

ANNUAL ACCOUNTS

BYGGÐASTOFNUN

The Icelandic Regional Development Institute

2016

INDEPENDENT AUDITORS' REPORT

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

Opinion

We have audited the following annual accounts of Byggðastofnun, the Icelandic Regional Development Institute, for the year 2016. The annual accounts comprise a statement of the executive board and officers, a profit and loss account, a balance sheet, a cash-flow statement, and details of significant accounting procedures and other explanatory notes.

It is our opinion that the annual accounts give a true and fair picture of the Institute's performance in the year 2016, its financial position as at 31 December 2016, and its cash flows in the year 2016, in accordance with the Act on Annual Accounts, the Act on Financial Undertakings, and the Regulation on the Annual Accounts of Credit Institutions.

In accordance with the provisions of Article 104, paragraph 2, of the Act on Annual Accounts, no. 3/2006, we certify that to the best of our knowledge the directors' statement which forms part of these annual accounts provides such information as should be provided therein under the Act on Annual Accounts and does not appear in the Notes.

Basis of opinion

The audit was carried out in compliance with international auditing standards. Our responsibility under these standards is set out more fully in the section on Auditors' Responsibility here below. We are external to the Icelandic Regional Development Institute in accordance with established ethical principles for auditors under Icelandic law and we have fulfilled their requirements. We believe that in the audit we have obtained sufficient and appropriate data to base our opinion upon.

Key features of the audit

Key features of the audit are those features which, in our professional judgement, have the greatest significance for our audit of the Institute's annual accounts for the year 2016. These features were scrutinised during the audit of the annual accounts and taken into account in our determining a proper opinion of them. In our endorsement we express no particular opinion on each of them individually.

Key points

Valuation of loans issued and impairment

Loans issued to clients represent the largest single asset on the Institute's balance sheet. Loans issued as per the balance sheet amounted to 9,679.6 billion Icelandic krónur (ISK) or 68% of the Institute's total assets at the end of the year 2016. The accumulated provision for losses on loans stood at ISK 1,334.4 billion at the end of 2016, or 12.12% of total loans issued. We refer to notes 2 and 14 in the Institute's annual accounts for details of the accounting procedure used in the valuation of impairment of loans. We consider the valuation of loans issued to be a key point in the audit on account of the size of the item on the balance sheet and because the valuation of impairment of loans is to a significant extent dependent on the judgement of the Institute's officers.

Responses during the audit

We have appraised the methods used by officers in the valuation, gone over the principles applied in the valuation of loans, and tested the control methods in the impairment process. A data audit was conducted on the impairment of loans issued and a sample selected where the probability of default and loan loss are greatest. The valuation of underlying guarantees was also gone over and they were verified and the officers' assumptions appraised. The Notes in the annual accounts were reviewed with a view to ensuring that the information found in them is in line with the underlying data.

Responsibility of the executive board and chief executive officer for the annual accounts

The executive board and chief executive officer are responsible for the preparation and presentation of the annual accounts in accordance with the Act on Annual Accounts, the Act on Financial Undertakings, and the Regulation on the Annual Accounts of Credit Institutions. The board and chief executive officer are also responsible for such internal control as is necessary in respect of the preparation and presentation of the annual accounts, so that they are free from material misstatement, whether due to fraud or error.

In the preparation of the annual accounts the board and chief executive officer are responsible for assessing the Institute as a going concern. If applicable, the board and chief executive officer shall present relevant explanations of the Institute's capacity to act as a going concern and why it was decided to adopt the going-concern basis in the preparation and presentation of the accounts, unless the board and chief executive officer have decided to dissolve the Institute or cease operations, or have no other viable possibilities than so to do.

The board and audit committee shall oversee the preparation and presentation of the annual accounts.

Auditors' responsibility for the auditing of the annual accounts

Our purpose is to obtain sufficient certainty that the annual accounts are free from material misstatement, whether due to fraud or error, and to issue an endorsement that incorporates our opinion. Sufficient certainty represents a high degree of certainty but does not guarantee that an audit carried out in compliance with international auditing standards will identify all material inaccuracies if such are present. Inaccuracies can arise due to error or fraud and are considered to be material if they might influence the financial decision making of users of the annual accounts, either individually or acting in common.

Our audit in compliance with international auditing standards is based on professional judgement and we apply professional scepticism throughout the audit. We also perform the following tasks:

- Identification and assessment of the risk of material inaccuracy in the annual accounts, whether due to error or fraud, design and implementation of auditing procedures to respond to such risks, and collection of sufficient and appropriate auditing data to base our opinion upon. The danger of failure to identify material inaccuracy due to fraud is greater than that of failure to identify inaccuracy due to error, since fraud can encompass conspiracy, forgery, misleading presentation of annual accounts, intentional omission or circumvention of internal control procedures.
- Obtaining an understanding of such internal control as concerns the audit with the purpose of designing appropriate auditing procedures but not with the purpose of providing an opinion on the effectiveness of the Institute's internal control.

- Assessment of the appropriateness of the accounting procedures used and related notes and of whether the officers' valuation for accounting purposes is realistic.
- Drawing conclusions on the officers' adoption of the going-concern basis and assessment on the basis of the audit of whether there is any significant question as to the Institute's status as a going concern or whether conditions exist that might give rise to significant doubts as to its viability as a going concern. If we consider there is significant uncertainty on the Institute's ability to act as a going concern we are obliged in our Report to draw special attention to the relevant Notes in the annual accounts. If such Notes are incomplete or inadequate we must avoid giving the accounts our unreserved endorsement. Our conclusion is based on the auditing data that was obtained up to the date of our endorsement. This notwithstanding, events or circumstances in the future can give rise to uncertainty regarding the Institute's viability as a going concern.
- Assessment of whether, in their whole, the annual accounts give a true and fair picture of the underlying business and events, and of their presentation, structure, and contents, including notes, as regards giving a true and fair picture.

We are obliged to inform the executive board and audit committee *inter alia* of the proposed scope and date of the audit and of significant matters that arise during our audit, including, if applicable, material deficiencies in internal control that come to light during the audit.

We have also declared to the executive board and audit committee that we have met the requirements of the ethical principles of independence and have provided them with information on connections and other matters that might possibly effect our independence and, where appropriate, what preventative measures we employ to ensure our independence.

Of those matters of which we have informed the executive board and audit committee, we assessed which had the greatest significance for the audit in the present year and these constitute key points of the audit. We declare these matters in our Report unless their disclosure is forbidden under legislation or, in individual cases, where the auditor judges that the matter in question should not be disclosed since the negative consequences of such disclosure are felt to outweigh public interest from disclosure.

Reykjavík, 31 March 2017

Endurskoðendathjónustan ehf

['Auditing services, private limited company',
division of Íslenskir Endurskoðendur ehf, 'Icelandic Auditors, private limited company']

Sævar Thór Sigurgeirsson
State Authorised Public Accountant

Hinrik Gunnarsson
State Authorised Public Accountant

STATEMENT OF THE EXECUTIVE BOARD AND OFFICERS

Functions

The Institute operates under the terms of the Icelandic Regional Development Institute Act, no. 106/1999, and Regulation no. 347/2000. The function of the Icelandic Regional Development Institute is to promote rural settlement and economic activity, with special emphasis on the creation of equal opportunities to employment and habitation for all people in Iceland. In accordance with its function the Institute prepares, organises and funds projects and provides loans with the aim of supporting regional settlement, strengthening employment and encouraging innovation in business and industry. The financing of projects shall, where appropriate, be in collaboration with others. The Institute organises and contributes to consultancy services in co-operation with economic development agencies, local authorities, and other interested parties. The Institute monitors regional development trends in Iceland, through among other means research and the collection of data. The Institute may draw up or have drawn up plans for regional development and economic activity with the aim of supporting settlement and employment in the country's non-metropolitan areas.

Operations in the year 2016

According to the profit and loss account, the Institute's operating profit during the period was ISK 157.1 million. Capital and reserves at the end of the year 2015 as per the balance sheet stood at ISK 2,907.7 million. The capital adequacy ratio under the terms of the Act on Financial Undertakings was 22.74%.

Under Article 86.d, clauses 1 and 2, of Act no. 161/2002 on Financial Undertakings, the Financial Supervisory Authority is authorised to set a countercyclical capital buffer of 0-2.5% of the risk-weighted asset base. Under Article 86.e, clause 1, of the same Act, financing institutions are required to maintain a capital conservation buffer of 2.5%. According to a letter from the Financial Supervisory Authority, dated 1 November 2016, a capital conservation buffer of 1% is required from the date of the letter. The capital conservation buffer goes up to 1.75% on 1 January 2017 and a countercyclical capital buffer of 1% will be added on 1 March 2017. According to an overview from the Financial Supervisory Authority, the aggregate capital buffer requirement will become 3.75% on 1 January 2018.

Páll Baldursson resigned from the executive board of the Icelandic Regional Development Institute on 2 September 2016. In his place, Gunnar Thór Sigbjörnsson was appointed to the board as a principal director with Lilja Sigurðardóttir as deputy. Gunnar resigned from the board on 4 January 2017.

In December 2016 the Institute issued an index-linked tranche of bonds for ISK 2 billion which was listed on the Icelandic stock exchange. The issue is intended to finance the Institute's lending activities.

Hótel Mývatn ehf filed a claim against the Institute regarding the legality of loans that had been restructured from Icelandic krónur into euros. A judgement was delivered in the District Court for the North of Iceland (West) on 6 August 2015 in which the Institute was cleared of the plaintiff's claims. The case was appealed and counterappealed to the Supreme Court, which delivered a judgement on Thursday, 13 October 2016, in which the case was dismissed from the District Court on the grounds that the plaintiff's case was in breach of the terms of Article 25(1) of Act no. 91/1991 on Civil Procedure. This result means that the case is now at an end and cannot be brought back before the courts.

In 2015 the executive board of the Icelandic Regional Development Institute decided to request permission for the construction of new office premises for the Institute in Sauðárkrókur. Authority for this project was granted during the year, with the work to be carried out under the supervision of Framkvæmdasýsla ríkisins (FSR – The Government Construction Contracting Agency). The design of the project was put out to tender in December 2016 and attracted eight bids. A contract for the design was signed in March 2017 with Úti og Inni sf architects and VSB Verkfræðistofa civil engineers and the intention is to issue a call for tenders for the construction of the building in autumn 2017.

At the end of the year the Institute employed 25 members of staff, with a full-day equivalent of 24.5.

Risk management

In 2015 a risk policy was ratified by the executive board of the Icelandic Regional Development Institute. It was reviewed by the board in 2016. Risk management and effective internal control is one of the central pillars of the Institute's responsible operation. The Institute has defined the principal risk factors in its operations; these are credit risk, concentration risk, market risk, exchange rate risk, interest rate risk, prepayment risk, inflation risk, liquidity risk, outflow risk, marketability risk, operational risk, information technology risk, political and legal risk, reputational risk and employee risk. The Institute operates active internal control and all processes have been logged. These processes and risk factors are assessed regularly. Appraisals have shown that the designated monitoring procedures are operating effectively.

Good governance

The present executive board of the Icelandic Regional Development Institute was appointed by the minister of fisheries and agriculture at the Institute's annual general meeting on 15 April 2016. The board will serve up to the Institute's next annual general meeting, which shall be held before 1 July 2017. The Financial Supervisory Authority vets the eligibility of board members under Article 52 of the Act on Financial Undertakings.

The board of the Icelandic Regional Development Institute seeks to maintain good governance and has established rules for the board's working functions as well as ethical rules for staff and officers that form part of a 'Handbook for staff and officers'. The handbook was first approved in 2002 and can be found on the Institute's website, www.byggdastofnun.is. Working rules have also been laid down for the audit committee, and the executive board has defined the functions of the compliance officer. Operating within the Institute there is a loans committee which discusses all loan applications and the sale of appropriated assets, along with making proposals to the board on the sale of shares. Also within the Institute there operate a risk committee, a default committee, and a security committee for which rules of procedures have been laid down. Operational procedures on loan granting activities and financial and asset management have been updated regularly and specify, among other matters, the authorisational powers of the loans committee.

On 15 April 2016 the executive board of the Icelandic Regional Development Institute agreed a policy on environmental and social matters. The Institute treats sustainable development and protection of the environment as a guiding principle in all its operations. In this way the Institute will play its part in meeting the needs of the present day without compromising the capacity of future generations to meet their own needs.

Events since the end of the accounting period

By a presidential decree that took effect on 12 January 2017, issues relating to regional affairs, including the Icelandic Regional Development Institute, were moved from the Ministry of Industries and Innovation to the Ministry of the Interior.

In January 2017 the executive board agreed rules for an administrator of risk management in accordance with Article 17 of Act no. 161/2002 on Financial Undertakings.

Future prospects

The Institute's capital position is strong, enabling it to provide effective and reliable support to companies in the non-metropolitan regions of Iceland. Applications for new loans have risen and the outlook is for a continuing increase in lending during the year. The Institute aims to issue a new class of loans in the year to support innovation companies in the regions.

Declaration of the executive board and officers

The annual accounts have been prepared in compliance with the Act on Annual Accounts and the Regulation on the Financial Statements of Credit Institutions. In accordance with our best knowledge it is our opinion that the annual accounts give a true and fair picture of the Institute's performance in the year 2016, its assets, liabilities and financial position as at 31 December 2016, and its cash flows in the year 2016.

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 for the year 2016.

Sauðárkrókur, 31 March 2017

Herdís Á. Sæmundardóttir
Chairman of the Executive Board

Einar E. Einarsson
Lilja Sigurðardóttir
Sigríður Jóhannesdóttir
Aðalsteinn Thorsteinsson
Chief Executive Officer

Karl Björnsson
Oddný María Gunnarsdóttir
Valdimar Hafsteinsson
Magnús Helgason
Operations Manager

PROFIT AND LOSS ACCOUNT FOR THE YEAR 2016

	<i>Notes</i>	2016 ISK 000s	2015 ISK 000s
INTEREST EARNED			
Interest on deposits with credit institutions		37,602	73,037
Interest earned and indexation adjustment on loans issued		768,286	764,750
		805,887	837,787
INTEREST EXPENSES			
Interest expenses and indexation adjustment on loans received		375,038	382,837
Other interest expenses		292	159
		375,330	382,996
		430,558	454,791
<i>Net interest earned</i>			
OPERATING INCOME			
Funding received from Treasury under Budget provisions	6	349,900	334,400
Foreign exchange adjustment	7	31,282	(12,657)
Other operating income	8	128,198	63,377
		509,380	385,120
		939,937	839,911
<i>Net operating income</i>			
OPERATING EXPENSES			
Disbursements to business consultants		190,500	182,600
Other subsidies granted		68,505	29,312
Salaries and salary-related expenses	3, 4	294,725	263,988
Other operating costs		133,455	128,612
Management of appropriated assets	12	5,215	67,904
Depreciation of fixed operating assets	16	7,236	7,593
Additions to provision for losses on loans etc.	2, 14	83,184	61,012
		782,821	741,021
		157,116	98,891
<i>Profit for the year</i>			

BALANCE SHEET

	<i>Notes</i>	2016 ISK 000s	2015 ISK 000s
ASSETS			
Reserves and balances with credit institutions			
Bank deposits	9	2,757,542	3,081,232
Loans issued			
Loans issued in Icelandic króna	10	7,045,297	6,167,088
Loans issued in foreign currencies	10	2,634,278	3,470,930
Appropriated assets	11, 13	445,552	669,510
		<u>10,125,127</u>	<u>10,307,529</u>
Shares and other variable income securities			
Tradable shares	15	683,414	372,768
		<u>683,414</u>	<u>372,768</u>
Shares in affiliated companies			
Shares in other companies	15	499,258	574,736
		<u>499,258</u>	<u>574,736</u>
Other assets			
Debtors		18,689	25,127
Fixed operating assets	16	56,194	55,384
		<u>74,883</u>	<u>80,511</u>
	Assets: total	<u>14,140,223</u>	<u>14,416,775</u>

31 DECEMBER 2016

	<i>Notes</i>	2016 ISK 000s	2015 ISK 000s
LIABILITIES AND CAPITAL AND RESERVES			
Loans received			
Index-linked securities issued		6,918,788	5,704,361
Loans from foreign institutions		4,084,953	5,791,042
	<i>18</i>	<u>11,003,741</u>	<u>11,495,402</u>
Other debts and liabilities			
Unallocated funds received		141,783	120,629
Other liabilities		87,037	50,197
		<u>228,820</u>	<u>170,826</u>
		11,232,561	11,666,228
		<u>11,232,561</u>	<u>11,666,228</u>
Capital and reserves	<i>2, 19</i>	<u>2,907,663</u>	<u>2,750,547</u>
		14,140,223	14,416,775
		<u>14,140,223</u>	<u>14,416,775</u>

CASH FLOW STATEMENT 2016

	2016 ISK 000s	2015 ISK 000s
Cash in hand from business operations		
Profit for the year	157,116	98,891
<i>Operating items that do not affect cash in hand:</i>		
Addition to provision for losses on loans and revaluation of shares	72,911	22,382
Depreciation of operating assets	7,236	7,593
Loss (profit) on sale of fixed operating assets	(3,730)	726
Profit on sale of appropriated assets	(6,198)	0
Interest, indexation adjustment and exchange rate adjustment	14,433	77,802
<i>Cash in hand from operations</i>	241,768	207,394
Cash flows from investment activities		
Instalment payments on loans issued	1,196,164	1,724,791
Loans issued	(1,943,933)	(1,563,207)
Assets redeemed	5,788	124,897
Shares	979	45,816
Fixed operating assets	(4,316)	(2,456)
Debtors	6,438	43,842
<i>Cash flows from investment activities</i>	(738,880)	373,684
Cash flows from financing activities		
Instalment payments on loans received	(1,884,572)	(5,312,249)
New loans received	2,000,000	5,685,899
Creditors	57,994	63,816
<i>Cash flows from financing activities</i>	173,422	437,466
Increase (decrease) in cash in hand	(323,690)	1,018,544
Cash in hand at start of year	3,081,232	2,062,688
Cash in hand at end of year	<u>2,757,542</u>	<u>3,081,232</u>

NOTES

1. About the Institute

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

2. Accounting principles

Basis of preparation of accounts

The annual accounts have been drawn up in compliance with the Act on Annual Accounts and the Regulation on the Financial Statements of Credit Institutions. They are prepared on a historical cost basis. They employ for the most part the same accounting procedures 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

Officers are required to assess and take specific decisions affecting important items in the annual accounts which by their nature are subject to valuation at any time. The valuation methods used by the officers 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 according to the valuation.

Price-indexed assets and liabilities and assets and liabilities in foreign currencies

Accrued adjustments to the principal value of assets and liabilities as a result of changes in exchange rates and price levels are entered in the annual accounts. Index-linked assets and liabilities are entered on the basis of price indices that took effect on 1 January 2017. Loans issued and loans received in foreign currencies are converted to ISK at the last listed selling rate at the Central Bank of Iceland at the end of the year. Balances in foreign currency accounts at Icelandic commercial banks are converted to ISK at the last listed buying rate of the relevant bank. The difference that arises from exchange rate movement is entered on the profit and loss account and the balance sheet.

*Central Bank of Iceland exchange rate
at end of period:*

	31.12.2016	31.12.2015
USD	113.09	129.90
DKK	16.07	18.99
JPY	0.97	1.08
EUR	119.46	141.71

Arion Bank exchange rate at end of year:

DKK	15.97	18.87
EUR	118.74	140.83

Landsbanki exchange rate at end of year:

EUR	118.83	140.88
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Íslandsbanki exchange rate at end of year:

USD	112.53	129.71
JPY	0.96	1.08
EUR	118.81	140.83

Price indices at start of year:

	1.1.2017	1.1.2016
Consumer prices index for purposes of price indexation	438.4	429.4

Operating assets

Permanent operating assets are entered at acquisition cost less depreciation. Improvements and enhancements are entered as assets if it is likely that they will yield a future profit to the Institute and it is possible to make a reliable estimate of the cost. All maintenance costs are debited to the profit and loss account as and when they are incurred. Depreciation is based on the estimated useful life of individual operating assets and calculated as a fixed annual percentage of the initial acquisition cost, less estimated residual value, based on the period of ownership during the year.

Provision for losses on loans

A provision for losses on loans issued is set up to cover the exposure that is inherent in lending activities but does not imply that assets are irrevocably written off. Additions to the provision for losses on loans are entered as costs on the profit and loss account, reduced by any repayments on account of loans previously written off.

Holdings in companies

Affiliated companies are companies in which the Institute typically holds a 20-50% share. The Institute's interests in affiliated companies are entered initially at purchase price and after the initial entry according to the equity position of the relevant company based on the most recent available information from these companies. Holdings in other companies are entered at purchase cost less impairment. Revaluations are reflected on the profit and loss account and balance sheet.

Appropriated assets

Appropriated assets are entered at their estimated sale value. Revaluations are reflected on the profit and loss account and balance sheet.

Loans issued

Loans issued by the Institute are broken down into loans to clients and appropriated assets. They are originally measured at fair value, i.e. the amount of the loan inclusive of all transaction costs. Loans issued are subsequently measured at amortised cost. All transactions undertaken by the Institute arising from its investments are entered as at the date of transaction, which is taken to be the date on which the Institute committed itself to the transaction. Accrued interest and indexation adjustments are included in the book value of loans. Interest received from loans and deposits are entered under the item 'Interest earned' on the profit and loss account and an adjustment arising from changes in exchange rates appears under the item 'Foreign exchange adjustment'. Depreciation is based on an evaluation of the risk of loss with respect to individual loans. Irrecoverable loans are written out of the Institute's books.

Debtors

Claims against debtors are entered according to the original transaction price, adjusted to cover movements in foreign exchange rates, less a writing-down allowance made to cover doubtful accounts receivable. The writing-down allowance is based on an assessment of the risk of loss with respect to each debtor. Irrecoverable claims are written out of the Institute's books.

Cash in hand

Balances held with banks are included under cash in hand on the balance sheet and in the preparation of the cash flow statement.

Income

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

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

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

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

3. Salaries and salary-related expenses

	2016	2015
	ISK 000s	ISK 000s
Salaries	238,886	212,409
Pension contributions	31,868	27,596
Social security contributions	19,434	18,240
Accrued holiday pay in the year	143	3,183
Other salary-related expenses	4,395	2,559
	<hr/>	<hr/>
Salaries and salary-related expenses: total	294,725	263,988

The Institute had an average workforce of 25 in the year on a full-year basis. On 31 December 2016 there were 25 members of staff on the Institute's payroll, with a full-day equivalent of 24.5.

4. Remuneration of directors and chief executive officer

Salaries paid to the Institute's directors and chief executive officer break down as follows:

	2016	2015
	ISK 000s	ISK 000s
Herdís Á. Sæmundardóttir, chairman of the board from 10.04.2015	2,359	1,568
Thóroddur Bjarnason, chairman of the board to 10.04.2015	0	675
Ásthildur Sturludóttir, director to 15.09.2015	0	733
Einar E. Einarsson, deputy chairman	1,531	1,247
Gunnar Thór Sigbjörnsson, from 1.10.2016	272	0
Halla Björk Reynisdóttir (deputy)	0	43

Karl Björnsson	1,166	1,063
Oddný María Gunnarsdóttir	1,166	1,063
Páll Baldursson, director 15.09.2015-30.09.2016	769	415
Sigríður Jóhannesdóttir	1,166	1,063
Sveinn Auðunn Sæland (deputy)	0	133
Valdímar Haftsteinsson	1,166	1,063
Aðalsteinn Thorsteinsson, chief executive officer	16,350	15,070
Remuneration of directors and chief executive officer: total	25,945	24,134

5. Auditors' fees

Auditors' fees break down as follows:

	2016	2015
	ISK 000s	ISK 000s
Audit of annual accounts and review of interim financial statement	6,678	5,380
Other professional services/internal audit	2,360	5,093
Auditors' fees: total	9,039	10,472

6. Treasury funding as per Budget provisions and other Treasury funding

	2016	2015
	ISK 000s	ISK 000s
General operations	159,400	152,300
Business consultants in the rural regions	190,500	182,100
Treasury funding as per Budget	349,900	334,400
	2016	2015
	ISK 000s	ISK 000s
Treasury subsidy for project <i>Brothættar byggðir</i> ('Fragile communities')	100,000	50,000
Treasury subsidy to Byggðarannsóknasjóður ('Rural Regions Research Fund')	7,000	7,000
Treasury subsidy towards offset of transportation costs	0	150,000
Treasury subsidy for <i>Sóknaráætlun Landshluta</i> campaign ('Moving Iceland Forward: Regional Development')	0	317,301
Other Treasury funding: total	107,000	524,301

	2016 ISK 000s	2015 ISK 000s
Subsidies granted out of Treasury funding entered on the balance sheet		
Subsidy to Byggðarannsóknasjóður ('Rural Regions Research Fund')	5,650	3,000
Subsidies towards offset of transportation costs	0	113,358
Subsidies to <i>Sóknaráætlun Landshluta</i> campaign ('Moving Iceland Forward: Regional Development')	21,071	293,243
Subsidies granted: total	26,721	409,601

Unallocated grants and subsidies arising from other Treasury funding are entered on the balance sheet.

Costs to the Institute arising from the project *Brothættar byggðir* ('Fragile Communities') amounted to ISK 54,105,000 in the year and are entered on the profit and loss account.

7. Foreign exchange adjustment

	2016 ISK 000s	2015 ISK 000s
Foreign exchange adjustment on loans issued	(665,278)	(205,922)
Foreign exchange adjustment on loans received	696,559	193,266
	31,282	(12,657)

8. Other operating income

	2016 ISK 000s	2015 ISK 000s
Rental income	1,255	1,181
Miscellaneous operating income	126,943	62,195
	128,198	63,377

9. Reserves and balances with credit institutions

	31.12.2016 ISK 000s	31.12.2015 ISK 000s
Bank deposits in Icelandic krónur	2,097,967	1,508,932
Bank deposits in foreign currencies	659,575	1,572,300
Reserves and balances with credit institutions: total	2,757,542	3,081,232

10. Loans issued to clients

	31.12.2016	31.12.2015
Broken down by borrowers:		
Local authorities	0.29%	0.27%
Private individuals	20.26%	11.62%
Broken down by sector:		
Services	38.56%	42.07%
Fisheries	19.96%	12.10%
Industry	12.13%	27.38%
Agriculture	8.79%	6.45%
Financial institutions	0.01%	0.10%
	100%	100%

Loans issued inclusive of accrued interest break down by period outstanding as follows:	31.12.2016	31.12.2015
	ISK 000s	ISK 000s
Claims fallen due	153,114	183,530
Up to 3 months	372,260	151,641
3 months to 1 year	624,665	723,164
1 year to 5 years	2,899,512	3,106,263
Over 5 years	5,630,024	5,473,421
	9,679,575	9,638,019

11. Appropriated assets

	31.12.2016	31.12.2015
	ISK 000s	ISK 000s
Real estate	437,552	669,510
Boats	8,000	0
	445,552	669,510

12. Management of appropriated assets

	2016	2015
	ISK 000s	ISK 000s
Rental income	39,342	44,608
Management costs	(44,557)	(112,512)
	(5,215)	(67,904)

13. Appropriated assets

	Rateable valuation ISK 000s	Size m²
Eyrarland 1, Hvammstangi	8,110	159.2
Grænigarður, Ísafjörður	60,091	1,366.7
Fiskislóð 1, Hólmavík	7,300	281.4
Héðinsbraut 4, Húsavík	49,450	1,129.4
Langanesvegur 2, Thórshöfn	9,275	170.7
Nesbraut 7, Reyðarfjörður	33,250	722.4
Pálsbergsgata 3 & 5, Ólafsfjörður	34,350	1,851.4
Sandhorn, Hrísey	20,600	832.7
Seljavogur 10, Hafnir	24,075	231.8
Sindragata 27, Ísafjörður	35,900	659.6
Sólvellir 23, Breiðdalsvík	73,444	2,081.6
Strandarvegur 29-33, 29R, Seyðisfjörður	10,750	601.0
Strandgata 37, Tálknafjörður	11,010	456.1
Valgerðarstaðir 4, Fljótisdalshérað	108,950	5,148.3
Vatneyri machine workshop, Patreksfjörður	10,057	736.1
	496,612	16,428.4
Boats		Gross tonnage
Bobby 12, IS-372		4.68 t
Bobby 16, IS-376		5.68 t
		9.36 t

Appropriated assets are entered in the annual accounts at a value of ISK 445,552,000.

14. Provision for losses on loans

The item 'Additions to provision for losses on loans etc.' on the profit and loss account covers additions to the depreciation allowance for loans issued and accounts receivable and the revaluation of share capital and appropriated assets. The provision for losses on loans is divided into a special depreciation provision and a general depreciation provision. Under the special depreciation provision come borrowers with arrears of over 3 months plus those who are judged to be poor risks.

The provision for losses on loans breaks down as follows.

Provision for losses on loans	Special depreciation provision ISK 000s	General depreciation provision ISK 000s	Total ISK 000s
Position at 1 January	483,885	684,459	1,168,344
Additions in the period	268,451	(19,883)	248,568
Write-offs	(82,531)		(82,531)
Position at 31 December	669,806	664,576	1,334,382
Provision for losses on loans in proportion to loans issued	6.08%	6.03%	12.12%

	2016 ISK 000s	2015 ISK 000s
Addition in the year	248,568	139,342
Addition to cover guarantees provided	0	(990)
Addition to cover accounts receivable	(1,887)	2,048
Revaluation of appropriated assets	72,650	0
Change in value of holdings in affiliated companies	(91,541)	(71,165)
Change in value of other shareholdings	(144,606)	(8,223)
Additions to provision for losses on loans as per profit and loss account	83,184	61,012

15. Shareholdings

At the end of the period the Icelandic Regional Development Institute held the following shares, broken down as follows by nominal value and share of ownership:

Affiliated companies, ownership share > 20%	Share of ownership	Nominal value ISK 000s
Atvinnuthróunarfélag Vestfjarða hf	22.38%	1,933
Dýralíf ehf	33.81%	4,000
Eignarhaldsfélag Suðurlands hf	40.00%	109,142
Fasteignafélagið Borg ehf	29.82%	7,309
Fasteignafélagið Hótel Hellissandur ehf	25.49%	19,534
Fasteignafélagið Hvammur ehf	24.85%	16,919
Fasteignafélagið Kirkjuból ehf	30.00%	7,124
Fjárfestingafélagið Vör hf	41.95%	35,940
Hvetjandi ehf	43.12%	129,635
Molta ehf	30.00%	50,000
Nes-Listamiðstöð ehf	35.71%	5,000
Raflagnir Austurlands ehf	22.37%	3,600

Ullarvinnsla Frú Láru ehf	29.76%	2,500
Útgerðarfélagið Skúli ehf	30.00%	24,274
Vilko ehf	29.13%	21,555
Thörungaverksmiðjan hf	27.67%	7,919

Affiliated companies: total nominal value

446,384

Tradable securities, ownership share ≤ 20%

**Share of
ownership**

**Nominal
value
ISK 000s**

Ámundakinn ehf	19.67%	34,273
Ásgarður hf	13.10%	15,000
Borg, saumastofa ehf	19.82%	170
Eðalís ehf	11.06%	3,000
Eignarhaldsfélag Suðurnesja hf	19.03%	96,840
Fánasmiðjan ehf	9.95%	4,167
Fiskvinnslan Drangur ehf	4.08%	1,000
Fjallalamb hf	13.35%	15,344
Grand Hótel Mývatn ehf	7.22%	10,000
Hótel Flúðir hf	4.77%	1,194
Hótel Húsavík ehf	0.38%	136
Hótel Varmahlíð hf	13.04%	3,000
Hvalamiðstöðin Húsavík ehf	19.70%	2,000
Hæðin á Höfðabraut ehf	12.28%	2,000
P/F Smyril-line (DKK 1,868,000)	1.67%	30,019
Samkaup hf	2.77%	10,801
Snorri Thorfinnsson ehf	19.89%	12,000
Tröllasteinn ehf	18.92%	7,000
Urtusteinn ehf	8.45%	32,818
Yrkjar ehf	7.29%	1,800
Thórsberg ehf	16.69%	30,191

Tradable securities: total nominal value

312,752

Shareholdings: total nominal value

759,136

Shares in affiliated companies are entered in the annual accounts at a value of ISK 499,258,000. Tradable securities are entered at a value of ISK 683,414,000. The value of shares obtained in connection with financial reorganisation stands at ISK 531,940,000.

The change in value of tradable shares between years is attributable principally to cases where the ownership share in a company fell below 20% in the year.

16. Operating assets

Permanent operating assets break down as follows:

	Land & buildings ISK 000s	Motor vehicles ISK 000s	Software ISK 000s	Total ISK 000s
Base value at 1/1	70,388	22,830	7,216	100,434
Total depreciation to 1/1	<u>(32,427)</u>	<u>(11,180)</u>	<u>(1,443)</u>	<u>(45,051)</u>
Book value at 1/1	37,961	11,650	5,773	55,384
Additions in the year	0	10,316	0	10,316
Written off in the year	(1,947)	(3,846)	(1,443)	(7,236)
Sold in the year	0	(6,000)	0	(6,000)
Profit (loss) on sales	0	3,730	0	3,730
Book value at 31/12	36,014	15,850	4,330	56,194
Total base value at 31/12	70,388	30,876	7,216	108,481
Total depreciation to 31/12	<u>(34,374)</u>	<u>(15,026)</u>	<u>(2,887)</u>	<u>(52,287)</u>
Book value at 31/12	36,014	15,850	4,330	56,194
Depreciation ratios	2-3%	20%	20%	

The Institute's land and buildings are valued as follows. The book value of the assets is given for comparative purposes:

	Rateable valuation ISK 000s	Insurance valuation ISK 000s	Book value ISK 000s
Skagfirðingabraut 17-21, Sauðárkrókur	30,818	106,453	24,810
Háahlíð 4, Sauðárkrókur	<u>35,750</u>	<u>63,300</u>	<u>11,205</u>
	66,568	169,753	36,014

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

	31.12.2016 ISK 000s	31.12.2015 ISK 000s
Foreign:		
Assets in foreign currencies	3,293,854	5,043,230
Liabilities in foreign currencies	<u>(4,084,953)</u>	<u>(5,791,042)</u>
Net balance of foreign assets and liabilities	(791,100)	(747,811)

Index-linked:

Index-linked assets	6,200,189	5,419,493
Index-linked liabilities	<u>(6,918,788)</u>	<u>(5,070,315)</u>
Net balance of index-linked assets and liabilities	<u>(718,599)</u>	<u>349,179</u>

Figures are given with depreciation of assets factored in.

Foreign assets and liabilities break down as follows by currency:

31.12.2016	USD ISK 000s	JPY ISK 000s	EUR ISK 000s	Total ISK 000s
Loans issued	216,210	975,942	1,442,127	2,634,279
Cash in hand	401,581	1	257,993	659,575
Assets: total	<u>617,791</u>	<u>975,943</u>	<u>1,700,120</u>	<u>3,293,854</u>
Borrowings	914,887	1,008,054	2,162,012	4,084,953
Net balance	<u>(297,097)</u>	<u>(32,111)</u>	<u>(461,892)</u>	<u>(791,100)</u>

31.12.2015	USD ISK 000s	DKK ISK 000s	JPY ISK 000s	EUR ISK 000s	Total ISK 000s
Loans issued	486,992	0	1,197,087	1,786,852	3,470,930
Cash in hand	637,369	1,281	13,151	920,499	1,572,300
Assets: total	<u>1,124,361</u>	<u>1,281</u>	<u>1,210,238</u>	<u>2,707,350</u>	<u>5,043,230</u>
Borrowings	1,345,074	0	1,425,816	3,020,152	5,791,042
Net balance	<u>(220,713)</u>	<u>1,281</u>	<u>(215,578)</u>	<u>(312,802)</u>	<u>(747,811)</u>

Figures are given with depreciation of assets factored in.

18. Loans received

Loans received break down as follows by period outstanding:

	31.12.2016 ISK 000s	31.12.2015 ISK 000s
Fallen due	0	634,046
Up to 3 months	121,047	143,075
3 months to 1 year	1,388,621	1,456,032
1 year to 5 years	3,964,924	4,183,251
Over 5 years	5,529,150	5,078,999
	<u>11,003,741</u>	<u>11,495,402</u>

Loans received break down as follows by currency:

	Payment terms	Final maturity	Interest terms	31.12.2016 ISK 000s	31.12.2015 ISK 000s
ISK	Equal payments	2030-2034	3.08-5.0% index-linked	6,918,788	5,704,361
USD	Equal instalments	2017-2025	Libor +0.2-1.5%	914,887	1,345,074
JPY	Equal instalments	2017-2023	Libor +0.13-1.5%	1,008,054	1,425,816
EUR	Equal instalments	2017-2025	Euribor +0.2-1.45%	2,162,012	3,020,152
				11,003,741	11,495,402

19. Capital and reserves

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. At the end of the period the Institute's capital adequacy ratio was 22.74%.

Under Article 86.d, clauses 1 and 2, of Act no. 161/2002 on Financial Undertakings, the Financial Supervisory Authority is authorised to set a countercyclical capital buffer of 0-2.5% of the risk-weighted asset base. Under Article 86.e, clause 1, of the same Act, financing institutions are required to maintain a capital conservation buffer of 2.5%. According to a letter from the Financial Supervisory Authority, dated 1 November 2016, a capital conservation buffer of 1% is required from the date of the letter.

The capital conservation buffer goes up to 1.75% on 1 January 2017 and a countercyclical capital buffer of 1% will be added on 1 March 2017. According to an overview from the Financial Supervisory Authority, the aggregate capital buffer requirement will become 3.75% on 1 January 2018.

	31.12.2016 ISK 000s	31.12.2015 ISK 000s
Tier I capital	2,907,663	2,750,547
Total	2,907,663	2,750,547
Credit risk	10,350,188	10,328,038
Market risk	791,100	748,900
Operational risk	1,642,638	1,678,425
Risk-weighted asset base	12,783,925	12,755,363
Position at start of the year	2,750,547	2,651,656
Profit for the year	157,116	98,891
	2,907,663	2,750,547
Capital adequacy ratio	22.74%	21.56%

20. Guarantees provided and commitments

The Icelandic Regional Development Institute did not act as guarantor for any loans with respect to third parties as at 31 December 2016. At the end of the year there were 55 loan commitments to the sum of ISK 1,944 million outstanding. Under the rules of the Icelandic Regional Development Institute, loan commitments lapse after 12 months from the date they are agreed.

21. Other matters

Hótel Mývatn ehf filed a claim against the Institute regarding the legality of loans that had been restructured from Icelandic krónur into euros. A judgement was delivered in the District Court for the North of Iceland (West) on 6 August 2015 in which the Institute was cleared of the plaintiff's claims. The case was appealed and counterappealed to the Supreme Court, which delivered a judgement on Thursday, 13 October 2016, in which the case was dismissed from the District Court on the grounds that the plaintiff's case was in breach of the terms of Article 25(1) of Act no. 91/1991 on Civil Procedure. This result means that the case is now at an end and cannot be brought back before the courts.

22. Business with related parties

The directors of the Icelandic Regional Development Institute, its key officers and affiliated companies, together with close family members of the above and legal entities under their control, fall within the definition of related parties. No unusual transactions took place with related parties during the period. No guarantees have been granted to related parties arising from commercial debts or claims.

Loans provided to related parties at the end of the period amounted to ISK 373,386,000, of which ISK 6,062,000 were in arrears.