount of the investment property was 2,000 thousand euros. The group’s gain on the sale of the subsidiary amounted to 98 thousand euros. The group had cash receipts from the sale in amount of 1,610 thousand euros. See also note 6.

Out of total sales of investment property in 2012, 4,065 thousand euros (carrying amount at the date of sale) stemmed from the sale of a right of superficies (building rights) by Kerberon OÜ in February 2012. The transaction price was 3,400 thousand euros. As a result of the transaction, the group repaid a bank loan of 2,200 thousand euros and received cash of 1,140 thousand euros. Together with direct sales costs, the transaction gave rise to a loss of 712 thousand euros. See also note 9.

For information on investment properties pledged as loan collateral, see note 27.

Land plots, which are classified as investment properties, have been measured using comparison method, i.e. specialists have estimated the price for which the assets could be realised within one year by reference to prevailing market prices. Assets that generate cash flow have been measured using the discounted cash flow method. In 2013 and 2012, the values of all of the group’s investment properties were determined by internal experts.

As at 31 December 2013, investment properties with carrying values of 672 thousand euros have not required value adjustment (2012: 565 thousand euros).

As at 31 December	2013	2012
In thousands of euros		
Measured using the discounted cash flow method	10,509	10.659
Measured using comparison method	822	3,438
Total investment property	**11,331**	**14,097**

At 31 December 2013, the carrying amount of investment properties measured using the discounted cash flow method was 10,509 thousand euros (31 December 2012: 10,659 thousand euros). The discount rates applied in valuation were 8% in 2012 and 2013. In 2013, the exit yields used were 10% (2012:10.5%) on office spaces, 9.5% (2012:10%) on sales areas and 5-6% on rental apartments (the same in 2012 and 2013). Monthly rental income per m2 from commercial and office areas was 10 euros on average, the same assumption applied in valuation of year 2012 and 2013.

The sensitivity of the carrying amount of investment properties measured using the discounted cash flow method to the key valuation assumptions applied was as follows.

- A change of 1 percentage point (+/-) in the discount rate, would have reduced or increased the fair value of investment property by 102 thousand euros (2012: by 104 thousand euros).
- A change of 5% (+/-) in the forecasted net operating cash flows, would have increased or reduced the fair value of investment property by 529 thousand euros (2011: by 542 thousand euros).
- A decrease of 1% in the exit yields, would have increased the fair value of investment property by 1,304 thousand euros (2012: by 1,275 thousand euros) and an increase of 1% would reduce the fair value by 1 008 thousand euros (2012: by 993 thousand euros).

Operating leases: the group as a lessor

In 2013, the group’s rental income on investment properties amounted to 1,012 thousand euros (2012: 1,349 thousand euros), see also note 7. Direct property management expenses totalled 367 thousand euros (2012: 390 thousand euros).

Future operating lease rentals receivable under non-cancellable contracts break down as follows:

As at 31 December	2013	2012
In thousands of euros		
No later than 1 year	389	445
Later than 1 year and no later than 5 years	697	748
Later than 5 years	255	414
Total	**1,341**	**1,607**

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21 Property, plant and equipment

	Land and buildings	Plant and equipment	Other items of property, plant and equipment	Prepayments of property, plant and equipment	Total property, plant and equipment
In thousands of euros					
Carrying amount at 31 December 2011	**794**	**31**	**100**	**9**	**934**
Of which cost	*1,247*	*221*	*485*	*9*	*1,962*
Of which accumulated depreciation	*-453*	*-190*	*-385*	*0*	*-1,028*
Additions	0	8	21	-1	28
Disposals	0	-9	-11	0	-20
Write-down	-318	0	0	0	-318
Reclassification to investment property (note 20)	0	0	0	-8	-8
Depreciation for the year	-31	-17	-28	0	-76
Carrying amount at 31 December 2012	**445**	**13**	**82**	**0**	**540**
Of which cost	*926*	*195*	*413*	*0*	*1 534*
Of which accumulated depreciation	*-481*	*-182*	*-331*	*0*	*-994*
Additions	0	0	34	0	34
Disposals	0	0	-1	0	-1
Reversal of write-down	72	0	0	0	72
Depreciation for the year	-9	-5	-27	0	-41
Changes in sales group assets	-137	-8	0	0	-145
Carrying amount at 31 December 2013	**371**	**0**	**88**	**0**	**459**
Of which cost	*431*	*0*	*392*	*0*	*823*
Of which accumulated depreciation	*-60*	*0*	*-304*	*0*	*-364*

22 Loans and borrowings

Loans and borrowings comprise the following items:

	As at 31 December 2013			As at 31 December 2012		
	Total	*of which current portion*	*of which non-current portion*	**Total**	*of which current portion*	*of which non-current portion*
In thousands of euros						
Bank loans	14,121	12,576	1,545	18,032	16,824	1,208
Bonds	751	0	751	0	0	0
Finance lease liabilities	25	13	12	37	14	23
Total	**14,897**	**12,589**	**2,308**	**18,069**	**16,838**	**1,231**

At 31 December 2013, the weighted average interest rate of loans and borrowings was 6.0% (31 December 2012: 6.5%).

In 2013, the group settled loans and borrowings of 4,809 thousand euros (2012: 3,384 thousand euros) through cash transactions and raised new loans and borrowings of 3,046 thousand euros (2012: 1,391 thousand euros). In 2013, the group's loans and borrowings also decreased through non-cash transactions:

- by 447 thousand euros through the sale of Pärnu Turg OÜ (see note 6);

- by 963 thousand euros that customers who purchased real estate property paid directly to banks.

On 21 August 2013, Arco Vara AS issued bonds as targeted issue in total amount of 750 thousand euros. The bonds maturity date is 21 August 2016 and annual interest rate is 14%. See also note 29.

In June 2013, the group's subsidiary Kolde AS raised new bank loan in amount of 1 400 thousand euros, which was used to acquired land plot at Paldiski road 70c Tallinn. For additional information on aquistion see also note 29.

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Amounts, interest rates and maturity dates of loans and borrowings:

	Maturity date (month/year)	Loan amount, EUR, thousands As at 31 December		Interest rate, % As at 31 December		Type of interest rate
		2013	2012	**2013**	2012	
Bank loan, development[1]	1/2014	12,155	13,288	5.3	6.7	3M Euribor
Bank loan, acquisition of land	6/2015	1,400	-	7.9	-	6M Euribor
Bonds, development	8/2016	750	-	14,0	-	Fixed
Bank loan, acquisition of land	11/2014	217	282	4.7	4.9	6M Euribor
Bank loan, development	10/2014	184	278	6.3	6.3	6M Euribor
Bank loan, development	5/2016	145	-	5.8	-	3M Euribor
Finance leases	1/2016	25	37	3.2-3.7	3.2-3.7	3M Euribor
Bank loan, working capital	12/2015	20	-	5.8	-	3M Euribor
Covertible bond	12/2016	1	-	5.0	-	Fixed
Bank loan, development	-	-	2,255	-	6.7	3M Euribor
Bank loan, cash flow	-	-	783	-	6.7	6M Euribor
Bank loan, development	-	-	547	-	3.7	3M Euribor
Bank loan, acquisition of land	-	-	350	-	4.7	3M Euribor
Bank loan, working capital	-	-	174	-	10.0	Fixed
Bank loan, development	-	-	75	-	3.5	6M Euribor
Total		**14,897**	**18,069**			

[1] At 31 December 2013, the group was in breach of loan terms and the bank had the right to call in the entire amount early. Therefore, the whole balance is reported as a current liability. See also note 33.

The group stopped scheduled loan principal repayments to Piraeus bank in Bulgaria. As a result, whole loan amount 12 155 thousand euros could become redeemable prematurely. The group started negations with the bank to refinance the loan. See also note 33.

As regards non-cash transactions, in 2012 loans and borrowings were affected the most by repayment of a bank loan of 2,200 thousand euros in the framework of the sale of a right of superficies by the group's subsidiary Kerberon OÜ, payments of 2,957 thousand euros that customers who purchased apartments in the Kodukolde and Baltezers-5 projects made directly to the creditor, transfer of loan liabilities of 620 thousand euros in connection with purchase of the non-controlling interest in Arco Development SIA (see note 6) and waiver of a loan of 553 thousand by a creditor (see note 9). Growth in loans and borrowings in 2012 resulted mainly from financing of construction costs of 2,025 thousand euros provided by the builder of the Kodukolde project.

The Group's management estimates that carrying amounts of the group's loans and borrowings do not significantly differ from their fair value. The group's major interest bearing liabilities were raised or refinanced in 2013 and are mostly related to Euribor and therefore reflect adequately the situation of current market interest rates.

Information on the contractual maturities of the group's loans and borrowings is presented in note 26. Information on assets pledged as loan collateral is presented in note 27.

23 Payables and deferred income

Short-term payables and deferred income

As at 31 December	**2013**	2012
In thousands of euros		
Trade payables	**464**	**2,050**
Miscellaneous payables [1]	**15**	**739**
Taxes payable		
Value added tax	172	291
Corporate income tax	11	220
Personal income tax	20	33
Social security tax	41	61
Other taxes	270	91
Total taxes payable	**514**	**696**

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Accrued expenses		
Interest payable	8	91
Payables to employees	132	217
Other accrued expenses	38	29
Total accrued expenses	**178**	**337**
Deferred income		
Prepayments received on sale of real estate	575	2,080
Due to customers under long-term construction contracts	0	742
Other deferred income	0	1
Total deferred income	**575**	**2,823**
Total short-term payables and deferred income	**1,746**	**6,645**

Long-term payables

As at 31 December	2013	2012
In thousands of euros		
Retentions and deposits received	0	64
Total long-term payables	**0**	**64**

[1] Includes a debt (31 December 2012: 707 thousand euros; 31 December 2011: 674 thousand euros) for an investment property acquired in 2010. Interest on the liability accrues at 5% per year and the maturity date of the debt is in November 2013.

24 Provisions

	Warranties provisions	Other provisions related to operating activities	Total provisions
In thousands of euros			
Provisions at 31 December 2011	**246**	**959**	**1,205**
Amounts used and reversed	-157	0	-157
Additional provisions made	78	1,958	2,036
Provisions at 31 December 2012	**167**	**2,917**	**3,084**
Amounts used and reversed	-41	-2,917	-2,958
Additional provisions made	46	0	46
Provisions at 31 December 2013	**172**	**0**	**172**

Warranties provisions

The group's Bulgarian development companies have created a builder's warranty provision. At 31 December 2013, the provision amounted to 61 thousand euros (31 December 2012: 59 thousand euros).

The warranties provisions of the group's subsidiary Arco Ehitus OÜ are recognised based on management's estimates, i.e. by reference to the terms and conditions of each construction contract (whether work is performed as a general contractor or using own labour, who the subcontractors are, how complicated the project is, where the project is performed, etc). A provision amounts to up to 2% of the cost of a contract. The specific percentage applied to a contract depends on its cost. Warranties provisions are recognised for covering the costs that may be incurred during the warranty period. A warranty period lasts for two years from the delivery of work performed. While Arco Ehitus OÜ was sold after the reporting date, the warranties from construction business line are the obligation of the group. At 31 December 2013, warranties provisions from construction business line totalled 111 thousand euros (31 December 2012: 108 thousand euros).

Other provisions related to operating activities

At 31 December 2012, other provisions included:

- An amount of 1,917 thousand euros consisted of a provision made for a surety guarantee provided by the group to a bank loan taken by a joint venture. The provision amounted to 100% of the surety guarantee.

- In 2012, the group also recognised a provision for a surety guarantee provided to a loan taken by another joint venture. The maximum amount of the surety guarantee was 5,650 thousand euros. Management assessed the probability of the realisation of the surety guarantee and recognised a provision of 1,000 thousand euros.

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In 2013, the group was released from both sureties and reversed both provisions related to the sureties in full amount. See also note 29.

In the statement of comprehensive income, expenses relating to provisions made in connection with joint ventures and income earned from reversal of provisions are recognised within *Gain on transactions involving joint ventures*.

25 Share capital

As at 31 December	2013	2012
Number of issued shares fully paid up	4,741,707	4,741,707
Share capital (EUR, thousands)	3,319	3,319
Statutory capital reserve (EUR, thousands)	2,011	2,011

The articles of association have to set out the size of a company's share capital or the minimum and maximum amount of its capital. In accordance with its articles of association, the Company's minimum and maximum authorised share capital amount to 2,500 thousand euros and 10,000 thousand euros respectively. The Company has issued registered ordinary shares of one class. The par value of a share is 70 cents and each share carries one vote. A share provides the holder with the right to participate in the Company's general meetings, the allocation of the Company's profit, and the distribution of remaining assets on the dissolution of the Company as well as with other rights provided by law and the Company's articles of association.

Under the Commercial Code of the Republic of Estonia, every year a limited company has to transfer to the capital reserve at least 5% of its profit for the year until the capital reserve amounts to at least 10% of its share capital. The statutory capital reserve of the group's parent is in compliance with the regulatory requirement, amounting to 61% of share capital.

26 Financial instruments and financial risk management

The group's activities expose it to various financial risks: credit risk, liquidity risk and market risk.

The group's overall risk management programme is based on the assumption that the financial markets are unpredictable and appropriate measures have to be adopted to minimise potential adverse impacts on the group's financial activities. The group may use derivative financial instruments to hedge certain risk exposures.

The group's risk management process is based on the premise that the group's success depends on constant monitoring, accurate assessment and effective management of risks. Centralised financial risk management is the responsibility of the group's financial team. The main objective of financial risk management is to prevent any damage or financial loss that could jeopardise the group's equity and ability to continue operating as a going concern. The group designs and implements risk management policies and activities that are aimed at identifying and evaluating risks and spreading risks across time, activities and geographical areas. Risk management policies and activities are implemented by the managers of group entities.

In managing its financial risks, the group's main focus is on monitoring the risk exposures of the Development segment because a significant proportion of the group's liquidity and interest rate risks are concentrated in one segment, the Development segment, and in two geographical areas, Estonia and Bulgaria.

Credit risk

Credit risk is the risk that the counterparty to a financial instrument will cause a financial loss to the group by failing to discharge an obligation. The group's credit risk exposures result from cash placed in bank deposits and trade and other receivables.

The group's cash and cash equivalents are held at different banks which reduces credit risk associated with deposits. Fitch long-term credit rating vary between A+ to B- on four banks, there more than 95% out of all the group's cash are deposited. At 31 December 2013, 64% of the goup's cash and cash equivalents were held at one banking group: Swedbank AB, which has Fitch long-term credit rating of A+. For further information on cash and cash equivalents, see note 17.

Credit risk is managed mainly by making sure that there are no major concentrations of credit risk. Group entities prevent and minimize credit risk by monitoring and managing customers' settlement behaviour daily so that appropriate measures could be applied on a timely basis. In addition, sales and construction activities are partly financed with customer prepayments and in real estate transactions, where the counterparty is often financed by a credit institution, the group cooperates with banks. Consequently, the group considers the total risk arising from customer insolvency to be, in all material respects, mitigated.

Allowances are made for potential losses. Potential losses are estimated based on historical experience, the counterparty's ability to meet existing obligations in the short term, and developments in the economic environment.

Group entities perform transactions only with counterparties who are considered creditworthy. As a rule, a prepayment is demanded. Credit is granted against additional collateral. Accordingly, management believes that the need for additional mitigation of credit risk is minimal.

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Other financial assets, trade and other receivables, are also exposed to credit risk. The group has receivables that are past due but have not been provided for. Management has estimated the value of such receivables on an individual basis and has determined that the items are recoverable. The total amount of financial assets exposed to credit risk as at 31 December 2013 is 1,431 thousand euros (31 December 2012: 4,557 thousand euros).

Financial assets by maturity as at 31 December 2013

By maturity	< 3 month	3-12 month	1-2 years	Total
In thousand of euros				
Cash and cash equivalents (note 17)	818	0	0	818
Term deposits (note 18)	5	18	240	263
Trade and other receivables (note 18)	338	0	12	350
Total	**1,161**	**18**	**252**	**1,431**

Liquidity risk

Liquidity risk is the risk that a potential change in its financial position will cause the group to encounter difficulty in meeting its financial liabilities in a due and timely manner, or that the group will be unable to realise its assets at market price and within the desired timeframe. Above all, the group's liquidity is affected by the following factors:

- group entities' ability to generate independent positive net operating cash flows and the volatility of those cash flows;
- mismatch in the maturities of assets and liabilities and flexibility in changing them;
- marketability of long-term assets;
- volume and pace of real estate development activities;
- financing structure.

Short-term liquidity management is based mainly on group entities' continuously monitored monthly cash flow forecasts. The purpose of short-term liquidity management is to guarantee the availability of a sufficient amount of highly liquid funds (i.e. cash and cash equivalents and highly liquid investments in financial instruments). The main tool for short-term liquidity management both in Estonia and at group entities outside Estonia is intra-group borrowing from the parent company.

Long-term liquidity is primarily influenced by investment decisions. The group observes the principle that group entities' total net cash inflow from operating and investing activities has to cover the group's total cash outflows from financing activities. Accordingly, the purpose of long-term liquidity management is to ensure sufficient liquidity of the real estate portfolio (investment properties portfolio), to match the timing of cash flows from investing and financing activities, and to use the optimal financing structure. Long-term projects are monitored to ensure that the timing and amounts of investing cash flows do not differ significantly from the timing and amounts of financing cash flows.

Maturity structure of financial liabilities

	As at 31 December 2013			
By maturity	< 3 months	3-12 months	1-5 years	Total
In thousands of euros				
Interest-bearing liabilities	12,195	393	2,309	14,897
Interest payable	228	780	662	1,670
Other financial liabilities	657	0	0	657
Total	**13,080**	**1,173**	**2,971**	**17,224**

	As at 31 December 2012			
By maturity	< 3 months	3-12 months	1-5 years	Total
In thousands of euros				
Interest-bearing liabilities	16,651	818	940	18,700
Interest payable	285	830	1,361	2,476
ther financial liabilities	2,388	68	0	2,456
Total	**19,324**	**1,716**	**2,592**	**23,632**

Based on the maturities of liabilities included in the group's loan portfolio, at 31 December 2013 the average weighted maturity of the group's loans and borrowings was 0.3 years (31 December 2012: 2.0 years). At 31 December 2012, the figure has been determined taking into account the amendments to the loan agreements agreed after the reporting date.

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Refinancing risk is managed by monitoring the liquidity position on a daily basis, analysing different financing options on an ongoing basis and involving partner banks from different countries already in the initial stage of the process.

Market risk

Interest rate risk

Interest rate risk is the risk that a rise in market interest rates will increase interest expense to an extent that will have a significant impact on the group's performance. The group's exposure to interest rate risk results from:

- use of loans and borrowings with a floating interest rate;
- refinancing liabilities on the arrival of their due dates; and
- raising new loans for realising an investment plan in a situation where the volatility of financial markets is increasing and the economic environment is changing.

The group's long-term loans and borrowings are mostly linked to 3-month or 6-month Euribor. Therefore, the group is exposed to developments in the international financial markets. Interest rate risk is managed, among other things, by monitoring movements in the money market interest rate curve, which reflects the market participants' expectations of market interest rates and allows estimating a trend for euro-denominated interest rates. In 2013, Euribor interest rates have not changed significantly.

The sensitivity analysis of the group's profit before tax, which was conducted based on the balance of loans and borrowings as at 31 December 2013, indicated that a 1 percentage point change (increase or decrease) in interest rates would have affected (increased or reduced) profit before tax by 149 thousand euros (2012: 181 thousand euros).

In managing its short-term interest rate risks, the group regularly compares potential losses from changes in interest rates against corresponding risk hedging expenses. To date, no financial instruments have been used to hedge short-term interest rate risks because according to management's assessment hedging expenses would exceed the losses that might be incurred from changes in interest rates.

The interest rate of liabilities with a fixed interest rate does not differ significantly from the current market interest rates.

Currency risk

Because the only significant currency for the group beside euro, Bulgarian lev, is pegged to the euro, the main currency risk is the risk of devaluation of Bulgarian lev. Currency risk from Latvia will be ceased since the beginning of 2014, because Latvian Republic introduced euro as its official currency. Currency risk is mitigated also by conducting most of transactions and signing all major agreements, including loan contracts in euros. In view of the abovementioned facts the group's management considers currency risk to be insignificant.

Capital management

The Commercial Code of the Republic of Estonia sets forth the following requirements to the share capital of companies registered in Estonia:

• the minimum share capital of a limited company defined as *aktsiaselts* has to amount to at least 25 thousand euros;

• the net assets of a limited company defined as *aktsiaselts* have to amount to at least half of its share capital but no less than 25 thousand euros.

The size of the share capital or the minimum and maximum capital of a limited company have to be set out in the company's articles of association whereby minimum capital has to amount to at least one quarter of maximum capital. According to the effective articles of association of Arco Vara AS, the Company's share capital consists of 4,741,707 ordinary shares that have been fully paid for and without changing the articles of association share capital may be increased or reduced within the range of 2,500 thousand to 10,000 thousand euros. As at 31 December 2013, the share capital of Arco Vara AS was 3,319 thousand euros and net assets were 6,854 thousand euros. Thus, the Company's share capital and net assets (equity) were in accordance with the regulatory requirements of the Republic of Estonia.

In addition to meeting regulatory requirements, the net assets of some of the group's subsidiaries have to meet the loan covenants agreed with credit institutions. These refer to legal requirements to the capital of a company and are limited to the obligation of obtaining the credit institution's written consent for changing the debtor's capital. Group entities are not in breach of any covenants imposed by credit institutions.

The total capital of Arco Vara AS is the sum of its short- and long-term interest-bearing liabilities and equity less cash and cash equivalents. At 31 December 2013, total capital amounted to 20,933 thousand euros (31 December 2012: 19,661 thousand euros).

The guiding principle in capital management is to safeguard the Company's reliability and sustainable development.

The group finances its operations with both debt and equity capital. Property development is very capital intensive. Therefore, related investment projects are financed on the assumption that, as a rule, equity financing should amount to at least 20-30% of the total cost of the investment.

In designing the optimal financing structure and identifying and evaluating risks, the group monitors its equity to assets ratio. At 31 December 2013, equity accounted for 27.2% (31 December 2012: 10.8%) of total assets.

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Other information

27 Assets pledged as collateral

The group has secured its loans and borrowings by putting up the following collateral:

As at 31 December	2013	2012
In thousands of euros		
Cash and cash equivalents	160	872
Receivables	149	235
Properties (real estate) recognised as inventories	9,243	10,378
Investment property	11,291	13,272
Property, plant and equipment	343	427
Total carrying value of assets pledged as collateral	**21,186**	**25,184**

Share pledges

Arco Investeeringute AS, a wholly-owned subsidiary of Arco Vara AS, has pledged its 100% interest in the subsidiary Arco Invest EOOD to Piraeus Bank. The shares have been pledged to secure investment loans of 12,155 thousand euros.

28 Contingent liabilities

Contingent income tax liability

As at 31 December 2013, the group's retained earnings amounted to 1,452 thousand euros. Income tax of 21/79 of net dividend paid is imposed on the profit distributed as dividends. Upon the payment of all retained earnings, income tax liability would be 305 thousand euros and the amount to be paid out to shareholders would total 1,147 thousand euros. Income tax liability could be decreased by income tax amount paid on distributing profit in subsidiaries and joint ventures.

Contingent liabilities related to the tax authorities

Tax authorities have the right to review the Group's tax records for up to 5 years after submitting the tax declaration and upon finding errors, impose additional taxes, interest and fines. The tax authorities have performed tax audits in 2009-2013 only some of the group companies. The management of the group's parent company believes that there are not any circumstances which may lead the tax authorities to impose significant additional taxes on the group companies.

29 Related party disclosures

The group has conducted transactions or has balances with the following related parties:

1) **the group's joint ventures and associates**;
2) **companies under the control of the chief executive officer and the members of the supervisory board of Arco Vara AS that have a significant interest in the group's parent company**;
3) **Other related parties** – companies under the control of the chief executive officer and members of the supervisory board of Arco Vara AS (excluding companies that have a significant interest in the group's parent company)..

Transactions with related parties

	2013	2012
In thousands of euros		
Joint ventures and associate		
Revenue	1	2
Provision of loans	48	314
Conversion of receivables	0	959

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Companies that have significant impact on the group's parent company		
Inventories purchased [1]	1 102	0
Services purchased	28	0
Bonds issued	500	0
Paid interest	25	0
Other related parties		
Services sold	0	95
Inventories purchased [1]	1 102	0
Services purchased	27	248
Settlement of other liabilities	0	309
Prepayments made	0	62
Repayment of loans provided	0	633
Receipt of loans	0	207
Repayment of loans received	0	52
Bonds issued	251	0
Paid interest	13	0

Balances with related parties

As at 31 December	**2013**	2012
In thousands of euros		
Joint ventures and associate		
Short-term loan receivables	33	5
Short-term interest receivables	1	0
Companies that have significant impact on the group's parent company		
Trade receivables	0	4
Short-term loan receivables[1]	0	376
Short-term interest receivables[1]	0	136
Trade payables	3	0
Bonds issued	500	0
Other related parties		
Short-term loan receivables[1]	0	175
Short-term interest receivables[1]	0	93
Other short-term receivables[1]	0	7
Trade payables	7	3
Bonds issued	251	0

[1] The group's receivables to companies controlled by members of the supervisory board of Arco Vara AS of 804 thousand euros in aggregate were offset against part of the purchase cost (total of 2,204 thousand euros) of a property at Paldiski mnt 70c in Tallinn, acquired by the group from the same companies.

In June 2013, the group's partner in joint venture company Tivoli Arendus OÜ purchased the properties belonging to Tivoli Arendus OÜ at a public auction. Through the transaction, Arco Vara AS disposed of the surety guarantee it had provided to the loan commitments of Tivoli Arendus OÜ and, thus, the group could reverse a provision of 1,000 thousand euros that had been recognised in 2012.

In November 2013, the group sold its 50% share in joint venture company Arco HCE OÜ. As a result of transaction, the group disclaimed all its receivables to Arco HCE OÜ (loss from allowance of loan claims in amount of 20 thousand euros) and was released from bank loan surety obligation (gain from reversal of provision in amount of 1,917 thousand euros). See also notes 12 and 30.

On 21 August 2013, Arco Vara AS issued bonds as targeted issue in total amount of 750 thousand euros. The bonds maturity date is 21 August 2016 and annual interest rate is 14%. Whole issue was subscribed by key management

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personnel and by the companies that have a significant interest in the group's parent company. The issued bonds are guaranteed with mortgage on property in Sofia that belongs to the subsidiary of Arco Vara AS.

In 2013, the remuneration provided to the group's key management personnel, i.e. the chief executive/member of the management board and the members of the supervisory board of the group's parent company, including social security charges, amounted to 174 thousand euros (in 2012: 230 thousand euros). The remuneration provided to the chief executive/member of the management board is based on his service contract. The termination benefits agreed with Tarmo Sild, who was appointed chief executive officer/member of the management board of Arco Vara AS in October 2012, amount to up to five months' basic board member remuneration. The basis for the remuneration provided to the members of the supervisory board was changed since July 2013. According to the resolution of the general meeting of Arco Vara AS, the members of the supervisory board will get paid 500 euros (net amount) for every participated meeting but not more that 1,000 euros (net amount) per month. The payment of the remuneration is made dependent on the signing of the minutes of the meetings of the supervisory board. The group's key management personnel was not provided or paid any other remuneration or benefits (bonuses, termination benefits, etc) in 2013.

In favor of chief executive/member of management board is issued convertible bond, which gives him the right to subscribe up to 390 thousand ordinary shares of Arco Vara AS for 0.7 euros per share during the year 2016. See also note 15.

30 Joint ventures

As at 31 December 2012, the group had interests in one joint venture, Tivoli Arendus OÜ. As at 31 December 2012, the group had also investment in another joint venture company Arco HCE OÜ.

On 29 November 2013, Arco Investeeringute AS sold its 50% share in the joint venture Arco HCE OÜ to Ahtrimaa OÜ, the other 50% shareholder of the joint venture. In the framework of the transaction the credit relations related to Ahtri 3 were restructured and all court disputes between Danske bank on the one hand and Arco HCE OÜ, Arco Investeeringute AS and Ahtrimaa OÜ on the other hand became settled. The group has no more rights or obligations related to Arco HCE OÜ or Ahtri 3 land plot. As a result of the transaction the group reversed provision in amount of 1,917 thousand euros that was created in previous years to cover the possible obligations arising from the surety to Danske bank.

In 2012, the following changes took place in joint ventures of the group.

On 27 April 2012, Arco Investeeringute AS sold its 49.4% stake in the joint venture Bišumuižas Nami SIA for 2 euros to the venture partner SIA Linstow Baltic. Through the transaction, the group disposed of its interest in Bišumuižas Nami SIA and SIA Linstow Baltic became the sole shareholder of the entity. The transaction had no significant effect on the group's financial position and financial performance. However, by divesting the interest the group disposed of a potential obligation to support the joint venture in the development of apartment buildings and in servicing loan liabilities. As a result of the transaction, the group's interest in Bišumuižas Nami SIA's subsidiary Sportings Riga SIA also decreased from 49.4% to nil.

Through a transaction finalised on 5 September 2012 by which the group increased its stake in the subsidiary Arco Development SIA, Arco Development SIA divested its 50% interest in the joint venture AD Saulkrasti SIA.

Assets and liabilities of joint ventures

As at 31 December	**2013**		**2012**	
In thousands of euros	Assets	Liabilities	Assets	Liabilities
Arco HCE OÜ	-	-	12,062	12,330
Tivoli Arendus OÜ	390	3,761	10,630	10,944
Total	**390**	**3,761**	**22,692**	**23,274**

Income and expenses of joint ventures

	2013		**2012**	
EUR, thousands	Income	Expenses	Income	Expenses
Arco HCE OÜ[1]	21	67	23	689
Bišumuižas Nami SIA (together with Sportings Riga SIA)[1]	-	-	0	110
AD Saulkrasti SIA[1]	-	-	0	30
Tivoli Arendus OÜ	7,800	8,717	0	110
Total	**7,821**	**8,784**	**23**	**939**

[1] Income and expenses have been recognised until the date of sale of the joint venture.

Information on group's transactions and balances with joint ventures is provided in note 29.

31 Events after the reporting date

On 14 February 2014, Arco Vara AS divested its 100% share in Arco Ehitus OÜ to the company Stratcorp OÜ. The sale price of the share included two parts:

- 10 thousand euros paid on transfer of the share;

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- 30% out of the amount, that Arco Ehitus OÜ will gain from actions brought by Arco Ehitus OÜ through Ministry of Education and Research and OÜ Loksa Haljastus. Income tax is deducted from proceeds.

The group's gain on the transaction amounted to 652 thousand euros not considering the impact of sale price. As a result of the divestment, the group's liabilities decreased by 1,020 thousand euros and its assets declined by 368 thousand euros.

Effect of subsidiary's sale on the group's statement of financial position	
In thousand of euros	
Decrease in cash	-18
Decrease in receivables	-300
Decrease in inventory and property, plant and equipment	-50
Decrease in liabilities and prepayments collected	1 020
Total effect on the group's net assets	**652**

32 Discontinued operations

In February 2014, with the divestment of Arco Ehitus OÜ, the group completed the exit from construction activities. That was one of the targets for the group during 2013. Therefore, construction business line income and expenses are presented as discontinued operations, and construction business line assets and liabilities are presented as sales group assets and liabilities. The sales group assets and liabilities are measured at carrying values. The group management estimates that the carrying values do not differ much from fair value of those assets and liabilities.

Components of net loss from discontinued operations	**2013**	2012
In thousands of euros		
Revenue	3,497	9,801
Cost of goods sold and services provided	-3,299	-9,319
Administrative expenses	-329	-942
Other income and expenses	3	179
Net loss from discontinued operations	**-128**	**-281**
Earnings per share from discontinued operations (in euros)	**-0.03**	**-0.06**

Sales group assets and liabilities	
As at 31 December	**2013**
In thousands of euros	
Cash and cash equivalents	80
Receivables and prepayments	717
Inventories	44
Property, plant and equipment and intangible assets	6
Total sales group assets	**847**
Liabilities and prepayments	1,488
Total sales group liabilities	**1,488**

33 Negative working capital and going concern of the group's significant subsidiary

As at 31 December 2013, the group's current liabilities exceeded its current assets by 2,894 thousand euros. At the reporting date, a major proportion of current liabilities was made up of the loan liability of the group's Bulgarian subsidiary Arco Invest EOOD that amounted to 12,155 thousand euros. The whole loan amount is classified as current liablitiy because since December 2013 the company has not made any scheduled loan settlements and under the terms of the loan agreements the bank had the right to call in the entire loan amount early. As at 31 December 2013, total external assets (intra-group balances exluded) of Arco Invest EOOD amounted to 13,510 thousand euros, of which 13,185 thousand euros was the total amount of inventories and investment property pledged to secure the loan. Beside the loan obligation, other external liabilities of Arco Invest EOOD amounted to 983 thousand euros.

The described situation may refer to the possibility that at the reporting date there were material uncertainties related to conditions that may cast significant doubt that the group's significant subsidiary Arco Invest EOOD is able to realise its assets and meet its liabilities in the ordinary course of business. Total scope of the net risk equals to external net assets of Arco Invest EOOD in amount of 372 thousand euros. Other assets of the group are not endangered by the loans of Arco Invest EOOD.

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At the release date of this report, the group had negotiations under the way with the bank for restructuring the loan of Arco Invest EOOD. The bank's offer for refinancing the loan foresees partial loan repayment of 1,200 thousand euros during year 2014. The management of the group is of the opinion that refinancing is possible only then the group succeeds on raising additional capital from Arco Vara investors. The management of the group estimates that raising the necessary capital is likely. Considering the above, the group's financial statements have been prepared based on the assumption that Arco Invest EOOD carries its activities as going concern.

34 Structure of Arco Vara group

		Group's ownership interest	
Company	Domicile	**As at 31 December 2013**	As at 31 December 2012
%			
Service segment			
Subsidiaries			
Arco Real Estate AS	Estonia	100	100
Arco Imoti EOOD[1]	Bulgaria	100	100
Arco Real Estate SIA[1]	Latvia	78.5	78.5
Adepto SIA[1]	Latvia	78.5	78.5
Associates			
Arco Property Management SIA[1]	Latvia	40	40
Development segment			
Subsidiaries			
Arco Investeeringute AS	Estonia	100	100
Kerberon OÜ	Estonia	100	100
Kolde AS	Estonia	100	100
Arco Vara Haldus OÜ [3]	Estonia	100	100
Fineprojekti OÜ[1]	Estonia	100	100
Arco Manastirski EOOD	Bulgaria	100	-
Arco Invest EOOD[1]	Bulgaria	100	100
Arco Facility Management EOOD[1]	Bulgaria	100	100
Arco Project EOOD[1]	Bulgaria	100	100
Marsili II SIA	Latvia	100	100
Arco Development SIA	Latvia	100	100
Ulmana Gatves Nami SIA[1]	Latvia	100	100
Arco Invest UAB	Lithuania	100	100
Arco Development UAB[1]	Lithuania	100	100
Arco Capital Real Estate SRL[1]	Romania	100	100
Arco Investments TOV[1]	Ukraine	75	75
Pärnu Turg OÜ[1]	Estonia	-	100
Joint ventures			
Tivoli Arendus OÜ[1]	Estonia	50	50
Arco HCE OÜ[1]	Estonia	-	50
Construction segment			
Subsidiaries			
Arco Ehitus OÜ[2]	Estonia	100	100
AE Ehitusjuhtimine OÜ[1]	Estonia	100	100

[1] Interest through a subsidiary
[2] Ownership sold after the reporting date
[3] Until 30 September 2013, the company named T53 Maja OÜ

On 9 August 2013, the group's Bulgarian subsidiary Arco Invest EOOD established subsidiary Arco Manastirski EOOD with 100% ownership and share capital amounted to 2,676 thousand euros. The share capital was paid in the way of non-monetary contribution of Manastirski Livadi project assets.

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35 Parent company's unconsolidated primary financial statements as required by the Estonian Accounting Act

PARENT COMPANY'S INCOME STATEMENT

	2013	2012
In thousands of euros		
Revenue from rendering of services	**137**	**257**
Other income	4	3
Marketing and distribution expenses	-36	-48
Administrative expenses	-719	-936
Other expenses	-148	-286
Gain/loss on investments in subsidiaries and joint ventures	2,352	-20,151
Operating loss	**1,590**	**-21,161**
Interest income	551	1,099
Interest expense	-40	-1
Other finance costs	0	-153
Total finance income and costs	**511**	**945**
Loss for the year	**2,101**	**-20,216**

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PARENT COMPANY'S STATEMENT OF FINANCIAL POSITION

As at 31 December	2013	2012
In thousands of euros		
Cash and cash equivalents	29	20
Receivables and prepayments	1,762	5,871
Inventories	0	2
Total current assets	**1,791**	**5,893**
Investments[1]	5,440	0
Receivables and prepayments	1,104	494
Property, plant and equipment	7	4
Total non-current assets	**6,551**	**498**
TOTAL ASSETS	**8,342**	**6,391**
Loans and borrowings	81	0
Payables	74	116
Provisions	0	1,000
Total current liabilities	**155**	**1,116**
Loans and borrowings	751	0
Total non-current liabilities	**751**	**0**
TOTAL LIABILITIES	**906**	**1,116**
Share capital	3,319	3,319
Statutory capital reserve	2,011	2,011
Other reserves	60	0
Retained earnings	2,046	-55
Total equity	**7,436**	**5,275**
TOTAL LIABILITIES AND EQUITY	**8,342**	**6,391**

[1] At 31 December 2013, line item *Investments* included investments in subsidiaries of 5,540 thousand euros.
In Arco Vara AS's unconsolidated statement of financial position investments in subsidiaries are carried at cost less impairment losses.

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PARENT COMPANY'S STATEMENT OF CASH FLOWS
(direct method)

	2013	2012
In thousands of euros		
Cash receipts from customers	360	370
Cash paid to suppliers	-540	-1,236
Taxes paid	-136	-172
Cash paid to employees	-209	-255
Other cash payments related to operating activities	-81	-4
Other cash receipts related to operating activities	5	7
NET CASH USED IN OPERATING ACTIVITIES	**-601**	**-1,290**
Paid on acquisition of property, plant and equipment	-9	0
Proceeds from sale of property, plant and equipment	6	3
Proceeds from sale of investments in subsidiaries	1,610	3
Loans provided	-2,664	-775
Repayment of loans provided	879	458
Change in amount receivable from the group's cash pool	0	1,780
Placement of security deposits	-258	0
Release of security deposits	258	0
Interest received	19	722
NET CASH FROM/USED IN INVESTING ACTIVITIES	**-159**	**2,191**
Proceeds of loans received	486	0
Settlement of loans received	-430	-40
Proceeds of bond issues	751	0
Change in amount payable to the group's cash pool	0	-1,242
Interest paid	-38	-2
NET CASH FROM/USED IN FINANCING ACTIVITIES	**769**	**-1,284**
NET CASH FLOW	**9**	**-383**
Cash and cash equivalents at beginning of year	**20**	**403**
Change in cash and cash equivalents	9	-383
Cash and cash equivalents at end of year	**29**	**20**

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PARENT COMPANY'S STATEMENT OF CHANGES IN EQUITY

	Share capital	Statutory capital reserve	Other reserves	Retained earnings	Total
In thousands of euros					
Balance at 31 December 2011	**3,319**	**2,011**	**0**	**21,047**	**26,377**
Loss for the year	0	0	0	-21,102	-21,102
Balance at 31 December 2012	**3,319**	**2,011**	**0**	**-55**	**5,275**
Formation of equity reserve	0	0	60	0	60
Loss for the year	0	0	0	2,101	2,101
Balance at 31 December 2013	**3,319**	**2,011**	**60**	**2,046**	**7,436**

Adjusted unconsolidated equity

As at 31 December	**2013**	**2012**
In thousands of euros		
Parent company's unconsolidated equity	**7,436**	**5,275**
Carrying amount of investments in subsidiaries in the parent company's unconsolidated statement of financial position (-)	-5,440	0
Value of investments in subsidiaries under the equity method (+)	5,484	0
Parent company's adjusted unconsolidated equity	**7,480**	**5,275**

Statement by the management board

The member of the management board of Arco Vara AS declares and confirms that according to his best knowledge, the annual accounts, prepared according to the Financial Reporting Standards (IFRS) as adopted by the EU, present a correct and fair view of the assets, liabilities, financial situation and loss or profit of Arco Vara AS and the group as a whole, and the management report gives a correct and fair view of the development and results of the business activities and financial status of Arco Vara AS and the group as a whole and contains a description of the main risks and doubts.

17 April 2014

Tarmo Sild
Chief Executive Officer and Member of the Management Board of Arco Vara AS

INDEPENDENT AUDITOR'S REPORT

(Translation of the Estonian original)*

To the Shareholders of Arco Vara AS

We have audited the accompanying consolidated financial statements of Arco Vara AS and its subsidiaries (the Group), which comprise the consolidated statement of financial position as of 31 December 2013 and the consolidated statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes comprising a summary of significant accounting policies and other explanatory information.

Management Board's Responsibility for the Consolidated 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, and for such internal control as the Management Board determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

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 about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 consolidated financial statements.

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Arco Vara AS and its subsidiaries as of 31 December 2013, and their financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the European Union.

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Emphasis of Matter

We draw attention to Note 33 to these consolidated financial statements, which describes the circumstances around the ability of the Group's significant subsidiary Arco Invest EOOD to refinance its borrowings and continue as a going concern, and describes the magnitude of the effect on the Group's financial position if this subsidiary will not be able to realize its assets and discharge its liabilities in the normal course of business. Our opinion is not qualified in respect of this matter.

AS PricewaterhouseCoopers

Tiit Raimla	Märten Padu
Auditor's Certificate No. 287	Auditor's Certificate No. 513

17 April 2014

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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.*

Proposal for distribution of profit

The chief executive officer proposes that the annual general meeting of Arco Vara AS transfer the net profit for the year ended 31 December 2013 of 3,427 thousand euros to retained earnings.

As at 31 December 2013, retained earnings (after transfer of year 2013 net profit) amount to 1,452 thousand euros.

17 April 2014

Tarmo Sild
Chief Executive Officer and Member of the Management Board of Arco Vara AS