Annual Accounts of Byggðastofnun

Icelandic Regional Development Institute

2010

Contents

Signatures and Report of the Board of Directors of the Icelandic Regional Development Institute

The annual accounts are prepared in accordance with the Annual Accounts Act and rules on the financial statements of credit institutions. The annual accounts are made according to the same accounting principles as the previous year.

The company is mainly in the business of providing loans or other financial support in order to, among other things, improve living conditions in individual communities and prevent unwanted demographic changes or that viable inhabited areas become deserted.

According to the profit and loss statement the institute's operations suffered a loss of ISK 2,628 million in 2010. Owners' equity at year end according to the balance sheet was negative by ISK 498 million. The equity ratio, as defined by the Act on Financial Undertakings, was -2.40%.

At the end of the year the equity ratio was -2.40% as stated above. The Act on Financial Undertakings states that equity shall be at least 8% of the credit risk and the Institute does therefore not fulfil this provision at the end of 2010. It is therefore clear that the State Treasury needs to provide the institute with funds if its operations are to continue.

The Icelandic parliament granted an authorisation in the 2011 budget to strengthen the owners' equity of The Regional Development Institute by up to ISK 1,000 million following a review by the Ministry of Industry of the Institute's future credit operations.

The Minister of Industry has appointed a committee to propose a future arrangement for the Institute's credit operations. The committee is expected to present its proposals no later than 1 May this year.

Following the collapse of the banks and the falling rate of the Icelandic krona the Institute has been forced to write off more than ISK 8 billion since 2008. Loan portfolio, shareholdings and appropriated assets have been reviewed in detail and their value assessed in a regular manner.

By signing below, the Board of Directors, CEO and Director of Finance hereby confirm the Regional Development Institute's annual accounts for 2010.

Reykjavik, 25 February 2011

Anna Kristín Gunnarsdóttir
Chairman

Arndís Soffía Sigurðardóttir	Ásmundur Sverrir Pálsson
Bjarni Jónsson	Drífa Hjartardóttir
Herdís Á. Sæmundardóttir	Sturla Böðvarsson

Aðalsteinn Þorsteinsson
Director

Magnús Helgason
Director of finance

Independent Auditors' Report

To the Board of Directors and Chief Executive Officer of the Icelandic Regional Development Institute

On behalf of the National Audit Office, we have audited the accompanying 2010 annual accounts of the Icelandic Regional Development Institute. The annual accounts contain the signatures and report of the Board of Directors, a profit and loss account, balance-sheet, statement of cash flow, information on important accounting methods, and other explanations.

Directors' responsibility for the annual accounts

The Directors are responsible for the annual accounts being prepared and presented according to the Annual Accounts Act. The Directors shall, accordingly, organise, adopt and maintain internal controls over the preparation and presentation of the annual accounts, such that they will generally be free of significant defects, whether through fraud or mistakes. Directors' responsibility also extends to the use of accounting and valuation methods appropriate for the circumstances.

Auditors' responsibility

Our responsibility involves the opinion that we give of the annual account, as based on our audit. Our audit was carried out in accordance with international auditing standards. According to these standards, we must observe ethical rules and organise and perform the audit in a manner that provides sufficient certainty of the annual accounts having no substantial shortcomings.

The audit entailed measures to confirm amounts and notes in the annual accounts. The selection of auditing procedures was based on the auditor's professional assessment, for instance of the risk of substantial shortcomings in the annual accounts, whether due to fraud or mistakes. This risk assessment took into consideration the Institute's internal control over the preparation and presentation of the annual accounts, in order to plan appropriate auditing measures rather than to give an opinion on the effectiveness of the Institute's internal control. Moreover, the audit includes an assessment of the accounting methods and methods of valuation used by the management in compiling the annual accounts as well as an assessment of their overall presentation.

We believe that during our audit, we have obtained sufficient and appropriate data to base our opinion on.

Opinion

In our opinion, the annual accounts provide a true and fair view of the performance of the Icelandic Regional Development Institute during 2010, its financial position as of 31 December 2010, and the changes in its liquid assets during 2010, in accordance with the Annual Accounts Act and rules on credit institution accounting.

Comment

Without qualifying the accounts we would like to draw attention to Note 17, concerning the ability of the Institute as a going concern after having to make large provisions for loan losses. The Institute is owned by and the responsibility of the State Treasury, therefore we consider it secure as an ongoing concern and that the basic condition of the statements of an ongoing concern is not lacking.

Reykjavik, 25 February 2011

Árni Snæbjörnsson
Certified Public Accountant
Ernst & Young hf.
Borgartúni 30, IS-105 Reykjavík

Income statement for the year 2010

	Note	2010	2009
		ISK 000s	ISK 000s
Interest income			
Interest from bankdeposits and securities		139.744	293.633
Interest on loans		1.071.787	1.685.689
		1.211.531	**1.979.323**
Interest expenses			
Interest on borrowings		675.875	1.292.804
Other interest expense		1.733	1.914
		677.608	1.294.718
Net interest income		**533.922**	**684.604**
Other income			
Regular budget allocation		365.700	385.200
Other budget allocation	6	49.225	46.535
Foreign exchange differences		(205.487)	41.188
Other income		19.198	36.333
		228.635	509.256
Net income		***762.558***	**1.193.861**
Other expenses			
Grants to economic development agencies		155.400	164.700
Other grants		51.225	49.437
Salaries and related expenses	*3,4*	170.113	162.831
General operating expenses		115.461	104.521
Depreciation of operational assets		4.109	6.052
Allowance for losses on loans and change in share capital		2.894.164	3.720.936
		3.390.472	4.208.477
Net profit (loss)		**(2.627.914)**	**(3.014.616)**

Balance sheet

	Notes	2010 ISK 000s	2009 ISK 000s
Assets			
Funds and claims against financial institutions			
Bank deposits and securities	*7*	1.875.859	2.167.413
Loans			
Loans to customers	*8*	13.196.171	17.412.611
Appropriated assets	*9*	867.644	350.755
		14.063.814	17.763.366
Shares held in companies			
Shares	*11*	951.483	1.054.191
		951.483	1.054.191
Other assets			
Debtors		43.036	2.675.108
Operational assets	*12*	60.282	54.223
		103.318	2.729.331
Total assets		**16.994.474**	**23.714.302**

as of 31 Desember 2010

	Note	2010 ISK 000s	2009 ISK 000s
Liabilities and equity			
Borrowings			
Securities issued		4.492.411	7.606.178
Loans from financial institutions		12.736.896	14.832.426
	13	17.229.307	22.438.604
Other liabilities			
Allowance for losses on collateral	*16*	161.771	19.383
Creditors		101.390	126.394
		263.161	145.778
Total liabilities		**17.492.468**	**22.584.381**
Equity capital	*2,15*	**(497.993)**	**1.129.921**
Total liabilities and equity		**16.994.474**	**23.714.302**
Outside the balance sheet items			
Guarantees provided	*16*	220.659	368.282

Statement of cash flow, 2010

	2010 ISK 000s	2009 ISK 000s
Cash flow from operations		
Net profit (loss)	(2.627.914)	(3.014.616)
Items not affecting liquid assets:		
Allowance for losses on loans and reduction in share capital	2.894.164	3.720.936
Depreciation of fixed assets	4.109	6.052
Interest, indexation and exchange rate difference	(1.888.701)	(191.570)
Unpaid grants	(2.850)	1.225
Cash flow from operations	**(1.621.192)**	**522.028**
Investment activities		
Repayment of loans	555.730	781.246
New loans made	(463.906)	(1.147.937)
Redeemed assets	41.529	(13.512)
Shares	23.172	(64.846)
Operational assets bought	(10.167)	(5,724)
Money market loan SPRON	0	(256.086)
Debtors	(13.950)	2.880
Investment activities	**132.408**	**(703.979)**
Financing activities		
Repayment of borrowinga	(2.339.395)	(1.156.511)
New borrowings	0	1.000.000
New capital	3.600.000	0
Accounts payable	(63.375)	33.378
Financial activities	**1.197.230**	**(123.133)**
Increase (decrease) in cash on hand	**(291.554)**	**(305.084)**
Cash on hand at beginning of year	**2.167.413**	**2.472.498**
Cash on hand at year-end	**1.875.859**	**2.167.413**

Notes to the 2010 financial statements

1. Information on the Institute

The Regional Development Institute is a credit institution, its Id. No. 450679-0389, and its main business is providing loans and other financial support. The Institute's registered domicile is Ártorg 1, IS-550 Saudárkrókur, Iceland.

2. Accounting Methods

Basis of financial statement

The annual accounts are prepared in accordance with the Annual Accounts Act and rules on the financial statements of credit institutions. It is a cost accounting statement, except for investment assets, derivatives and financial instruments intended for resale which are assessed at fair value. The annual accounts are made according to the same accounting principles as the previous year. It is in Icelandic krona (ISK) and all amounts are in ISK thousands, except where otherwise indicated.

Methods of assessment

The directors must assess and make specific decisions regarding important items in the annual accounts that are subject to assessment from time to time due to their nature. The methods of assessment are based on generally accepted accounting principles. The real value of items assessed in this way may prove different from the assessment upon sale or other disposal.

Assets and liabilities linked to a price index and foreign exchange rates

Accrued exchange rate difference is entered in the annual accounts, as well as inflation adjustments to the principals of assets and liabilities. Indexed assets and liabilities are entered based on the indices of 1 January 2011. Assets and liabilities in foreign currencies are converted into Icelandic krona at the last registered rate of the year. The exchange rate difference is then entered in the profit and loss account.

Property, plant and equipment

All property, plant and equipment are entered at cost, less depreciation. Improvements are capitalised if they are considered likely to yield a profit to the Institute in the future and if the cost can be reliably assessed. Any maintenance cost is charged in the profit and loss account as incurred. Depreciation is based on the estimated useful life of individual fixed assets and calculated as a fixed annual percentage of the initial purchase price, less estimated residual value, considering the period of ownership during the year.

Provisions for losses on loans

Provisions for losses on loans are made to meet the risk associated with lending, however, this does not constitute a final write-off. Provisions for losses on loans are charged to the profit and loss account less repayments for loans previously written-off.

Ownership in companies

Ownership in companies is entered at cost or fair value where possible. Changes in assessment are entered in the profit and loss account.

Investments

The Institute's investments are divided into loans and claims. They are originally assessed at fair value or cost plus transaction costs. All investment trade by the Institute is recorded on the business day, which is the date when the Institute has undertaken to make the trade.

Loans and claims

Loans and claims are financial assets, excluding derivatives that have a fixed or predetermined payment flow and are not registered in an active market. Loans and claims are generally assessed at cost price.

Debtors

Claims on debtors are recorded according to the original trade price, following exchange rate adjustments and less a write-down to meet claims that may be lost. The write-down is based on an assessment of the risk of loss with respect to individual claims and the claims as a whole. Claims that are considered completely lost are removed from the Institute's books.

Cash

Cash in the balance sheet and cash flow statement includes bank deposits and due claims on credit institutions.

Income

Income is recorded when there is a considerable probability that the financial benefit thereof will come to the Institute and when it can be assessed in a reliable manner. Interest income is entered in the profit and loss account when they occur.
Dividend income is entered when the Institute's right to collect is recognised.
Lease income from leasing of investment assets is recognized on a straight-line basis during the lease period.

3. Salaries and related expenses

	2010	2009
	ISK 000s	ISK 000s
Wages	137,363	134,092
Pention contribution	16,850	16,369
Other salaries-related expenses	15,900	12,370
Total	170,113	162,831

In terms of full-year positions, the Institute had an average of about 20 employee's in 2010. At year-end 2010 the company had 20 employees on the payroll.

4. Payments to the Board and Director-General

Wages to the Board and Director-General of the Institute of Regional Development were as follows:

Örlygur Hnefill Jónsson, chairman	0	933
Anna Kristín Gunnardóttir, chairman	1,796	1,796
Other Board Members (6)	5,430	6,324
Aðalsteinn Þorsteinsson, Director-General	10,583	10,683
Total	17,809	19,709

5. Þóknarnir endurskoðenda

	2010	2009
Budget allocations for employment promotion	5,212	3,255
Budget allocations for economic dev. projects	3,166	4,085
Total	8,378	7,340

6. Allocations from supplementary budget

Budget allocations for employment promotion	44,225	42,935
Budget allocations for economic dev. projects	5,000	3,600
Total	49,225	46,535

7. Cash and claims on financial Institutions

Cash on hand consists of unrestricted bank deposits in domestic and foreign currencies and claims due at credit institutions.

Bank deposits in ISK	284,013	2,162,639
Bank deposits in foreign currencies	8,568	4,774
Gov. bonds	1,583,278	0
Total	1,875,859	2,167,413

8. Loans

Breakdown by sector:		
Municipalities	0,70%	0,57%
Individuals	6,61%	5,82%
Industry:		
Services	41,14%	36,60%
Fisheries	31,34%	32,60%
Manufacturing	16,76%	15,97%
Financial Institute	0,04%	5,85%
Agricultue	3,42%	2,59%
Total	100,00%	100,00%

Loans by maturity:

On demand	624,423	534,765
Up to 3 months	241,836	275,757
3 months up to 1 year	896,116	1,079,371
1 to 5 years	3,723,597	5,073,926
Over 5 years	7,710,199	10,448,792
Total	13,196,171	17,412,611

9. Appropriated assets

Real estate	867,644	350,155
Moveable assets	0	600
Total	867,644	350,755

10. Provision to loan-loss account

Changes during year (ISK 000s)

	2010	2009
Balance at the beginning of the year	4,632,422	1,767,115
Provision for impairment losses	2,550,472	3,295,694
Loans write off	(2,640,740)	(430,387)
Balance at end of year	4,542,154	4,632,422

Allowance during the year	2,504,454	3,295,694
Provision for guarantees	142,388	8,128
Changes in shares	201,304	228,097
Impairment for other claims	46,018	192,065
Prev. written off loans	0	(3,048)
Allowance for credit losses, according to profit and loss statemen	2,894,164	3,720,936
Allowance for credit losses, as a percentage of loans	25.61%	21.01%

11. Shareholdings

Breakdown of shares held by the IRDI at year-end, by nominal value and holding proportion:

	Share %	Normal value ISK 000s
Real estate		
Ámundakinn ehf.	13,49%	21,000
Ásgarður hf.	13,10%	15,000
Dalagisting ehf.	12,11%	8,000
Dýralíf ehf.	28,92%	4,000
Fasteignafélagið Borg ehf.	29,78%	18,825
Fasteignafélagið Hvammur ehf.	24,86%	16,919
Grand hótel Mývatn ehf.	7,22%	10,000
Hótel Hellissandur hf.	24,98%	19,534
Hótel Norðurljós ehf.	46,40%	2,320
Tröllasteinn ehf.	18,92%	7,000
Urtusteinn ehf.	8,45%	32,818
Total real estate		**155,416**
Travel		
Brimnes hótel ehf.	12,00%	4,610
Ferðaskrifstofa Austurlands ehf.	5.81%	900
Hótel Flúðir hf.	11,94%	3,109
Hótel Húsavík hf.	0,38%	136
Hótel Valaskjálf hf.	18,80%	4,500
Hótel Varmahlíð hf.	13,04%	3,000
Hvalamiðstöðin Húsavík ehf.	19,70%	2,000
Hvíldarklettur ehf.	26,63%	30,000
Nes-Listamiðstöð ehf.	41,67%	5,000
P/F Smyril-line	1,30%	65,541
Rauðka ehf.	16,67%	2,000
Snorri Þorfinnsson ehf.	19,89%	12,000
Textílsetur Íslands ses.	32,15%	2,000
Total travel		**134,796**

	Share %	Normal value ISK 000s
Holding Companies		
Eignarhaldsfélag Suðurlands hf.	40,00%	109,142
Eignarhaldsfélag Suðurnesja hf.	19,03%	96,840
Eignarhaldsfél. Vestmannaeyja hf.	38,77%	7,850
Fjárfestingafélagið Vör hf.	41,83%	35,940
Gjöll ehf.	22,04%	110
Hilda hf.	0,36%	354
Hvetjandi ehf.	49,29%	55,429
Saga eignarhaldsf. hf.	0,36%	354
Tvídrangi ehf.	15,27%	4,991
Total Holding Companies		**311,010**
Agriculture		
Sláturfélag Austurlands fsvf.	28,00%	18,000
Yrkjar ehf.	7,29%	1,800
Total Agriculture		**19,800**
Consulting		
Atvinnuþróunarfélag Vestfjarða hf.	22,10%	1,933
Atvinnuþróunarfélag Þingeyinga hf.	31,86%	1,833
Forsvar ehf.	12,28%	2,000
Frumkvöðlasetur Austurlands ehf.	14,08%	7,000
Total Consulting		**12,766**
Industries		
Barri hf.	48,40%	43,904%
Borg, saumastofa ehf.	19,82%	170
Eðalís ehf.	11.06%	3,000
Fjallalamb ehf.	10,68%	10,000
Kjörorka ehf.	8,25%	2,000
Raflagnir Austurlands ehf.	22,37%	3,600
Sigurjón Magnússon ehf.	30,00%	214
Skaginn hf.	3,08%	5,928
TH ehf.	4,50%	2,000
Trico ehf.	33,33%	5,000
Ullarvinnsla frú Láru ehf.	29,76%	2,500
Vilko ehf.	8,22%	2,955
Þörungaverksmiðjan hf.	27,67%	7,919
Total Industries		**89,190**
Health and Biotechnology		
Globodent á Íslandi ehf.	7,18%	2,353
Total Health and Biotechnology		**2,353**
Fisheries		
Bernskan ehf.	34,53%	22,444
Eignarhaldsfélagið Gláma hf.	36,52%	114,500
Kampi ehf.	35,35%	28,000
Norðurskel ehf.	1,34%	1,261
Reykofninn-Grundarfirði ehf.	15,24%	5,160
Tó hf.	10,40%	2,667
Þórsberg ehf.	6,09%	2,308
Total Fisheries		**176,340**
IT		
Gagnaveita Skagafjarðar hf.	32,37%	103,750
HotMobileMail ehf.	24,53%	15,000
Óley ehf.	42,02%	10,000
Total IT		**128,750**
Verslun og þjónusta		
Samkaup hf.	2,77%	10,801
Total IT		**10,801**
Total shares as ISK		**1,041,222**

The value of shares held by the Institute is entered á in the financial statement as ISK 951,483,000

12. Operational assets

Fixed asset reavaluation and depreciation of operational assets:

	Real Estate	Fixtures	Cars	Total
Total value 1/1	70.389	0	5,724	76,113
Depreciated total 1/1	(20,745)	0	(1,145)	(21,890)
Added in year	0	3,219	6,949	10,168
Depreciated during the year	(1,947)	(322)	(1,840)	(4,109)
Book value 31/12	47,697	2,897	9,688	60,282
Total value 31/12	70,389	3,219	12,673	86,281
Total depreciated 31/12	(22,692)	(322)	(2,985)	(25,999)
Book total 31/12	47,697	2,897	9,688	60,282
Depreciation ratios	2 - 3%	20%	20%	

The institutions real estate are valued according to the following way. For comparison is the book value.

	Retail value	Insurance value	Book value
Skagfirðingabraut 17-21	26.754	84.210	34.518
Háuhlíð 4	26.450	46.850	13.179
	53.204	131.060	47.697

13. Assets and liabilities linked to foreign currencies or inflation-indexed

	2010 ISK 000s	2009 ISK 000s
Exchange rate-indexed:		
Assets	9,175,994	13,289,618
Liabilities	12,736,896	14,832,426
Difference	(3,560,902)	(1,542,808)
Inflation-indexed:		
Assets	4,028,743	4,298,063
Liabilities	4,492,411	7,606,178
Difference	(463,668)	(3,308,115)

14. Borrowing

Breakdown of liabilities by maturity:

On demand	0	0
Up to 3 months	204,088	331,018
3 month up to 1 year	1,118,394	4,435,196
1 to 5 years	9,987,220	7,072,110
Over 5 years	5,919,605	10,600,280
Total	17,229,307	22,438,604

15. Equity capital

According to provisions in the Act on Financial Undertakings, No. 161/2002, a lending institution´s equity may at no time fall below an amount equivalent to 8% of the risk base. In reference to this, the equity ratio of the Icelandic Regional Development institute amounted to -2,4% at year end.

In 2010, a 1,000 million ISK contribution was agreed in the national budget to respond to the fact that the institution´s equity ratio did not meet the provisions No. 161/2002 on financial undertakings at year end 2010.

Equity capital and equity ratio, as stipulated by law:

Balance at the beginning of the year	1,129,921	1,544,537
Budget contribution	1,000,000	2.600.000
Year loss	(2.627.914)	(3.014.616)
	(497.993)	1.129.921
Equity ratio	-2,40%	4,92%

16. Guarnatees granted

The Regional Development Institute has granted guarantees to a total amount of ISK 382.4 millions. The risk of the Institute having to pay the guarantees has been assessed. Guarantees of ISK 161.8 million that are considered a probable default have been credited in the financial statement. Guarantees outside the balance sheet are therefore approximately ISK 220.7 millions at year end.

17. Going concern

As stated in note 15 the Institute did not meet equity ratio requirements for financial undertakings. According to Act No. 161/2002 the equity ratio of credit institutions may not go below 8% of so-called risk-weighted assets, and the Institute's equity ratio at year end was -2.4%.

Once the Institute's interim statement was available, the Financial Supervisory Authority was informed of the main reasons why the equity ratio did not meet the requirements of the Act. The principal reason is that the Institute has been obliged to allocate large provisions for losses, cf. note 10. This alone constitutes circumstances that may cause a considerable uncertainty on the going concern and thereby an uncertainty on whether the Institute can sell its assets and pay its liabilities under normal operating conditions.

"In November of 2010 the Minister of Industry appointed a task force to address the futhre of the Institute's credit operations. The main reason why the task force was appointed was that the equity ratio had fallen below a statutory minimum. The task force presented its report in January this year and its main conclusions are:

Assuming a cautious assessment the State Treasury will have to supply the Institute with ISK 3.5 billion in the next five years, and 2.5 billion thereof to bring the equity ratio up to 8%.

Experience shows us that it is not realistic to expect the Institute of Regional Development to maintain the real value of its equity, while its role as a promoter of rural development and employment remains unchanged.

If the Institute is to continue its credit operations, the time has come to develop more funding tools for the Institute and adapt its financing operations to circumstances in society. Experience has shown that demand for loans from the Institute decreases when national production grows fast.

The Minister has appointed a committee of representatives from the parliamentary parties based on the task force report, and this committee will propose a future arrangement for the credit function of the Regional Development Institute. The committee shall have presented its report at the beginning of May this year, or early enough for its conclusions to be considered when preparing the 2012 budget.

The Institute is, however, owned by the state and, according to Note 15, the parliament included in the 2011 budget an authorisation to strengthen the Institute's equity by ISK 1,000 millions.

Presentation of the Regional Development Institute's annual statements are based on the basic premises that the Institute is an ongoing concern, and can liquidate its assets and pay debts under normal operating conditions. With reference to what has been said above the Institute is operated at a loss and its capital position is negative. It is not clear yet what the future keeps in store for the Institute. However, with reference to the fact that the Institute is owned by and the responsibility of the State Treasury, we are of the opinion that the Institute is an ongoing concern and we are therefore of the opinion that there is no uncertainty that would fail to make the Institute meet that basic principle for the accounts.