

INDEPENDENT AUDITORS' REPORT TO THE SHAREHOLDERS OF AB KAUNO ENERGIJA


We have audited the accompanying balance sheet of AB Kauno Energija, a public limited liability company, registered in the Republic of Lithuania ("KE" or the "Company"), as of 31 December 2005 and the related statements of income, changes in equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

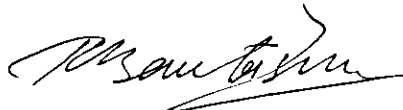
KE's subsidiary UAB Naujasodžio energijos paslaugos was established in the end of 2003 with a view to separate and sell non-core activities of the Company (Note 1). Due to these intentions the subsidiary has not been consolidated by the Company. However, under IAS 27 Consolidated and Separate Financial Statements (last revised with the effective date of 1 January 2005) the subsidiary should have been consolidated up to its sale in the beginning of 2005.

In our opinion, except for the effects of the matter discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of AB Kauno Energija as of 31 December 2005, and the results of its operations and its cash flows for the year then ended in conformity with International Financial Reporting Standards, as adopted by the EU.

UAB ERNST & YOUNG BALTIC
Audit company's licence No. 000514



Jonas Akelis
Auditor's licence No. 000003



Ramūnas Bartašius
Auditor's licence No. 000362

The audit was completed on 21 March 2006.

AB Kauno Energija

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005

Balance sheet

	Notes	As of 31 December 2005	As of 31 December 2004
ASSETS			
Non-current assets			
Intangible assets	3	1,863	1,435
Property, plant and equipment	5		
Land and buildings		30,291	29,145
Structures and machinery		93,173	96,915
Vehicles		1,292	1,790
Equipments and tools		5,504	9,031
Other property, plant and equipment		1,901	2,540
Construction in progress and prepayments		2,757	5,925
Total property, plant and equipment		134,918	145,346
Investment property	4	-	15,315
Non-current financial assets			
Non-current accounts receivable	7	2,654	647
Other financial assets		433	433
Total non-current financial assets		3,087	1,080
Long-term portion of deferred expenses		-	431
Total non-current assets		139,868	163,607
Current assets			
Inventories and prepayments			
Inventories	6	4,888	6,759
Prepayments		464	868
Total inventories and prepayments		5,352	7,627
Current accounts receivable	7		
Trade receivables		41,490	37,826
Other receivables		5,975	6,817
Total accounts receivable		47,465	44,643
Other current assets		-	10
Cash and cash equivalents	8	4,333	4,957
Total current assets		57,150	57,237
Total assets		197,018	220,844

The accompanying notes are an integral part of these financial statements.

Balance sheet (cont'd)

	Notes	As of 31 December 2005	As of 31 December 2004
EQUITY AND LIABILITIES			
Equity			
Share capital	1	118,310	118,310
Reserves	9		
Legal		-	11,831
Other reserves		-	5,090
Total reserves		-	16,921
Retained earnings (deficit)			
Net profit (loss) for the current year		6,348	9,357
Net profit (loss) for the previous years		(1,365)	(27,643)
Total retained earnings (deficit)		4,983	(18,286)
Total equity		123,293	116,945
Liabilities			
Non-current liabilities			
Non-current borrowings	10	26,138	43,610
Trade payables		71	163
Other accounts payable		38	431
Deferred income tax liability	16	1,278	194
Grants (deferred income)	11	4,545	4,312
Total non-current liabilities		32,070	48,710
Current liabilities			
Current portion of non-current borrowings and financial lease liabilities	10	7,771	12,469
Current borrowings	10	5,278	5,180
Trade payables		24,343	28,750
Advances received		746	857
Taxes payable		864	1,017
Payroll-related liabilities		2,112	2,192
Interest payable		334	670
Other current liabilities		207	4,054
Total current liabilities		41,655	55,189
Total liabilities		73,725	103,899
Total equity and liabilities		197,018	220,844

General Manager Aleksandras Sigitas Matelionis 21 March 2006

Acting Chief Accountant Jadvyga Umbrasienė 21 March 2006

Income statement

	Notes	2005	2004
Sales	12	171,382	170,430
Operating expenses	13		
Fuel and heat acquired		(106,464)	(109,176)
Salaries and social security		(22,447)	(22,867)
Raw materials		(2,959)	(3,562)
Taxes other than income tax		(4,162)	(5,027)
Electricity		(3,512)	(3,290)
Depreciation and amortization		(17,908)	(16,692)
Repairs and maintenance		(1,521)	(1,215)
Water		(479)	(683)
Change in allowance for accounts receivable		(206)	5,118
Change in allowance for inventories		(279)	1,290
Other operating expenses		(8,467)	(14,855)
Total operating expenses		(168,404)	(170,959)
Profit (loss) from operations		2,978	(529)
Other activities	14		
Other operating income		6,833	25,584
Other operating expenses		(6,517)	(5,878)
Other operating income (expenses), net		316	19,706
Financial and investment activities	15		
Income from financial and investment activities		1,926	2,261
Expenses from financial and investment activities		2,212	(9,766)
Financial and investment activities, net		4,138	(7,505)
Profit (loss) before tax		7,432	11,672
Income tax	16	(1,084)	(2,315)
Net profit (loss)		6,348	9,357
Basic earnings per share (litas)	17	0.32	0.47

The accompanying notes are an integral part of these financial statements.

General Manager	Aleksandras Sigitas Matelionis	21 March 2006
Acting Chief Accountant	Jadvyga Umbrasienė	21 March 2006

Statement of changes in equity

	Notes	Share capital	Reserves	Retained earnings (deficit)	Total
Balance as of 31 December 2003		118,310	10,930	(21,652)	107,588
Transfer to reserves		-	5,991	(5,991)	-
Net profit for the year		-	-	9,357	9,357
Balance as of 31 December 2004		118,310	16,921	(18,286)	116,945
Offsetting the accrued losses	9	-	(16,921)	16,921	-
Net profit for the year		-	-	6,348	6,348
Balance as of 31 December 2005		118,310	-	4,983	123,293

The accompanying notes are an integral part of these financial statements.

<u>General Manager</u>	<u>Aleksandras Sigitas Matelionis</u>	<u>21 March 2006</u>
<u>Acting Chief Accountant</u>	<u>Jadvyga Umbrasienė</u>	<u>21 March 2006</u>

Cash flow statement

	2005	2004
Cash flows from (to) operating activities		
Net profit	6,348	9,357
Adjustments for non-cash items:		
Depreciation and amortization	18,497	17,809
Change in allowance for accounts receivable	206	(5,118)
Loss (gain) from sale and write-off of property, plant and equipment and shares	1,150	(19,215)
Change in allowance for inventories	279	(1,290)
Change in deferred income tax	1,084	2,315
Impairment of property, plant and equipment	-	1,573
Accruals	(7,734)	9,689
Amortization of grants	(708)	(252)
Change in currency exchange rate	445	(737)
Interest expenses	2,080	2,058
Elimination of other financial and investment activity results	(1,418)	(662)
	<u>20,229</u>	<u>15,527</u>
Changes in working capital:		
Decrease in inventories	1,592	3,824
Decrease in prepayments	404	570
(Increase) decrease in trade receivables	(3,870)	4,355
(Increase) decrease in other receivables	(1,280)	4,602
(Decrease) in non-current trade payable	(92)	(92)
Increase in current trade payables and advances received	1,795	3,548
(Decrease) increase in payroll-related liabilities	(24)	21
(Decrease) in other liabilities to budget	(153)	(594)
(Decrease) increase in interest payable	(336)	600
(Decrease) increase in other liabilities	(2,482)	170
Net cash flows from operating activities	<u>15,783</u>	<u>32,531</u>

The accompanying notes are an integral part of these financial statements.

Cash flow statement (cont'd)

	<u>2005</u>	<u>2004</u>
Cash flows from (to) investing activities		
(Acquisition) of tangible and intangible assets	(24,404)	(26,927)
Proceeds from sale of tangible and intangible assets and investments	30,082	568
Penalty interest and fines (received)	1,873	1,438
Increase in cash flows from (to) non-current accounts receivable	206	532
Net cash flows from (to) investing activities	<u>7,757</u>	<u>(24,389)</u>
Cash flows from (to) financing activities		
Proceeds from loans	113,838	45,163
(Repayment) of loans	(135,876)	(48,604)
Interest (paid)	(2,080)	(2,058)
Financial lease (payments)	(33)	(62)
Grants received	941	149
Penalty interest and fines (paid)	(954)	(39)
Net cash flows from (to) financing activities	<u>(24,164)</u>	<u>(5,451)</u>
Net (decrease) increase in cash and cash equivalents	<u>(624)</u>	<u>2,691</u>
Cash and cash equivalents at the beginning of the year	<u>4,957</u>	<u>2,266</u>
Cash and cash equivalents at the end of the year	<u>4,333</u>	<u>4,957</u>

The accompanying notes are an integral part of these financial statements.

_____ General Manager	_____ Aleksandras Sigita Matelionis	_____ 21 March 2006
_____ Acting Chief Accountant	_____ Jadvyga Umbrasienė	_____ 21 March 2006

AB KAUNO ENERGIJA

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005

(all amounts are in LTL thousand unless otherwise stated)

Notes to the financial statements

1 General information

AB Kauno Energija (hereinafter "the Company") is a public limited liability company registered in the Republic of Lithuania. The address of its registered office is as follows:

Raudondvario Rd 84
Kaunas
Lithuania

The Company is involved in heat and electricity generation and distribution. The Company was registered on 1 July 1997 after the reorganization of AB Lietuvos Energija. The Company's shares are traded on the Current List of the National Stock Exchange.

As of 31 December 2005 and 2004 the shareholders of the Company were as follows:

	Number of shares owned	Percentage of ownership
Municipality of Kaunas city	16,954,892	85.99
Municipality of Kaunas district	1,606,168	8.14
The municipality board of Jurbarkas district	443,810	2.25
Other minor shareholders	713,512	3.62
	<u>19,718,382</u>	<u>100.00</u>

All the shares with a nominal value of LTL 6 each are ordinary shares and were fully paid as of 31 December 2005 and 2004. The share capital did not change in 2005 and 2004. The Company did not hold its own shares in 2005 and 2004.

AB Kauno Energija consists of the Company's head office and the branch of Jurbarko Šilumos Tinklai.

Operations of AB Kauno Energija are regulated by the Heating Law No IX-1565 of 20 May 2003 of the Republic of Lithuania.

According to the Heating Law of the Republic of Lithuania, the Company's activities are licensed and regulated by the State Price Regulation Commission of Energy Resources (hereinafter "the Commission"). On 26 February 2004 the Commission granted the Company the heat distribution license. The license has indefinite maturity, but is subject to meeting certain requirements and may be revoked based on the respective decision of the Commission. The Commission also sets price cap for the heat supply.

In 2003 the Company sold part of the assets of the subdivision Kauno Elektrinė, to UAB Kauno Termofikacinė Elektrinė (KTE) and committed to purchase at least 80% of the annual demand of integrated heating network in Kaunas from this company. The contract is valid for 15 years from the sales agreement date. The contract establishes that the purchase price of heat energy from KTE will not increase during the first 5 years from the date of signing the contract.

The Company established a subsidiary UAB Naujasodžio Energijos Paslaugos with the purpose of separating its secondary activities. In 2003 the Company sold the non-current assets and inventories of the branch Naujasodžio Energija and transferred the activities performed by the former branch consisting of extraction of the peat, polyurethane isolation of pipes, installation and repair of heating substations and recreation activity to the newly established UAB Naujasodžio Energijos Paslaugos. Since Turto Bankas lodged an objection to this transaction, the Company recovered the non-current assets sold to the subsidiary and therefore the profit was accounted for in the income statement (other operating income) in 2004 (please refer to Note 14). The recovered assets were rented out to UAB Naujasodžio Energijos Paslaugos.

AB KAUNO ENERGIJA

FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005

(all amounts are in LTL thousand unless otherwise stated)

1 General information (cont'd)

In 2004 the Company announced a tender to sell the shares of the subsidiary UAB Naujasodžio Energijos Paslaugos and the Company's assets leased to this subsidiary. In order to present property, plant and equipment at not higher than the recoverable amount of these assets, in 2004 the Company accounted for an impairment loss on property, plant and equipment of LTL 1,573 thousand. The recoverable amount was determined based on the value of the preliminary sales agreement. In the Company's accounts as of 31 December 2004 assets rented out to UAB Naujasodžio Energijos Paslaugos were accounted for at net book value of LTL 25,433 thousand. In April 2005 these assets with the net book value of LTL 24,853 thousand and the shares of UAB Naujasodžio Energijos Paslaugos (with the cost of LTL 10 thousand) were sold, the profit and loss from this transaction was accounted for under the other activities caption (refer to Note 14).

In 2005 Noreikiškės Cogeneration Plant started its operation. This plant is running on biogas produced by Kaunas Wastewater Treatment Plant. The installed electricity capacity is 0.75 MW, thermal capacity - 1.0 MW. The energy produced is sold to AB VST. After implementation of this project, in September 2005 the Company received a grant from the Lithuanian Environmental Investment Fund of LTL 345 thousand (EUR 100 thousand) (Note 11).

The Company's generation capacity includes a power plant in Petrašiūnai, 3 district boiler-houses in Kaunas integrated network, 8 regional boiler-houses in Kaunas and Marijampolė regions, 8 district and 54 local gas burning boiler-houses.

The Company's total heat and electricity generation capacity is 758 MW and 10 MW, respectively, out of which 406 MW of heat generation and 8 MW of electric capacity are located at the power plant in Petrašiūnai. Total Company's power generation capacity is 768 MW.

In 2005, the average number of employees at the Company was 905 (918 employees in 2004).

The shareholders of the Company have a statutory right to either approve or not approve the financial statements after the Company's management approves these financial statements.

2 Accounting principles

2.1. Basis of preparation

IASB issued IFRS 1, which requires that an entity's first IFRS financial statements are the first annual financial statements in which the entity adopts all IFRS, by an explicit and unreserved statement in those financial statements of compliance with IFRS. IFRS 1 requires the Company to prepare its IFRS financial statements as first-time adopter as the Company's financial statements for certain prior years were not issued. The Company chose 1 January 2004 as the date of transition to IFRS. There are no reconciling differences between the net assets as of 31 December 2004, and as of 1 January 2004, and the profit for the year 2004 as reported in accordance with Business Accounting Standards and as reported in these financial statements.

These financial statements are prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union.

2 Accounting principles (cont'd)

2.1. Basis of preparation (cont'd)

IFRSs and International Financial Reporting Interpretation Committee (IFRIC) Interpretations not yet effective

The Company did not apply the following IFRSs and IFRIC Interpretations that have been issued but are not yet effective and which may be applicable to the Company:

- IFRS 6 Exploration for and Evaluation of Mineral Resources (effective from 1 January 2006);
- IFRIC 4 Determining whether an Arrangement Contains a Lease (effective from 1 January 2006);
- IFRIC 5 Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds (effective from 1 January 2006);
- IFRIC 7 Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies (effective from 1 March 2006);
- Amendments to IFRS 1 First-time Adoption of IFRS and the Basis for Conclusions of IFRS 7 - Financial Instruments: Disclosures (effective from 27 January 2006);
- Amendment to IAS 1 Presentation of Financial Statements - Capital Disclosures (effective from 27 January 2006);
- Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts - Financial Guarantee Contracts (effective from 27 January 2006);
- IFRIC Interpretation 6 Liabilities arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment (effective from 27 January 2006);
- IFRIC Interpretation 8 Scope of IFRS 2 (effective from 1 May 2006);
- IFRIC Interpretation 9 Reassessment of Embedded Derivatives (effective from 1 June 2006).

The Company expects that adoption of the pronouncements listed above as they become effective will not have a significant impact on the financial statements.

2.2. Measurement and presentation currency

The amounts shown in these financial statements are presented in the local currency of the Republic of Lithuania, litas (LTL).

Starting from 2 February 2002, Lithuanian litas is pegged to EUR at the rate of 3.4528 litas for 1 euro, and the exchange rates in relation to other currencies are set daily by the Bank of Lithuania.

2.3. Intangible assets

Intangible assets are initially measured at cost. Intangible assets are recognized if it is probable that future economic benefits that are attributable to the asset will flow to the enterprise and the cost of asset can be measured reliably. After initial recognition, intangible assets are measured at cost less accumulated amortization and any accumulated impairment losses. Intangible assets are amortized on a straight-line basis over their estimated useful lives (3-4 years).

Licenses

Amounts paid for licenses are capitalized and then amortized over a 3-year period.

Software

The costs of acquisition of new software are capitalized and treated as an intangible asset if these costs are not an integral part of the related hardware. Software is amortized over a period not exceeding 3 years.

Costs incurred in order to restore or maintain the future economic benefits of performance of the existing software systems are recognized as an expense for the period when the restoration or maintenance work is carried out.

2 Accounting principles (cont'd)**2.4. Accounting for emission rights**

The Company applies a 'net liability' approach in accounting for the emission rights received. It records the emission allowances granted to it at a nominal amount, as permitted by paragraph 23 of IAS 20 Accounting for Government Grants and Disclosure of Government Assistance.

Liabilities for emissions are recognized only as emissions are made (i.e. provisions are never made on the basis of expected future emissions) and only when the reporting entity has made emissions in excess of the rights held.

When applying the net liability approach, the Company has chosen a system that measures deficits on the basis of an annual allocation of emission rights.

The outright sale of an emission right is recorded as a sale at the value of consideration received. Any difference between the fair value of the consideration received and its carrying amount is recorded as a gain or loss, irrespective of whether this creates an actual or an expected deficit of the allowances held. When a sale creates an actual deficit an additional liability is recognized with a charge to the income statement.

2.5. Property, plant and equipment

Property, plant and equipment are stated at cost less accumulated depreciation and impairment losses.

When assets are sold or retired, their cost, accumulated depreciation and impairment are eliminated from the accounting, and any gain or loss resulting from their disposal is included in the income statement.

The initial cost of property, plant and equipment comprises its purchase price, including non-refundable purchase taxes and any directly attributable costs of bringing the asset to its working condition and location for its intended use. Expenditures incurred after the property, plant and equipment have been put into operation, such as repair and maintenance costs, are normally charged to the income statement in the period the costs are incurred.

Depreciation is computed on a straight-line basis over the following average estimated useful lives:

	Years
Buildings	7 - 50
Machinery and equipment	5 - 60
Vehicles	3 - 10
Equipment and tools	2 - 20
Other non-current assets	2 - 30

The useful lives are reviewed annually to ensure that the period of depreciation is consistent with the expected pattern of economic benefits from the items in property, plant and equipment.

Construction-in-progress is stated at cost. This includes the cost of construction, plant and equipment and other directly attributable costs. Construction-in-progress is not depreciated until the relevant assets are completed and put into operation.

Assets not in use in the Company's operations are accounted for under the other property, plant and equipment caption, where parts of these assets are leased for the value not less than its depreciation. Depreciation for assets that are not in use is calculated.

2 Accounting principles (cont'd)

2.6. Investment property

Investment property of the Company consists of investments in land and buildings that are held to earn rentals or for capital appreciation, rather than for use in the production or supply of goods or services or for administration purposes or sale in the ordinary course of business. In accordance with IAS 40 Investment Property, investment property is initially measured at cost, which is the fair value of the consideration given to acquire them, including transaction costs. Subsequently all investment property is carried at cost less any accumulated depreciation and any accumulated impairment losses. Management believes that carrying values of investment property approximate their fair values.

Transfers to, or from, investment property are made when and only when, there is an evidence of a change in use.

2.7. Financial instruments

According to IAS 39 "Financial Instruments: Recognition and Measurement" financial assets are classified as either financial assets at fair value through profit or loss, held-to-maturity investments, loans and receivables, and available-for-sale financial assets, as appropriate. All purchases and sales of financial assets are recognized on the trade date. When financial assets are recognized initially, they are measured at fair value, plus, in the case of investments not at fair value through profit or loss, directly attributable transaction costs.

Financial assets at fair value through profit or loss

The category 'financial assets at fair value through profit or loss' includes financial assets classified as held for trading. Financial assets are classified as held for trading if they are acquired for the purpose of selling in the near term. Gains or losses on investments held for trading are recognized in income statement.

Held-to-maturity investments

Non-derivative financial assets with fixed or determinable payments and fixed maturity are classified as held-to-maturity when the Company has the positive intention and ability to hold to maturity. Investments that are intended to be held-to-maturity are subsequently measured at amortized cost using the effective interest method. Gains and losses are recognized in income when the investments are derecognized or impaired, as well as through the amortization process.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Such assets are carried at amortized cost using the effective interest method. Gains and losses are recognized in income when the loans and receivables are derecognized or impaired, as well as through the amortization process.

Available-for-sale investments

Available-for-sale financial assets are those non-derivative financial assets that are designated as available-for-sale or are not classified in any of the three preceding categories. After initial recognition available-for-sale financial assets are measured at fair value with gains or losses (except impairment and gain or losses from foreign currencies exchange) being recognized as a separate component of equity until the investment is derecognized or until the investment is determined to be impaired at which time the cumulative gain or loss previously reported in equity is included in the income statement.

2.8. Non-current assets held for sale

Non-current assets item is classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing to use it. Calculation of depreciation of such assets is discontinued. Non-current asset held for sale is accounted at the lower of its carrying amount and fair value less costs to sell.

2 Accounting principles (cont'd)

2.9. Inventories

Inventories are valued at the lower of cost or net realizable value, after impairment evaluation for obsolete and slow moving items. Net realizable value is the selling price in the ordinary course of business, less the costs of completion, marketing and distribution. Cost is determined by the first-in, first-out (FIFO) method. Technological fuel is accounted for using the weighted average method. The cost of finished goods includes the applicable allocation of fixed and variable costs. Unrealizable inventory is written off.

2.10. Receivables and loans granted

Receivables are initially recorded at the fair value of the consideration given. Current receivables are subsequently carried at cost less impairment, and non-current receivables and loans granted – at amortized cost, less impairment.

2.11. Cash and cash equivalents

Cash includes cash on hand, cash with banks and cash in transit. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash with original maturities of three months or less and that are subject to an insignificant risk of change in value.

For the purposes of the cash flow statement, cash and cash equivalents comprise cash on hand, cash with banks, cash in transit, deposits held at call with banks, and other short-term highly liquid investments.

2.12. Borrowings (loans)

Borrowing costs are expensed as incurred.

Borrowings are initially recognized at fair value of the proceeds received, less the costs of transaction. They are subsequently carried at amortized cost, the difference between net proceeds and redemption value being recognized in the net profit or loss over the period of the borrowings.

2.13. Finance and operating leases – Company as lessor

Finance lease

The Company recognizes lease receivables at the value equal to the net investment in the lease, starting from the date of commencement of the lease term. Finance income is based on a pattern reflecting a constant periodic rate of return on the net investment outstanding. Initial direct costs are included in the initial measurement of the lease receivables.

Operating lease

The Group presents assets subject to operating leases in the balance sheets according to the nature of the asset. Lease income from operating leases is recognized in the statement of income on a straight-line basis over the lease term as other income. Initial direct costs incurred specifically to earn revenues from an operating lease are added to the carrying amount of the leased asset.

The depreciation policy for leased assets is consistent with the lessor's depreciation policy for similar assets, and depreciation is calculated in accordance with the accounting policies, used for the property, plant and equipment.

2 Accounting principles (cont'd)

2.14. Financial and operating leases – Company as lessee

Financial lease

The Company recognizes financial leases as assets and liabilities in the balance sheet at amounts equal at the inception of the lease to the fair value of the leased property or, if lower, to the present value of the minimum lease payments. The rate of discount used when calculating the present value of minimum payments of financial lease is the interest rate of financial lease payment, when it is possible to determine it, in other cases, Company's composite interest rate on borrowings applies. Directly attributable initial costs are included into the asset value. Lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability.

The depreciation is accounted for financial lease assets and it also gives rise to financial expenses in the Company's income statement for each accounting period. The depreciation policy for leased assets is consistent with that for depreciable assets that are owned. The leased assets cannot be depreciated over the period longer than the lease term, unless the Company, according by the lease contract, gets transferred their ownership after the lease term is over.

If the result of sales and lease back transactions is financial lease, any profit from sales exceeding the book value is not recognized as income immediately. It is postponed and amortized over the lease term.

Operating lease

Leases where the lessor retains all the risk and benefits of ownership of the asset are classified as operating leases. Operating lease payments are recognized as an expense in the income statement on a straight-line basis over the lease term.

The gains from discounts provided by the lessor are recognized as a decrease in lease expenses over the period of the lease using the straight-line method.

If the result of sales and lease back transactions is operating lease and it is obvious that the transaction has been carried out at fair value, any profit or loss is recognized immediately. If the sales price is lower than the fair value, any profit or loss is recognized immediately, except for the cases when the loss is compensated by lower than market prices for lease payments in the future. The profit is then deferred and amortized in proportion to the lease payments over a period, during which the assets are expected to be operated. If the sales price exceeds the fair value, a deferral is made for the amount by which the fair value is exceeded and it is amortized over a period, during which the assets are expected to be operated.

2.15. Grants (deferred income)

Grants received in the form of non-current assets or intended for the purchase, construction or other acquisition of non-current assets are considered as asset-related grants. Assets received free of charge are also allocated to this group of grants. The amount of the grants related to assets is recognized in the financial statements as used in parts according to the depreciation of the assets associated with this grant. In the income statement, a relevant expense account is reduced by the amount of grant amortization.

Grants received as a compensation for the expenses or unearned income of the current or previous reporting period, also, all the grants, which are not grants related to assets, are considered as grants related to income. The income-related grants are recognized as used in parts to the extent of the expenses incurred during the reporting period or unearned income to be compensated by that grant.

The balance of unutilized grants is shown in the caption "Grants (deferred income)" in the balance sheet.

2.16. Provisions

Provisions are recognized when the Company has a present obligation (legal or constructive) 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. The Company reviews provisions at each balance sheet date and adjusts them in order to present the most reasonable current estimate. If the effect of the time value of money is material, the amount of provision is equal to the present value of the expenses, which are expected to be incurred to settle the liability. Where discounting is used, the increase in the provision due to the passage of time is recognized as a borrowing cost.

2 Accounting principles (cont'd)

2.17. Income tax

Income tax charge is based on profit for the year and considers deferred taxation. Income tax is calculated based on the Lithuanian tax legislation.

Standard income tax rate applied to the Company is 15%. On 1 January 2006 the Provisional Social Tax Law came into effect in the Republic of Lithuania, which stipulates that along with the corporate income tax, for one financial year beginning on 1 January 2006, companies will have to pay an additional 4% tax calculated based on the income tax principles, and for the following year a 3% tax starting from 1 January 2007. After the year 2007 the income tax applied to the companies in the Republic of Lithuania will be standard, i.e. 15 %.

Tax losses can be carried forward for 5 consecutive years, except for the losses incurred as a result of disposal of securities and (or) derivative financial instruments that can be carried forward for 3 consecutive years. The losses from disposal of securities and (or) derivative financial instruments can only be used to reduce the taxable income earned from the transactions of the same nature.

Deferred taxes are calculated using the balance sheet liability method. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Deferred tax assets and liabilities are measured using the tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse based on tax rates enacted or substantially enacted at the balance sheet date.

Deferred tax assets have been recognized in the balance sheet to the extent the management believes it will be realized in the foreseeable future, based on taxable profit forecasts. If it is believed that part of the deferred tax asset is not going to be realized, this part of the deferred tax asset is not recognized in the financial statements.

2.18. Revenue recognition

Revenue is recognized when it is probable that the economic benefits associated with the transaction will flow to the enterprise and the amount of the revenue can be measured reliably. Sales are recognized net of VAT and discounts.

Every month the Company issues the bills for the heat energy and water heating services to residents and industrial users of heat energy, delivered until the end of the current month. The bills are issued based on monthly readings of heat energy meters, which at the beginning of the following (after the current) month are collected by the employees of the Company.

Income from overdue interest is recognized upon receipt.

2.19. Expense recognition

Expenses are recognized on the basis of accrual and revenue and expense matching principles in the reporting period when the income related to these expenses was earned, irrespective of the time the money was spent. In those cases when the costs incurred cannot be directly attributed to the specific income and they will not bring income during the future periods, they are expensed as incurred.

The amount of expenses is usually accounted for as the amount paid or due, excluding VAT. In those cases when a long period of payment is established and the interest is not distinguished, the amount of expenses is estimated by discounting the amount of payment using the market interest rate.

2.20. Foreign currencies

Foreign currency transactions are accounted for at the exchange rates prevailing at the date of the transactions. Gains and losses resulting from the settlement of such transactions and from the translation of monetary assets and liabilities denominated in foreign currencies on the balance sheet date are recognized in the income statement. Such balances are translated at period-end exchange rates.

2 Accounting principles (cont'd)

2.21. Impairment of assets

Financial assets

Financial assets, as well as goodwill are reviewed for impairment at each balance sheet date.

For financial assets carried at amortized cost, whenever it is probable that the Company will not collect all amounts due according to the contractual terms of loans or receivables, an impairment or bad debt loss is recognized in the income statement. The reversal of impairment losses previously recognized is recorded when the decrease in impairment loss can be justified by an event occurring after the write-down. Such reversal is recorded in the income statement. However, the increased carrying amount is only recognized to the extent it does not exceed the amortized cost that would have been had the impairment not been recognized.

Other assets

Other assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Whenever the carrying amount of an asset exceeds its recoverable amount, an impairment loss is recognized in the income statement. Reversal of impairment losses recognized in prior years is recorded when there is an indication that the impairment losses recognized for the asset no longer exist or have decreased. Reversal is accounted for in the same caption of income statement as impairment losses. For evaluation of impairment of assets the entire Company is considered one cash generating unit.

2.22. Use of estimates in the preparation of financial statements

The preparation of financial statements in conformity with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, income and expenses and disclosure of contingencies. The significant areas of estimation used in the preparation of these financial statements relate to depreciation and impairment evaluation. Future events may occur which may cause the assumptions used in arriving at the estimates to change. The effect of any changes in estimates will be recorded in the financial statements, when determinable.

2.23. Segments

The activities of the Company are organized in one major business and geographic segment.

2.24. Contingencies

Contingent liabilities are not recognized in the financial statements. They are disclosed unless the possibility of an outflow of resources embodying economic benefits is remote.

A contingent asset is not recognized in the financial statements but disclosed when an inflow or economic benefits is probable.

2.25. Subsequent events

Post-balance sheet events that provide additional information about the Company's position at the balance sheet date (adjusting events) are reflected in the financial statements. Post-balance sheet events that are not adjusting events are disclosed in the notes when material.

2.26. Offsetting and comparative figures

When preparing the financial statements, assets and liabilities, as well as revenue and expenses are not set off, except the cases when certain IFRS specifically require such set-off.

Where necessary, comparative figures have been adjusted to correspond to the presentation of the current year.

AB KAUNO ENERGIJA**FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005**

(all amounts are in LTL thousand unless otherwise stated)

3 Intangible assets

Movement of intangible assets for the reporting period is as follows:

	Concessions, patents, licenses
Cost:	
Balance as of 31 December 2004	2,247
Additions	754
Disposals and write-offs	(69)
Reclassifications	262
Balance as of 31 December 2005	<u>3,194</u>
Amortization:	
Balance as of 31 December 2004	812
Charge for the year	585
Disposals and write-offs	(66)
Balance as of 31 December 2005	<u>1,331</u>
Net book value as of 31 December 2005	<u>1,863</u>
Net book value as of 31 December 2004	<u>1,435</u>

Movement of intangible assets for the prior period is as follows:

	Concessions, patents, licenses
Cost:	
Balance as of 31 December 2003	956
Additions	1,293
Disposals and write-offs	(2)
Balance as of 31 December 2004	<u>2,247</u>
Amortization:	
Balance as of 31 December 2003	648
Charge for the year	165
Disposals and write-offs	(1)
Balance as of 31 December 2004	<u>812</u>
Net book value as of 31 December 2004	<u>1,435</u>
Net book value as of 31 December 2003	<u>308</u>

Amortization expenses of intangible assets are included in the depreciation and amortization expenses caption in the income statement.

Part of the non-current intangible assets of the Company with the acquisition value of LTL 639 thousand as of 31 December 2005 (LTL 564 thousand as of 31 December 2004) was fully amortized but still in use.

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4 Investment property

Movement of investment property for the reporting period is as follows:

	<u>Investment property</u>
Cost:	
Balance as of 31 December 2004	18,636
Additions	-
Transfer to assets held for sale	<u>(18,636)</u>
Balance as of 31 December 2005	<u>-</u>
Accumulated depreciation and impairment:	
Balance as of 31 December 2004	3,321
Charge for the year	-
Transfer to assets held for sale	<u>(3,321)</u>
Balance as of 31 December 2005	<u>-</u>
Net book value as of 31 December 2005	<u>-</u>
Net book value as of 31 December 2004	<u><u>15,315</u></u>

Movement of investment property for the prior period is as follows:

	<u>Investment property</u>
Cost:	
Balance as of 31 December 2003	-
Received back assets	<u>18,636</u>
Balance as of 31 December 2004	<u>18,636</u>
Accumulated depreciation and impairment:	
Balance as of 31 December 2003	-
Accumulated depreciation of returned assets	3,220
Change for the year	<u>101</u>
Balance as of 31 December 2004	<u>3,321</u>
Net book value as of 31 December 2004	<u><u>15,315</u></u>
Net book value as of 31 December 2003	<u>-</u>

Investment property consists of recovered buildings from UAB Naujasodžio Energijos Paslaugos that as of 1 January 2005 were transferred to non-current assets held for sale. In April 2005 these assets were sold (refer to Note 1).

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5 Property, plant and equipment

Movement of property, plant and equipment for the reporting period is as follows:

	Land and buildings	Structures and machinery	Vehicles	Equipment and tools	Other property, plant and equipment	Construction in progress and prepayments	Total
Cost:							
Balance as of							
31 December 2004	50,935	283,360	7,641	17,914	7,014	5,925	372,789
Additions	605	13,334	497	972	-	8,242	23,650
Disposals and write-offs	(961)	(15,716)	(3,969)	(11,116)	(1,087)	(1,486)	(34,335)
Reclassifications	2,097	6,348	326	1,006	(115)	(9,924)	(262)
Balance as of							
31 December 2005	52,676	287,326	4,495	8,776	5,812	2,757	361,842
Accumulated depreciation and impairment:							
Balance as of							
31 December 2004	21,790	186,445	5,851	8,883	4,474	-	227,443
Charge for the year	1,083	15,123	375	1,133	198	-	17,912
Disposals and write-offs	(489)	(5,617)	(3,195)	(6,772)	(785)	-	(16,858)
Impairment	-	(1,573)	-	-	-	-	(1,573)
Reclassifications	1	(225)	172	28	24	-	-
Balance as of							
31 December 2005	22,385	194,153	3,203	3,272	3,911	-	226,924
Net book value as of 31 December 2005	30,291	93,173	1,292	5,504	1,901	2,757	134,918
Net book value as of 31 December 2004	29,145	96,915	1,790	9,031	2,540	5,925	145,346

AB KAUNO ENERGIJA**FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005**

(all amounts are in LTL thousand unless otherwise stated)

5 Property, plant and equipment (cont'd)

Movement of property, plant and equipment for the prior period is as follows:

	Land and buildings	Structures and machinery	Vehicles	Equipment and tools	Other property, plant and equipment	Construction in progress and prepayments	Total
Cost:							
Balance as of							
31 December 2003	46,798	236,332	4,377	22,943	5,644	10,467	326,561
Additions	277	10,530	784	3,545	16	10,482	25,634
Recovered assets	-	8,358	3,036	10,329	-	1,045	22,768
Disposals and write-offs	-	(345)	(210)	(335)	(1,284)	-	(2,174)
Reclassifications	3,860	28,485	(346)	(18,568)	2,638	(16,069)	-
Balance as of							
31 December 2004	50,935	283,360	7,641	17,914	7,014	5,925	372,789
Accumulated depreciation and impairment:							
Balance as of							
31 December 2003	20,279	162,162	3,162	9,076	3,321	-	198,000
Charge for the year	976	13,723	351	2,409	84	-	17,543
Accumulated depreciation of returned assets	-	2,843	2,689	6,321	-	-	11,853
Impairment	-	1,573	-	-	-	-	1,573
Disposals and write-offs	-	(245)	(207)	(182)	(892)	-	(1,526)
Reclassifications	535	6,389	(144)	(8,741)	1,961	-	-
Balance as of							
31 December 2004	21,790	186,445	5,851	8,883	4,474	-	227,443
Net book value as of							
31 December 2004	29,145	96,915	1,790	9,031	2,540	5,925	145,346
Net book value as of							
31 December 2003	26,519	74,170	1,215	13,867	2,323	10,467	128,561

In 2004 the Company accounted for impairment of assets in the structures and machinery caption related to the assets leased to UAB Naujasodžio Energijos Paslaugos amounting to LTL 1,573 thousand. On 6 April 2005 the Company sold property, plant and equipment rented to UAB Naujasodžio Energijos Paslaugos (refer to Note 14).

The depreciation charge of the Company's intangible assets, investment property and property, plant and equipment for 2005 amounts to LTL 18,497 thousand (LTL 17,809 thousand in the year 2004). The amount of LTL 17,908 thousand for the year 2005 (LTL 16,692 thousand for the year 2004) was included into operating expenses in the Company's income statement. The remaining amounts were included into other expenses caption.

As of 31 December 2005 property, plant and equipment of the Company with the net book value of LTL 50.5 million (LTL 85 million as of 31 December 2004) was pledged to banks as a collateral for loans (refer to Note 10).

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6 Inventories

	<u>2005</u>	<u>2004</u>
Spare parts	2,110	2,089
Technological fuel	1,852	3,029
Materials	2,114	2,550
Total:	6,076	7,668
Realization allowance at the end of the year	(1,188)	(909)
	<u>4,888</u>	<u>6,759</u>

The acquisition cost of the Company's slow moving inventories accounted for at net realizable value as of 31 December 2005 amounted to LTL 1,188 thousand (LTL 909 thousand as of 31 December 2004).

Changes in the realization allowance for inventories for the year 2005 and 2004 was included into operating expenses.

7 Trade receivables

	<u>2005</u>	<u>2004</u>
Trade receivables, gross	64,869	61,430
Less: realization allowance for doubtful receivables	(23,379)	(23,604)
Trade receivables, net	<u>41,490</u>	<u>37,826</u>

Change in realization allowance for doubtful receivables in 2005 and 2004 is included into the operating expense caption in the income statement.

In 2005 the Company wrote off LTL 431 thousand of bad debts for which the realization allowance was recorded in the previous periods.

Other receivables as of 31 December 2005 amounted to LTL 5,975 thousand (as of 31 December 2004 – LTL 6,817 thousand). As of 31 December 2005 the major part of other receivables consist of the debt from UAB Energijos Sistemų Servisas and current portion of long-term receivable from sold non-current assets to UAB Nepriklausomos Energijos Paslaugos and UAB Ežerėlio Dūrpės.

In preparing the financial statements for 2005 the comparative information of other receivables was corrected by offsetting VAT receivable and payable amounting to LTL 1,390 thousand. This correction had no effect on the Company's result for 2004 and 2005.

8 Cash and cash equivalents

	<u>2005</u>	<u>2004</u>
Cash at bank	1,293	3,521
Cash on hand	10	19
Cash in transit	3,030	1,417
	<u>4,333</u>	<u>4,957</u>

The Company's accounts in foreign and national currency in all banks are pledged as collaterals to secure the loans (Note 10).

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9 ReservesLegal reserve

A legal reserve is a compulsory reserve under Lithuanian legislation. Annual transfers of not less than 5% of net profit calculated in accordance with IFRS are compulsory until the reserve reaches 10% of the share capital. As of 31 December 2005 the legal reserve of the Company was not formed, because the legal reserve in 2005 amounting to LTL 11,831 thousand was used to offset the accumulated losses from the previous periods as of 31 December 2004.

During the distribution of profit for 2005 at least LTL 317 thousand of the net result should be transferred to legal reserve. This amount might change based on the final decision of the Company's shareholders, which will be taken after these financial statements are prepared.

Other reserves

Other reserves are formed based on the decision of the General Shareholders' Meeting on appropriation of distributable profit. These reserves can be used only for the purposes approved by the General Shareholders' Meeting. In 2005 other reserves amounting to LTL 5,090 thousand were used to offset the accumulated losses from the previous periods as of 31 December 2004.

10 Borrowings

	As of 31 December 2005	As of 31 December 2004
Non-current borrowings		
Non-current borrowings	26,138	43,610
Current borrowings		
Current portion of non-current borrowings (other than financial lease in 2004)	7,771	12,436
Current borrowings (including credit line)	5,278	5,180
	<u>13,049</u>	<u>17,616</u>
	<u>39,187</u>	<u>61,226</u>

On 8 June 2005 the Company signed a long-term loan agreement with AB Šiaulių Bankas for the amount of LTL 1,485 thousand. The maturity date of the last portion of the loan is 1 December 2008. As of 31 December 2005 the outstanding balance of the loan amounted to LTL 1,485 thousand, of which LTL 495 thousand was accounted for as the current portion of non-current borrowings in the financial statements of the Company. The loan bears 6-month VILIBOR plus 1.67% interest rate.

On 1 August 2005 the Company signed a long-term loan agreement with AB Bankas Hansabankas for the amount of LTL 5,000 thousand. The maturity date of the last portion of the loan is 1 August 2012. As of 31 December 2005 the outstanding balance of the loan amounted to LTL 4,983 thousand, of which LTL 416 thousand was accounted for as the current portion of non-current borrowings in the financial statements of the Company. The loan bears 6-month VILIBOR plus 0.77% interest rate.

On 23 August 2005 the Company signed a long-term loan agreement with AB SEB Vilnius Bankas for the amount of LTL 30,300 thousand (EUR 8,776 thousand). The maturity date of the last portion of the loan is 31 December 2009. As of 31 December 2005 the outstanding balance of the loan amounted to LTL 27,442 thousand (EUR 7,948 thousand), of which LTL 6,860 thousand was accounted for as the current portion of non-current borrowings in the financial statements of the Company. The loan bears 6-month VILIBOR plus 0.4% interest rate. On 24 August 2005 this loan was used to refinance the loan from AB Turto Bankas amounting to LTL 30,001 thousand.

On 20 April 2005 after selling shares of UAB Naujasodžio Energijos Paslaugos the last portion of the loan to AB Turto Bankas amounting to LTL 19,994 thousand was repaid.

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(all amounts are in LTL thousand unless otherwise stated)

10 Borrowings (cont'd)

As of 31 December 2005 the Company's unused credit line with the maturity of June 2006 was LTL 1,722 thousand.

As of 31 December 2005 the Company's unused overdraft with the maturity date of 31 May 2006 was LTL 8,000 thousand.

In 2005 the Company signed new and prolonged the existing factoring agreements with AB SEB Vilnius Bankas until 1 July 2006 regarding debts for heat supplied to the companies financed by Kaunas Municipality.

Terms of repayment of loans are as follows (all loans are with variable interest rate) are as follows:

	As of 31 December 2005
2006	13,049
2007	8,187
2008	8,187
2009	7,692
2010	832
2011	832
2012	408
	<u>39,187</u>

Weighted average effective interest rates of borrowings outstanding at the year-end are as follows:

	2005	2004
Current borrowings	4.1	4.3
Non-current borrowings	2.9	4.9

Parts of borrowings at the end of the year in national and foreign currencies are as follows:

	2005	2004
Currency of the loan		
EUR	27,442	41,090
JPY	-	12,198
LTL	11,745	7,938
	<u>39,187</u>	<u>61,226</u>

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11 Grants (deferred income)

	<u>2005</u>	<u>2004</u>
Balance as of 31 December 2004	4,312	4,415
Received during the year		
Non-current assets received for free	426	133
Research works and machinery for decreasing the sulphurity of oil received from the Ministry of Economy	-	175
Lithuanian Environmental Investment Fund	345	-
Equipment provided by UAB Omnitel	170	-
	<u>941</u>	<u>308</u>
Write-offs of grants	-	(159)
Amortization	(708)	(252)
Balance as of 31 December 2005	<u>4,545</u>	<u>4,312</u>

In 2005 the Company received a grant amounting to LTL 941 thousand, from which LTL 345 thousand was allocated to Noreikiškės Cogeneration Plant project (Note 1). The remaining part of the grants received includes assets received for free.

12 Income

The Company's activities are heat energy supply, electricity production, maintenance of heating and hot water supply systems, electricity production and other activities. These activities are inter-related, consequently for management purposes the Company's activity is organized as one main segment – heat energy supply. The Company's sales by activities are stated below:

	<u>2005</u>	<u>2004</u>
Income		
Heat energy	161,532	160,951
Maintenance of heating and hot water supply systems in buildings	8,125	8,165
Electricity energy (Note 1)	1,725	1,314
	<u>171,382</u>	<u>170,430</u>

13 Operating expenses

In 2004 the net profit was reduced by LTL 2.7 million as a result of damage compensation to UAB Kauno Termofikacijos Elektrinė following the Kaunas District Court decision. In July 2005 a peace agreement was signed with the claimant for the reduction of the claims to 1.35 million, therefore in 2005 the operating expenses were reduced by LTL 1.35 million.

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(all amounts are in LTL thousand unless otherwise stated)

14 Other activities

	<u>2005</u>	<u>2004</u>
Income from other activities		
Gain from sale (reversal of loss in 2004) of non-current assets	3,946	20,834
Services provided by the Company	2,407	2,913
Valuables sold	379	1,019
Other	101	818
	<u>6,833</u>	<u>25,584</u>
Expenses from other operating activities		
Loss from sale of non-current assets and shares	(4,875)	(815)
Cost of services provided by the Company	(1,175)	(1,403)
Cost of valuables sold	(356)	(2,320)
Other	(111)	(1,340)
	<u>(6,517)</u>	<u>(5,878)</u>
	<u>316</u>	<u>19,706</u>

In 2005 loss from sale of non-current assets and shares is mainly related to the sale transaction of UAB Naujasodžio Energijos Paslaugos shares and the non-current assets rented out to them (refer to Note 1).

In 2004 gain from sale of non-current assets is mainly due to the reversed transaction with UAB Naujasodžio Energijos Paslaugos on sale of property, plant and equipment, from which in 2003 the Company incurred a similar loss (refer to Note 1).

In 2005 the Company's revenue from rent of non-current assets, rented to Naujasodžio Energijos Paslaugos comprised LTL 634 thousand (in 2004 - LTL 519 thousand).

15 Financial and investment activities

	<u>2005</u>	<u>2004</u>
Income from financial and investment activities		
Penalty interest and fines	1,873	1,438
Interest income	4	25
Foreign currency exchange gain	-	737
Other financial income	49	61
	<u>1,926</u>	<u>2,261</u>
Expenses of financial and investment activities		
Penalty interest and fines	5,359	(6,352)
Interest expenses	(2,080)	(3,257)
Foreign currency exchange loss	(445)	-
Other financial expenses	(622)	(157)
	<u>2,212</u>	<u>(9,766)</u>
	<u>4,138</u>	<u>(7,505)</u>

AB KAUNO ENERGIJA**FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005**

(all amounts are in LTL thousand unless otherwise stated)

15 Financial and investment activities (cont'd)

In 2004 the net profit was decreased by LTL 6.3 million for payment to AB Lietuvos Dujos due to the decision of the Lithuanian Court of Appeal. At the date of these financial statements the final and non-appealable decision of the Lithuanian Supreme Court regarding the cancellation of the decision of the Lithuanian Court of Appeal is known, therefore the expenses from financial and investment activities in the income statement are decreased by LTL 6.3 million. This amount in the balance sheet was accounted for under the trade payables caption.

16 Income tax

	<u>2005</u>	<u>2004</u>
Components of the income tax expense		
Current income tax for the reporting year	-	-
Deferred income tax expenses	1,084	2,315
Income tax expenses recorded in income statement	<u>1,084</u>	<u>2,315</u>

Deferred income tax asset and liability was accounted using the tariffs of 19%, 18% and 15% (refer to Note 2.17):

	<u>2005</u>	<u>2004</u>
Deferred income tax asset		
Tax loss carry forward	506	840
Change in loss carried forward	335	-
Accounts receivable	3,507	3,794
Allowance for inventories	178	115
Accruals	90	552
Deferred income tax asset before valuation allowance	4,616	5,301
Less: valuation allowance	(4,526)	(3,909)
Deferred income tax asset, net	<u>90</u>	<u>1,392</u>
Deferred income tax liability		
Investments incentive	(1,368)	(1,586)
Deferred income tax, net	<u>(1,278)</u>	<u>(194)</u>

The tax loss carry-forward as of 31 December 2005 was LTL 5,705 thousand (as of 31 December 2004 – LTL 5,604 thousand). Change in tax loss carry-forward connected to the correction of profit tax for the previous periods comprises LTL 2,232 thousand. These losses cannot be transferred to 2006, therefore an allowance is accounted for in full amount. In 2005 a tax loss carry-forward amounting to LTL 2,131 thousand has been used by the Company.

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16 Income tax (cont'd)

The recorded income tax for the year can be reconciled with the theoretical calculated income tax, which is computed by applying the standard income tax rate to profit before taxes as follows:

	<u>2005</u>	<u>2004</u>
Income tax (expenses) accounted at 15% rate	(1,115)	(1,751)
Change in deferred income tax due to change in tax rate	(165)	-
Non-deductible expenses	1,148	(1,713)
Change in realization allowance of the deferred tax	(617)	1,149
Adjustments of income tax for the previous years	(335)	-
Income tax expenses accounted in income statement	<u>(1,084)</u>	<u>(2,315)</u>

17 Basic earnings per share

Calculations of the basic earnings per share of the Company are presented below:

	<u>2005</u>	<u>2004</u>
Net profit attributable to the shareholders	6,348	9,357
Number of shares (thousand), opening balance	19,718	19,718
Number of shares (thousand), closing balance	19,718	19,718
Average number of shares (thousand)	19,718	19,718
Basic earnings (loss) per share (Litas)	0.32	0.47

18 Financial assets and liabilities and risk managementCredit risk

The Company does not have any credit concentration risk because it works with a large number of customers.

The Company does not guarantee obligations of the other parties.

The Company considers that its maximum exposure is reflected by the amount of trade receivables, net of allowance for doubtful accounts recognized at the balance sheet date.

Interest rate risk

All of the Company's borrowings are at variable interest rates, therefore the Company faces an interest rate risk. In 2005 the Company did not have financial instruments for managing the interest rate risk.

Liquidity risk

The Company's policy is to maintain sufficient cash and cash equivalents or have available funding through an adequate amount of committed credit facilities to meet its commitments at a given date in accordance with its strategic plans. The Company's liquidity and quick ratios as of 31 December 2005 were 1.37 and 1.25, respectively (1.04 and 0.92 as of 31 December 2004).

AB KAUNO ENERGIJA**FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2005**

(all amounts are in LTL thousand unless otherwise stated)

18 Financial assets and liabilities and risk management (cont'd)Foreign currency risk

Only insignificant part of the Company's transactions and respective monetary assets and liabilities is expressed in other currency than litas or euro as of 31 December 2005 and 2004. Therefore the Company does not face significant foreign exchange risk.

Fair value of financial instruments

The Company's principal financial instruments not carried at fair value are trade and other current and non-current receivables, trade and other payables, long-term and short-term borrowings.

Fair value is defined as the amount at which the instrument could be exchanged between knowledgeable willing parties in an arm's length transaction, other than in forced or liquidation sale. Fair values are obtained from quoted market prices, discounted cash flow models and option pricing models as appropriate.

The following methods and assumptions are used to estimate the fair value of each class of financial instruments:

- (a) The carrying amount of current trade and other payables, long-term and short-term borrowings approximates fair value.
- (b) The fair value of trade and other payables, long-term and short-term borrowings is based on the quoted market price for the same or similar issues or on the current rates available for borrowings with the same maturity profile. The fair value of non-current borrowings with variable and fixed interest rates approximates their carrying amounts.

19 Related parties transactions

The parties are considered related when one party has the possibility to control the other or have significant influence over the other party in making financial and operating decisions.

As of 31 December 2004 the Company had one related party – subsidiary UAB Naujasodžio Energijos Paslaugos. Transactions with this company were as follows:

2004	Purchases	Sales	Accounts receivable	Accounts payable
UAB Naujasodžio Energijos Paslaugos	5,013	745	4,327	68
	<u>5,013</u>	<u>745</u>	<u>4,327</u>	<u>68</u>

As of 31 December 2005 the Company did not have related parties.

Remuneration of the management and other payments

The Company's management remuneration amounted to LTL 320 thousand in 2005 (LTL 336 thousand in 2004). The management of the Company did not receive any loans, guarantees; no other payments or property transfers were made or accrued.

20 Subsequent events

In February 2006 the Company sold the EU carbon dioxide emission rights for 2005 for LTL 8,153 thousand (EUR 2,361 thousand). The emission rights sold include the portion that the Company did not use in 2005.