ERNST & YOUNG

Byggðastofnun

The Icelandic Regional Development Institute

Annual Accounts
2011

Ártorg 1
550 Sauðárkrókur

ID no. 450679-0389

Contents

Independent auditors' report

To the board of directors and chief executive officer of the Icelandic Regional Development Institute

We have audited the accompanying annual accounts of Byggðastofnun, the Icelandic Regional Development Institute, for the year 2011 on behalf of the National Audit Office. The annual accounts comprise the report and endorsement of the board of directors, a profit and loss account, a balance sheet, a cash flow statement, details of important accounting practices, and other notes.

Directors' and chief executive officer's responsibility for the annual accounts

The directors and the chief executive officer are responsible for the preparation and presentation of the annual accounts in accordance with the terms of the Act on Annual Accounts. The directors and chief executive officer are also responsible for such internal controls as are necessary in the preparation and presentation of the annual accounts to ensure that they contain no material misstatements, whether through fraudulent activity or error.

Auditors' responsibility

Our responsibility is to express an opinion on the annual accounts based on the audit. The audit was carried out in accordance with international auditing standards. These standards require that we observe established ethical principles and organise and conduct the audit such that sufficient assurance can be obtained that the annual accounts are free from material misstatements.

An audit includes measures designed to verify the amounts and notes in the annual accounts. The selection of auditing procedures is based on the auditor's professional assessment of, for instance, the risk that the annual accounts contain material omissions or misstatements, whether through fraudulent activity or error. In the assessment of this risk, consideration is given to the institution's internal controls in so far as they pertain to the preparation and presentation of the annual accounts, so as to be able to plan appropriate auditing methods, but not so as to give an opinion on the effectiveness of the institution's internal controls. The audit also includes an assessment of the accounting procedures and valuation methods used by the managers in the preparation of the annual accounts as well as an evaluation of their overall presentation.

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

Opinion

In our opinion, the annual accounts give a true and fair view of the performance of the Icelandic Regional Development Institute in the year 2011, its financial position as at 31 December 2011, and its cash flows during the year 2011, in accordance with the Act on Annual Accounts and the Regulations on the Financial Statements of Credit Institutions.

Keflavík, 27 February 2012

Árni Snæbjörnsson
State Authorised Public Accountant
Ernst & Young hf
Borgartún 30
105 Reykjavík

Report and endorsement of the directors of the Icelandic Regional Development Institute

The annual accounts have been prepared in compliance with the Act on Annual Accounts and the Regulations on the Financial Statements of Credit Institutions. They are based on the same accounting principles as for the previous year.

The primary function of the Institute is to provide loans or other financial support with the aim, among other things, of improving economic and living conditions in individual rural areas and preventing undesirable disruption to settlement and the depopulation of viable regions.

According to the profit and loss account, the Institute's operating loss for the year 2011 was ISK 235.7 million. Capital reserves at the end of the year as per the balance sheet stood at ISK 266.3 million. The capital adequacy ratio as defined under the terms the Act on Financial Undertakings was 1.34%.

As noted above, the capital adequacy ratio at the end of the year stood at 1.34%. The terms of the Act on Financial Undertakings stipulate that capital reserves may not at any time be less than 8% of the risk-weighted asset base. The Institute thus failed to meet the provisions prescribed by law in this regard at the end of the year 2011.

In the Budget for 2012 the Icelandic parliament agreed an authority to increase the Institute's capital reserves by up to ISK 2,000 million. Of this injection of funds, ISK 1,750 million was paid to the Institute in January 2012. In addition, under the terms of the Budget for 2011 the Treasury paid ISK 1,000 million to the Institute at the end of 2011 to increase the Institute's capital reserves. With the contribution that has been paid so far the Institute's capital adequacy ratio rose to 10.11% as compared to its balance sheet at the end of the year. When the balance of the authorised payment has been made over to the Institute, its capital adequacy ratio will increase to 11.37%. The provisions of the Act on Financial Undertaking will thus be fulfilled at the start of the year 2012.

The directors of the Icelandic Regional Development Institute, its chief executive officer and its operations manager herewith append their signatures in certification of the Institute's annual accounts.

Keflavík, 27 February 2012

Operations Manager

Chief Executive Officer

Profit and loss account for the year 2011

	Notes	2011 ISK 000s	2010 ISK 000s
Interest earned			
Interest on deposits with credit institutions		43,760	139,744
Interest earned and indexation adjustment on loans		1,281,885	1,071,787
		1,325,644	1,211,531
Interest expenses			
Interest expenses and indexation adjustment on loans taken out		684,555	675,875
Other interest expenses		1,156	1,733
		685,712	677,608
Net interest earned		639,933	533,922
Operating income			
Funding received from Treasury as per Budget		306,000	365,700
Other Treasury funding	6	5,000	49,225
Foreign exchange adjustment		(14,703)	(205,487)
Other operating income		22,754	19,198
		319,051	228,635
Net operating income		958,983	762,558
Operating expenses			
Professional consultancy fees		160,400	155,400
Other subsidies granted		11,649	51,225
Salaries and wage-related expenses	3, 4	182,166	170,113
Other operating costs		124,583	115,461
Depreciation of fixed assets	12	5,125	4,109
Provision to meet losses on loans and revaluation of shares	2, 10	710,772	2,894,164
		1,194,695	3,390,472
Profit (loss) for year		(235,712)	(2,627,914)

Balance sheet

	Notes	2011 ISK 000s	2010 ISK 000s
Assets			
Reserves and balances with credit institutions			
Bank deposits and securities	7	2,464,230	1,875,859
Loans granted			
Loans to clients	8	13,362,133	13,196,171
Appropriated assets	9	852,859	867,644
		14,214,991	14,063,814
Shareholdings in companies			
Shares	11	881,276	951,483
		881,276	951,483
Other assets			
Debtors		34,110	43,036
Fixed assets	12	55,157	60,282
		89,266	103,318
Assets: total		17,649,763	16,994,474

31 December 2011

	Notes	2011 ISK 000s	2010 ISK 000s
Liabilities and capital reserves			
Loans taken out			
Securities issued		4,865,650	4,492,411
Loans from credit institutions		12,272,240	12,736,896
	14	17,137,891	17,229,307
Other debts and liabilities			
Reserve to cover guarantees provided	16	179,352	161,771
Creditors		66,226	101,390
		245,578	263,161
Total liabilities		17,383,468	17,492,468
Capital reserves	2, 15	266,295	(497,993)
Liabilities and capital reserves: total		17,649,763	16,994,474
Off-balance-sheet items			
Guarantees provided	16	218,330	220,659

Cash flow statement 2011

	2011 ISK 000s	2010 ISK 000s
Cash flows from (to) operations		
Net profit (loss) for year	(235,712)	(2,627,914)
Items that do not affect cash in hand:		
Provision to meet losses on loans and revaluation of shares	710,772	2,894,164
Depreciation of fixed assets	5,125	4,109
Interest, indexation adjustment and exchange rate adjustment	229,539	(1,888,701)
Unpaid grants	(2,493)	(2,850)
Cash flows from (to) operations	707,231	(1,621,194)
Cash flows from investment activities		
Instalment payments on loans granted	755,443	555,730
Loans granted	(493,678)	(463,906)
Redeemed assets	(25,093)	41,529
Shares	(23,457)	23,172
Purchase of fixed assets	0	(10,167)
Debtors	11,420	(13,950)
Cash flows from investment activities	224,635	132,408
Cash flows from financing activities		
Instalment payments on loans taken out	(2,355,042)	(2,339,395)
New loans taken out	1,046,710	0
Funding received from Treasury	1,000,000	3,600,000
Creditors	(35,164)	(63,375)
Cash flows from financing activities	(343,495)	1,197,230
Increase (decrease) in cash in hand	588,371	(291,554)
Cash in hand at start of year	1,875,859	2,167,413
Cash in hand at end of year	2,464,230	1,875,859

Notes

1. The Icelandic Regional Development Institute

Byggðastofnun (the Icelandic Regional Development Institute) is a credit institution, ID no. 450679-0389, whose main function consists in the granting of loans and other financial support. The Institute's legal domicile is Ártorg 1, 550 Sauðárkrókur, Iceland.

2. Accounting principles

Basis of preparation of accounts

The annual accounts have been prepared in compliance with the Act on Annual Accounts and the Regulations on the Financial Statements of Credit Institutions. They are based on historical-cost principles. They use the same accounting methods as in the previous year. Financial figures are in ISK (Icelandic krónur) and all such figures are given in thousands of ISK unless otherwise specified.

Valuation methods

Managers are required to value and take individual decisions relating to important items in the annual accounts which by their nature are subject to changing valuation at any time. The valuation methods used are grounded in good accounting practice. The actual prices that items valued in this way may realise on sale or other disposal may prove different from the figures determined in the valuation.

Price-indexed and exchange-rate indexed assets and liabilities

Accrued adjustments to the principal value of assets and liabilities as a result of changes in price levels and foreign exchange rates are reflected in the annual accounts. Index-linked assets and liabilities are entered on the basis of price indexes that took effect on 1 January 2012. Assets and liabilities in foreign currencies are converted to ISK at the last listed exchange rate at the end of the year. The difference that arises from exchange rate fluctuations is entered on the profit and loss account.

Exchange rates at end of year:

	31.12.2011	**31.12.2010**
EUR	159.28	154.23
USD	123.00	115.32
JPY	1.59	1.42
DKK	21.43	20.70

Indexes at end of year:

	01.01.2012	**01.01.2011**
Comsumer price index	384.60	365.50

Fixed assets

Fixed assets are entered at acquisition cost less depreciation. Improvements and enhancements are treated as assets if it is likely that they will yield a future profit to the Institute and if the cost can be assessed reliably. All maintenance costs are charged to the profit and loss account as and when they are incurred. Depreciation is based on the estimated useful life of individual fixed assets and calculated as a fixed annual percentage of the initial acquisition cost, less estimated residual value, taking account of the period of ownership during the year.

Provision to meet losses on loans

A provision to meet losses on loans is created to cover exposures inherent in lending activities and does not imply that the assets are irrevocably written off. Additions to the provision to meet losses on loans are entered as expenses in the profit and loss account, reduced by any repayments arising from loans previously written-off.

Shareholdings in companies

Shareholdings in companies are entered at purchase price or at estimated fair value where such information is available. Revaluations are entered on the profit and loss account.

Investments

The Institute's investments are broken down into loans and balances held with financial institutions. They are originally valued at fair value or cost price, inclusive of transaction costs. All investment transactions made by the Institute are recorded on the date of transaction, which is taken as being the date on which the Institute commits itself to the transaction.

Loans and balances with financial institutions

Loans and balances with financial institutions are financial assets other than derivatives which have a fixed and pre-determined payment structure and which are not listed on an active market. Loans and balances with financial institutions are generally entered at cost value.

Debtors

Claims against debtors are entered at the original transaction value, adjusted to cover currency fluctuations and less a writing-down allowance to cover potential lost claims. The writing-down allowance is based on an estimate of the risk of loss with respect to individual claims and the claims as a whole. Claims that are irrevocably lost are written out of the Institute's books.

Cash in hand

Cash in hand (liquid assets) on the balance sheet and in the cash flow statement is made up of bank deposits and balances with instant access held at credit institutions.

Income

Income is entered in the accounts when there is a good probability that its financial benefits will accrue to the Institute and when it is possible to make a reliable assessment of its value.

Interest income is credited to the profit and loss account as and when it arises.

Dividend income is credited when the Institute's collection right has been established.

Rental income from the letting of investment assets is entered on a straight-line basis over the rental period.

3. Salaries and wage-related expenses

	2011 ISK 000s	**2010** ISK 000s
Salaries	147,269	137,363
Pension contributions	17,995	16,850
Other wage-related expenses	16,902	15,900
Salaries and wage-related expenses: total	182,166	170,113

On a full-year basis, the Institute employed on average a workforce of 20 during the year; this is unchanged from the previous year. At the end of the year there were 20 staff on the Institute's payroll, making up 20 full-day equivalent working days.

4. Remuneration of the Institute's directors and chief executive officer

Payments to the directors and chief executive officer of the Institute break down as follows:

	2011 ISK 000s	**2010** ISK 000s
Anna Kristín Gunnarsdóttir, chair of the board of directors up to 22 August 2011	1,802	1,796
Þóroddur Bjarnason, chair of the board of directors from 23 August 2011	732	0
Other directors	7,931	5,430
Aðalsteinn Þorsteinsson, chief executive officer	11,278	10,583
Payments to directors and chief executive officer: total	21,743	17,809

5. Auditors' fees

Auditors' fees break down as follows:

	2011 ISK 000s	**2010** ISK 000s
Audit of annual accounts	7,198	5,212

Other professional services	5,646	3,166
Auditors' fees: total	12,844	8,378

6. Other Treasury funding

	2011 ISK 000s	2010 ISK 000s
Treasury funding re industrial development	2,000	44,225
Treasury funding re economic development projects	3,000	5,000
Other Treasury funding: total	5,000	49,225

7. Reserves and balances with credit institutions

	2011 ISK 000s	2010 ISK 000s
Bank deposits in ISK	1,475,749	284,013
Bank deposits in foreign currencies	17,493	8,568
Government bonds	970,987	1,583,278
Reserves and balances with credit institutions: total	2,464,230	1,875,859

8. Loans to clients

Broken down by recipients:	2011	2010
Local authorities	1.08%	0.70%
Individuals	7.67%	6.61%
Broken down by sector:		
Services	42.69%	41.14%
Fisheries	29.15%	31.34%
Industry	15.24%	16.76%
Financial institutions	0.09%	0.04%
Agriculture	4.08%	3.42%
	100%	100%

Loans granted break down as follows by period outstanding:

Claims fallen due	731,215	624,423
Up to 3 months	273,700	241,836
3 months to 1 year	878,009	896,116

1 year to 5 years	3,831,493	3,723,597
Over 5 years	7,647,716	7,710,199
	13,362,133	13,196,171

9. Appropriated assets

	2011 ISK 000s	**2010** ISK 000s
Immovable assets and real estate	827,859	867,444
Liquid assets	25,000	0
Other bank deposits	0	0
	852,859	867,444

10. Provision to meet losses on loans

Changes in year:

	2011 ISK 000s	**2010** ISK 000s
Provision at start of year	4,542,154	4,632,422
Additions to provision during year	591,975	2,550,472
Loans permanently written off	(1,860,873)	(2,640,740)
Balance at end of year	3,273,256	4,542,154
Additions during year	591,975	2,504,454
Additions arising from guarantees provided	17,581	142,388
Revaluation of shareholdings	101,216	201,304
Depreciation on other claims	0	46,018
Additions to provision to meet losses on loans as per profit and loss account	710,772	2,894,164
Provision to meet losses on loans as percentage of loans granted	19.68%	25.61%

11. Shareholdings

At the end of the year the Icelandic Regional Development Institute held the following shareholdings, specified by nominal value and ownership share:

Property management	**Ownership share**	**Nominal value**
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
Hesthólar ehf	70.99%	14,672
Hótel Hellissandur hf	24.98%	19,534
Hótel Norðurljós ehf	46.40%	2,320
Hæðin á Höfðabraut ehf	12.28%	2,000
Tröllasteinn ehf	18.92%	7,000
Urtusteinn ehf	8.45%	32,818
Property management: total		172,088
Tourist services		
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	34.36%	12,153
Nes-Listamiðstöð ehf	41.67%	5,000
P/F Smyril-line	1.30%	67,669
Rauðka ehf	16.67%	2,000
Snorri Þorfinnsson ehf	19.90%	12,000
Textílsetur Íslands ses	32.15%	2,000
Tourist services: total		119,077
Investment companies		
Eignarhaldsfélag Suðurlands hf	40.00%	109,142
Eignarhaldsfélag Suðurnesja hf	19.03%	96,840
Eignarhaldsfélag Vestmannaeyja hf	38.77%	7,850
Fjárfestingafélagið Vör hf	41.83%	35,940
Hvetjandi ehf	49.29%	54,469
Tvídrangi ehf	15.27%	4,991
Investment companies: total		309,232
Agriculture		
Barri hf	48.40%	43,904

Sláturfélag Austurlands fsvf	28.00%	18,000
Yrkjar ehf	7.29%	1,800
Agriculture: total		63,704
Management consultancy		
Atvinnuþróunarfélag Vestfjarða hf	22.10%	1,933
Atvinnuþróunarfélag Þingeyinga hf	1.60%	159
Management consultancy: total		2,092
Industry		
Borg, saumastofa ehf	19.82%	170
Eðalís ehf	11.06%	3,000
Fánasmiðjan ehf	9.95%	4,167
Fjallalamb hf	10.68%	10,000
Kjörorka ehf	8.25%	2,000
Raflagnir Austurlands ehf	22.37%	3,600
Sigurjón Magnússon ehf	30.00%	214
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
Industry: total		41,525
Health and biotechnology		
Globodent á Íslandi ehf	7.20%	2,425
Health and biotechnology: total		2,425
Fisheries		
Bernskan ehf	34.53%	22,444
Eignarhaldsfélagið Gláma hf	36.52%	114,500
Kampi ehf	35.35%	23,328
Reykofninn-Grundarfirði ehf	15.24%	5,160
Tó hf	10.40%	2,667
Þórsberg ehf	6.09%	2,308
Fisheries: total		170,407
Information technology		
Gagnaveita Skagafjarðar hf	37.14%	103,750
HotMobileMail ehf	24.53%	15,000

Óley ehf	42.02%	10,000
Information technology: total		128,750
Retail and services		
Samkaup hf	2.77%	10,801
Retail and services: total		10,801
Total shareholdings		1,020,101

Shareholdings are entered on the balance sheet at a total value of ISK 881,276,000.

12. Fixed assets

Fixed assets break down as follows:

	Land and buildings ISK 000s	**Fixtures and fittings** ISK 000s	**Motor vehicles** ISK 000s	**Total** ISK 000s
Initial value 1/1	70,388	3,219	12,673	86,280
Total depreciation 1/1	(22,692)	(322)	(2,985)	(25,998)
Depreciation in year	(1,947)	(644)	(2,535)	(5,125)
Book value 31/12	45,750	2,253	7,154	55,157
Total initial value 31/12	70,388	3,219	12,673	86,280
Total depreciation 31/12	(24,639)	(966)	(5,519)	(31,124)
Book value 31/12	45,750	2,253	7,154	55,157
Depreciation ratios	2-3%	20%	20%	

The Institute’s land and buildings are valued as follows. The book value is shown for comparative purposes:

	Property valuation ISK 000s	**Insurance valuation** ISK 000s	**Book value** ISK 000s
Property Skagfirðingabraut 17-21	27,213	92,278	32,900
Property Háuhlíð 4	30,650	51,300	12,850
	57,863	143,578	45,750

13. Assets and liabilities linked to foreign currencies and subject to price indexation

	2011 ISK 000s	2010 ISK 000s
Currency-linked:		
Assets	8,728,795	9,175,994
Liabilities	12,272,241	12,736,896
Net balance of currency-linked assets and liabilities	(3,543,446)	(3,560,902)
Index-linked:		
Assets	4,650,831	4,028,743
Liabilities	4,865,650	4,492,411
Net balance of index-linked assets and liabilities	(214,819)	(463,668)

14. Loans taken out

Loans taken out break down as follows by period outstanding:

	2011 ISK 000s	2010 ISK 000s
Due for repayment	0	0
Up to 3 months	2,018,401	204,088
3 months to 1 year	1,177,660	1,118,394
1 year to 5 years	8,978,183	9,987,220
Over 5 years	4,963,647	5,919,605
	17,137,891	17,229,307

15. Capital reserves

In the year 2010, in the light of an assessment by the Minister of Industry of the future shape of the Institute’s lending activities, an authorisation was agreed in the Budget for 2011 to increase the Institute’s capital reserves by up to ISK 1,000 million. The funds thus authorised were paid to the Institute in December 2011.

Under the terms of Act no. 161/2002, the capital adequacy ratio of credit institutions may not fall below 8% of the so-called risk-weighted asset base; however, at the end of the year the Institute’s capital adequacy ratio stood at 1.34%.

In Article 6 of the Budget for 2012 as agreed by the Icelandic parliament in December 2011, the Minister of Finance was authorised (7.18) to increase the Institute’s capital reserves by up to ISK 2,000 million.

On 26 January 2012 an authority that the Financial Supervisory Authority had granted to the Institute under Article 84 of Act no. 161/2002 to bring the Institute’s capital base above prescribed minimum limits expired. On the same day the Treasury paid over to the Institute ISK 1,750 million as per the authorisation in the Budget detailed above.

Based on this contribution to capital reserves and the Institute's balance sheet at the end of the year 2011, the Institute's capital adequacy ratio would rise to 10.11% and the Institute would thus have fulfilled the Financial Supervisory Authority's requirement to bring the Institute's capital base above prescribed minimum limits. The Institute hopes that the balance of the authority, ISK 250 million, will be paid over to the Institute in the immediate future. This would bring its capital adequacy ratio up to 11.37%.

Capital reserves and capital adequacy ratio as per the relevant legal provisions

	2011 ISK 000s	**2010** ISK 000s
Position at start of year	(497,993)	1,129,921
Funding received from Treasury	1,000,000	1,000,000
Loss for the year	(235,712)	(2,627,914)
	266,295	(497,993)
Capital adequacy ratio	1.34%	-2.40%

16. Guarantees provided

The Institute has committed itself to stand surety for loans to the sum of ISK 397.7 million. At the end of the year an assessment was made of the risk that obligations arising from these guarantees would fall to the Institute. Guarantees to the sum of ISK 179.4 million which are likely to fall to the Institute have been debited in the annual accounts. Off-balance-sheet guarantees thus amount to around ISK 218.3 million at the end of the year.