Frjalsi Investment Bank hf.

Consolidated Financial Statements

Year ended 31 December 2005

Frjalsi Investment Bank
Lagmuli 6
108 Reykjavik
Iceland

Reg. no. 691282-0829

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Endorsement and Signatures of the Board of Directors and the Managing Director

The Consolidated Financial Statements of Frjalsi Investment Bank hf. (the Bank) for the year ended 31 December 2005 have been prepared in accordance with International Financial Reporting Standards (IFRS). These are the Bank's first Annual Consolidated Financial Statements where IFRS 1 has been applied. The Consolidated Financial Statements include the Financial Statements of Frjalsi Investment Bank ehf. and its subsidiaries, together referred to as "the Bank".

The changes in the Bank's shareholders´ equity as of 1 January 2005 as a result of the implementation of IFRS is a decrease amounting to ISK 89 million. Further information on the effects of adopting IFRS are in the notes to the Consolidated Financial Statements.

According to the Income Statement net profit for the year amounted to ISK 573 million. Equity, according to the Balance Sheet, amounted to ISK 3.926 million at year-end. The Board of Directors does not propose a payment of dividend for the year 2005. Changes in equity and allocation of profit are further explained in the notes to the Annual Accounts. The capital ratio of the Bank, calculated according to the Act on Financial Undertakings, was 18.0%. The ratio may not be lower than 8.0%.

Shareholders at year-end were 6. One shareholder held more than 10% of the Bank's share capital, SPRON, which held 99.9% of the shares in the Bank.

The Board of Directors and the Managing Director of Frjalsi Investment Bank hf. hereby confirm the Consolidated Financial Statements for the year 2005.

Reykjavik, 20 February 2006

Board of Directors:

Guðmundur Hauksson
Chairman

Árni Þór Sigurðsson

Hildur Petersen

Ólafur Haraldsson

Ósvaldur Knudsen

Managing Director:

Kristinn Bjarnason

Auditors' Report

To the Board of Directors and shareholders of Frjalsi Investment Bank hf.

We have audited the accompanying Consolidated Balance Sheet of Frjalsi Investment Bank hf. ("the Bank") as of 31 December 2005 and the related Consolidated Income Statement, Changes in Equity and Cash Flows for the year then ended. These Consolidated Financial Statements are the responsibility of the Bank'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. 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 management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the Consolidated Financial Statements give a true and fair view of the financial position of the Bank as of 31 December 2005 and of the results of its operations and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU.

Reykjavik, 20 February 2006

Sigurður Jónsson

Reynir Stefán Gylfason

KPMG Endurskodun hf.

Consolidated Income Statement
for the year 2005

	Notes	2005	2004
Interest income		2,582,572	1,940,470
Interest expense		(1,938,238)	(1,058,747)
Net interest income	25	644,334	881,723
Fee and commission income	26	106,878	67,027
Dividend income	27	11,983	0
Net gain on sale of financial assets measured at amortised cost		91,938	0
Net gain on assets designated at fair value through profit or loss	28	43,727	0
Foreign exchange difference		2,613	(394)
Other operating income	29	275,098	124,784
Net operating income		1,176,571	1,073,140
Salaries and related expenses	31	(217,175)	(195,525)
Administration expenses		(150,279)	(82,233)
Depreciation and amortisation	46-47	(22,309)	(7,058)
Impairment on loans and advances	41	(82,056)	(165,000)
Share of loss of associates	44	(8,174)	0
Profit before income tax		696,578	623,324
Income tax	33	(123,087)	(112,198)
Net profit for the year attributable to shareholders of Frjalsi Investment Bank hf.		573,491	511,126
Basic earnings per share		0.52	0.47

Consolidated Balance Sheet
as at 31 December 2005

	Notes	31.12.2005	1.1.2005
Assets			
Cash and cash balances with the Central Bank	34	2,564	2,360
Loans and advances	35-41	35,679,283	17,152,986
Trading financial assets	42	0	41,137
Financial assets designated at fair value through profit or loss	43	110,966	171,233
Investments in associates	44	113,677	552
Intangible assets	46	50,917	3,378
Property and equipment	47	802,120	33,438
Non-current assets and disposal groups classified as held-for-sale		7,665	90,002
Other assets	48	743,816	178,298
Total Assets		37,511,008	17,673,384
Liabilities			
Borrowings	49-50	33,348,495	14,182,492
Trading financial liabilities	51	359	0
Tax liabilities	52-54	106,177	113,260
Other liabilities	55	129,860	25,006
Total Liabilities		33,584,891	14,320,758
Equity			
Share capital		1,096,702	1,096,702
Share premium		274,176	274,176
Retained earnings		2,555,239	1,981,748
Total Equity	56	3,926,117	3,352,626
Total Liabilities and Equity		37,511,008	17,673,384

Consolidated Statement of Changes in Capital
for the year 2005

	Shareholders' equity			
	Share Capital	Share Premium	Retained earnings	**Total equity**
Changes in equity in 2004:				
Equity 1 January 2004	1,096,702	274,176	1,559,387	2,930,265
Net profit for the year			511,126	511,126
Equity 31 December 2004	1,096,702	274,176	2,070,513	3,441,391
Changes in equity in 2005:				
Equity 31 December 2004	1,096,702	274,176	2,070,513	3,441,391
Changes due to IFRS			(88,765)	(88,765)
Equity 1 January 2005, adjusted	1,096,702	274,176	1,981,748	3,352,626
Net profit for the year			573,491	573,491
Equity 31 December 2005	1,096,702	274,176	2,555,239	3,926,117

Consolidated Statement of Cash Flows
for the year 2005

	2005	2004
Operating activities:		
Net profit before income tax	696,578	623,324
Adjustments to reconcile net profit to cash flow from (used in) operating activities:		
Non-cash items included in net profit and other adjustments	(764,738)	166,887
Operating assets and liabilities, changes	(536,030)	(163,955)
Income taxes paid	(112,198)	(188,462)
Net cash used in operating activities	(716,388)	437,794
Investing activities:		
Investment in associated companies	(161,550)	(139,073)
Payment for acquisition of subsidiaries (less cash acquired)	40,933	(14,281)
Net cash inflow from disposal of subsidiaries	(17,712,464)	(3,721,936)
Proceeds from sale of assets designated at fair value through profit and loss	103,994	0
Purchase of property and equipment	(794,534)	(14,602)
Proceeds from sale of property and equipment	116,998	18,150
Cash provided by investing activities	(18,406,623)	(3,871,742)
Financing activities:		
Subordinated loan capital issued	19,115,066	(1,881,862)
Subordinated loan capital repaid	(155,327)	5,537,451
Cash from financing activities	18,959,739	3,655,589
(Decrease) increase in cash and cash equivalents	(163,272)	221,641
Effect of exchange rate changes on cash and cash equivalents	269,449	47,809
Cash and cash equivalents at beginning of the year		
Cash and cash equivalents at year-end	106,177	269,450

Consolidated Statement of Cash Flows
for the year 2005 - notes

Non-cash items in the Income Statement and other adjustments:	2005	2004
Impairment on loans and advances	82,056	165,000
Depreciation of property and equipment	19,904	7,058
Amortisation of intangible assets	2,405	0
Net profit of associated companies	(35,237)	(6,684)
Indexation and exchange rate difference	(778,293)	0
Net gain on a disposal of a subsidiary	(32,599)	0
Changes in other non cash items	(22,974)	1,513
	(764,738)	166,887

Changes in operating assets and liabilities:		
Other assets, changes	(565,519)	(151,186)
Other liabilities, changes	29,489	(12,769)
	(536,030)	(163,955)

Cash and cash equivalents:

Cash and cash equivalents at year-end	2005	2004	2003
Cash in hand and demand deposits	2,564	2,360	2,248
Due from credit institutions	163,607	267,090	45,561
Cash and cash equivalents at year-end	166,171	269,450	47,809

Notes to the Consolidated Financial Statements

Accounting policies

General information

Frjalsi Investment Bank is a company incorporated and domiciled in Iceland. The Consolidated Financial Statements for the year 2005 comprise Frjalsi Investment Bank (the parent) and its subsidiaries (together referred to as "the Bank").

The Consolidated Financial Statements are presented in Icelandic krona (ISK), rounded to the nearest thousand.

The Financial Statements were authorised for issue by the Board of Directors of Frjalsi Investment Bank on 20 February 2006.

Summary of significant accounting

1. Statement of compliance

The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU. These are the Bank´s first IFRS annual Consolidated Financial Statements and IFRS 1 *First-time Adoption of International Financial Reporting Standards* has been applied.

The preparation of the consolidated financial Statements in accordance with IFRS resulted in changes to the accounting policies as compared with the most recent annual financial Statements prepared under IS-GAAP. The accounting policies set out below have been applied consistently to all periods presented in these consolidated financial Statements except for IAS 32 and IAS 39 as explained hereafter. They have also been applied in preparing an opening IFRS Balance Sheet at 1 January 2004 for the purposes of the transition to IFRS, as required by IFRS 1, except for IAS 32 and IAS 39 as explained hereafter.

The Bank has decided to make use of the exemption provided in IFRS 1 *First-time Adoption of International Financial Reporting Standards* regarding restatement of comparative information and did not restate comparative information for the year 2004 so as to comply with IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement.* The date of transition to IFRS in respect of IAS 32 and IAS 39 as 1 January 2005. The comparative amounts presented in the Balance Sheet are the amounts reported under previous IS-GAAP as of 31 December 2004, adjusted for the adoption of IAS 32 and IAS 39 on 1 January 2005.

An explanation of how the transition to IFRS has affected the reported financial position and financial performance of the Bank is provided in note 69. This note includes reconciliations of equity and profit or loss for comparative periods reported under Icelandic Generally Accepted Accounting Principles (IS-GAAP), to those reported for those periods under IFRS.

The amendments made to IAS 39, IAS 32 and IFRS 1 relating to the fair value option have been are effective for annual periods beginning on or after 1 January 2006. The Bank has applied these amendments in the Consolidated Financial Statements for the year 2005, before their effective date. The application of the amendments coincides with the initial application of IAS 39 as expained above.

At the date of authorisation of these Consolidated Financial Statements, EU has adopted the following IFRS and amendments to IFRS as effective for annual periods beginning after 31 December 2005. The Group did not apply these IFRS and amendments to IFRS in the Consolidated Financial Statements for the year 2005 even though their earlier application is allowed:

- Amendments to IAS 39 and IFRS 4 (Financial Guarantee Contracts, effective from 1 January 2006)
- Amendment to IAS 39 (Cash Flow Hedge Accounting of Forecast Intragroup Transactions, effective from 1 January 2006)
- Amendment to IAS 21 (The Effects of Changes in Foreign Exchange Rates, effective from 1 January 2006)
- Amendments to IAS 1 (Capital Disclosures, effective from 1 January 2007)
- IFRS 7 Financial Instruments: Disclosures (effective from 1 January 2007)

2. Basis of preparation

The Consolidated Financial Statements are prepared on the historical cost basis except the following assets and liabilities are measured at their fair value: derivative financial instruments, financial instruments held for trading and financial instruments

Non-current assets and disposal groups held for sale are measured at the lower of carrying amount and fair value less costs to sell, unless IFRS 5 requires that another measurement basis shall be used.

The preparation of the Financial Statements in conformity with IFRS requires management to make judgements, estimates and assumptions. These judgements, estimates and assumptions affect the reported amounts of assets and liabilities as well as income and expenses recognised in the Financial Statements. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual may differ from the estimates and the assumptions made.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period or in the period of the revision and future periods if the revision affects both current and future periods.

Judgements made by management in the application of IFRS that have significant effect on the financial Statements and estimates with a significant risk of material adjustment in the next year are discussed in note 24.

The accounting policies have been applied consistently throughout the Bank for purposes of these consolidated financial Statements.

3. Basis of consolidation

a) *Subsidiaries*

Subsidiaries are entities controlled by the Bank. Control exists when the Bank has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control usually exists when the Bank holds more than 50% of the voting power of the subsidiary. In assessing control, potential voting rights that are currently exercisable or convertible, if any, are taken into account. The financial Statements of subsidiaries are included in the consolidated financial Statements from the date that control commences until the date that control ceases.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Bank. The cost of an acquisition is measured as the fair value, at the date of exchange, of the assets given, liabilities incurred or assumed and equity instruments issued, plus cost directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the Bank´s share of the identifiable net assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised directly in the Income Statement.

b) *Associates*

Associates are those entities over which the Bank has significant influence, i.e. the power to participate in the financial and operating policy decisions of the associates but not control or joint control over those policies. Significant influence generally exists when the Bank holds between 20% and 50% of the voting power, including potential voting rights, if any. Investments in associates are initially recognised at cost. The Bank´s investment in associates includes goodwill (net of any accumulated impairment loss) identified on acquisition (see note 21).

Investments in associates held as venture capital in Investment Banking are not accounted for on an equity basis but are designated upon initial recognition as financial assets at fair value through profit or loss and accounted for in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* .

The Consolidated Financial Statements include the Bank´s share of the total recognised gains and losses of associates on an equity accounted basis, from the date that significant influence commences until the date that significant influence ceases. When the Bank´s share of loss exceeds its interest in an associate, the Bank´s carrying amount is reduced to zero and recognition of further losses is discontinued except to the extent that the Bank has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the investor resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

If an investment in an associate is classified as held for sale the equity method is no longer applied and the investment is accounted for under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* (see note 15).

c) *Transactions eliminated on consolidation*

Intragroup balances, unrealised gains and losses or income and expenses arising from intragroup transactions, are eliminated in the Consolidated Financial Statements. Unrealised gains arising from transactions with associates and jointly controlled entities are eliminated to the extent of the Bank's interest in the entity. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

4. Foreign currency

The Bank's functional currency is Icelandic Kronas (ISK). Transactions in functional currencies are translated at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the Balance Sheet date are translated to Icelandic kronas at the foreign exchange rate ruling at that date. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are translated to Icelandic kronas at foreign exchange rates ruling at the dates the fair value was determined.

5. Derivatives

A derivative is a financial instrument or other contract within the scope of IAS 39, the value of which changes in response to a change in an underlying variable (such as share, commodity or bond prices, an index value or an exchange or interest rate), which requires no initial net investment or initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors and which is settled at a future date.

The Bank uses derivatives to hedge its exposure to foreign exchange risk arising from operating and financing activities.

Derivatives are recognised at fair value. Fair value changes are recognised in the Income Statement. Fair values of derivatives are split into (i) interest income (see note 25), (ii) foreign exchange differences. Interest income is recognised on accrual basis. Derivatives with positive fair values are recognised as trading assets and derivatives with negative fair values are recognised as trading liabilities (see notes 42 and 51).

The fair value of derivatives is determined in accordance with the accounting policy presented in note 9.

6. Hedging

Due to the Bank´s risk positions and funding structure, its risk management policies require that the Bank should minimise its exposure to changes in foreign currency rates and manage interest rate, credit risk and market price risk exposure within certain guidelines (see also separate section on risk management). The Bank uses both derivative and non-derivative financial instruments to manage the potential earnings impact of these risks. The Bank has selected not tu use hedge accounting.

Several types of derivatives are used for this purpose, including interest rate swaps and currency swaps, forward contracts and other derivatives. The purpose of the Bank´s hedging activities is to protect the Bank from the risk that the net cash inflows will be adversely affected by changes in interest or exchange rates, credit ratings or market prices. The Bank enters into transactions to ensure that it is economically hedged in accordance with risk management policies. The Bank has selected not to use hedge accounting.

7. Loans and advances

Loans and advances are non-derivative financial instruments with fixed or determinable payments that are not quoted in an active market, other than those that the Bank upon initial recognition designates as at fair value through profit or loss. Loans and advances include loans provided by the Bank to its customers, participation in loans from other lenders and purchased loans that are not quoted in an active market and which the Bank has no intention of selling immediately or in the near future.

Loans and advances are initially reported at disbursement of the loan. They are initially recognised at fair value, which is the cash given to originate the loan, including any transaction costs, and are subsequently measured at amortised cost using the effective interest method. Accrued interest is included in the carrying amount of the loans and advances.

8. Financial assets designated at fair value through profit and loss.

The Bank classifies certain financial assets upon their initial recognition as financial assets held at fair value with fair value changes recognised in the Income Statement if doing so results in more relevant information because:

i) it eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or

ii) financial assets and/or financial liabilities are managed and their performance is evaluated on a fair value basis, in accordance with the Bank´s risk management or investment strategy, and information about it is provided internally on that basis to the Bank's key management personnel.

When the Bank becomes a party to instruments containing embedded derivatives which meet specific conditions, the Bank classifies the instruments into this category in order to avoid the complexity of applying the rules on separation and accounting for the embedded derivatives.

The assets classified according to the above-mentioned conditions consist of:

equity acquired by the Bank with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

Financial assets designated at fair value through profit or loss are measured at fair value and changes in their fair value are recognised in the Income Statement as Net gain on assets designated at fair value through profit or loss. Interest and dividend income that arises from these assets are included in net interest income and dividend income, respectively. Interest income on debt instruments is calculated using the effective interest rate method.

9. Determination of fair value

The determination of fair value of financial assets and financial liabilities that are quoted in an active market is based on quoted prices. For all other financial instruments fair value is determined by using valuation techniques. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring market transactions on an arm's length basis.

Valuation techniques include recent arm's length transactions between knowledgeable, willing parties, if available, reference to the current fair value of other instruments that are substantially the same, the discounted cash flow analysis and option pricing models. Valuation techniques incorporate all factors that market participants would consider in setting a price and are consistent with accepted methodologies for pricing financial instruments. Periodically, the Bank calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument, without modification or repackaging, or based on any available observable market data.

The best evidence of the fair value of a derivative at initial recognition is the transaction price (i.e. the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Bank recognises profits on day one.

10. Recognition and derecognition of financial assets and financial liabilities

Purchases and sales of financial assets are recognised using trade date accounting, i.e. they are recognised on the date on which the Bank commits to purchase or sell the asset, except for loans which are recognised when cash is advanced to the borrowers.

Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Bank has transferred substantially all risks and rewards of ownership.

Financial liabilities are recognised when the Bank becomes a party to the contractual provisions of the liability instrument. Financial liabilities are derecognised when the obligation of the Group specified in the contract is discharged or cancelled or expires.

11. Offsetting financial assets and financial liabilities

Financial assets and liabilities are offset and the net amount reported in the Balance Sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

12. Intangible assets

a) *Goodwill*

All business combinations after 1 January 2004 are accounted for by applying the purchase method. Goodwill has been recognised on the acquisition of subsidiaries and associates. In respect of business acquisitions that have occurred since 1 January 2004, goodwill represents the difference between the cost of the acquisition and the fair value of the net identifiable assets acquired.

In respect of acquisitions prior to this date, goodwill is included on the basis of its deemed cost, which represents the amount recorded under IS-GAAP. The classification and accounting treatment of business combinations that occurred prior to 1 January 2004 has not been reconsidered in preparing the Bank's opening IFRS Balance Sheet at 1 January 2004, see note 69.

Goodwill is measured at cost less any accumulated impairment losses. Goodwill is allocated to cash-generating units and is no longer amortised but is tested annually for impairment, see note 21 b. In respect of associates, the carrying amount of goodwill is included in the carrying amount of the investment in the associate.

b) *Other intangible assets*

Intangible assets other than goodwill that are acquired by the Group are stated at cost less accumulated amortisation and impairment losses.

c) *Subsequent expenditure*

Subsequent expenditure on capitalised intangible assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

d) *Amortisation*

Amortisation is charged to the Income Statement on a straight-line basis over the estimated useful lives of intangible assets. Goodwill with an indefinite useful life is systematically tested for impairment at each Balance Sheet date. Other intangible assets are amortised from the date they are available for use. The estimated useful lives are as follows:

Software.. 3 years

13. Property and equipment

a) *Owned assets*

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses, according to the cost model in IAS 16.

Property that is being constructed or developed for future use as investment property is classified as property and equipment and stated at cost until construction or development is complete, at which time it is reclassified as investment property.

Where parts of an item of property and equipment have different useful lives, those components are accounted for as separate items of property and equipment.

b) *Subsequent costs*

The Bank recognises in the carrying amount of an item of property and equipment the cost of replacing part of such an item when that cost is incurred if it is probable that the future economic benefits embodied with the item will flow to the Bank and the cost of the item can be measured reliably. All other costs are recognised in the Income Statement as an expense as incurred.

c) *Depreciation*

The depreciable amount of property and equipment is determined after deducting its residual value. Depreciation is charged to the Income Statement on a straight-line basis over the estimated useful lives of each part of an item of property and equipment. The estimated useful lives are as follows:

Buildings.. 25-50 years
Machinery and equipment.. 3-5 years
Vehicles.. 7 years

The residual value is reassessed annually.

14. Non-current assets and disposal groups held for sale

Immediately before classification as held for sale, the measurement of the assets and all assets and liabilities in a disposal group is measured in accordance with applicable IFRS. Then, on initial classification as held for sale, non-current assets and disposal groups are recognised at the lower of carrying amount and fair value less costs to sell. Impairment losses on initial classification as held for sale are included in the Income Statement, even when there is a revaluation. The same applies to gains and losses on subsequent remeasurement.

Non-current assets and disposal groups held for sale are mainly mortgages foreclosed.

15. Borrowings

Borrowings are financial liabilities of the Bank which consist of issued bonds and leases from credit institutions. They are initially recognised at fair value less attributable transaction costs. Subsequent to initial recognition, borrowings are measured at amortised cost using the effective interest method. Accrued interest is included in the carrying amount of the borrowings.

16. Trading financial liabilities

Trading financial liabilities consist of derivatives with negative fair values, see note 5.

17. Other assets and other liabilities

Other assets and other liabilities are measured at cost.

18. Share capital

a) *Share capital*
When share capital recognised as equity is repurchased, the amount of the consideration paid, including directly attributable costs, is recognised as a change in equity. Repurchased shares are classified as treasury shares and deducted from equity.

b) *Dividend on shares*
Dividends on shares are recognised in equity in the period in which they are approved by the Bank´s shareholders.

19. Cash and cash equivalents

Cash and cash equivalents in the Consolidated Statement of Cash Flows consist of cash, demand deposits with the central banks and demand deposits with other credit institutions.

20. Income and Expense

a) *Interest income and expense*
Interest income and expense are recognised in the Income Statement as it accrues, taking into account the effective yield of the asset or an applicable floating rate. Interest income and expense includes the amortisation of any discount or premium or other differences between the initial carrying amount of an interest bearing instrument and its amount at maturity calculated on an effective interest rate basis.

The effective interest rate method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Bank estimates cash flows, considering all contractual terms of the financial instrument, but does not consider future credit losses. The calculation generally includes all fees and amounts paid or received between parties to the contract that are an integral part of the effective interest rate, as well as transaction costs and all other premiums or discounts.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised at the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss. Interest income on financial assets which have been written down as a result of impairment is calculated based on the net amount of the financial asset taking the write-down into consideration.

b) *Fee and commission income*
The Bank provides various services to its clients and earns income there from, such as income from Retail Banking earned from services that are provided over a certain period of time are recognised as the services are provided. Fees earned from transaction-type services are recognised when the service has been completed. Fees that are performance-linked are recognised when the performance criteria are fulfilled.

c) *Dividend income*
Dividend income is recognised in the Income Statement on the date that the dividend is declared. Income from equity investments and other non-fixed income investments is recognised as dividend income when it accrues.

21. Impairment

The carrying amount of the Bank's assets, other than financial assets measured at fair value with changes recognised in the Income Statement is reviewed at each Balance Sheet date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated, see note 21c.
An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognised in the Income Statement.

a) *Impairment on loans and advances*
The Bank recognises losses for impaired loans promptly where there is objective evidence that impairment of a loan or portfolio of loans has occurred. This is done on a consistent basis in accordance with the Bank's guidelines.

There are two basic methods of calculating impairment losses, those calculated on individual loans and those losses assessed on a collective basis. Losses expected as a result of future events, no matter how likely, are not recognised.

Objective evidence of impairment includes observable data about the following loss events:

i) significant financial difficulty of the borrower;

ii) a breach of contract, such as a default on installments or on interest or principal payments;

iii) the Bank granting to the borrower, for economic or legal reasons relating to the borrower’s financial difficulty, a refinancing concession, that the lender would not otherwise consider;

iv) it becomes probable that the borrower will enter bankruptcy or undergo other financial reorganisation;

v) the disappearance of an active market for that financial asset because of financial difficulties; or

vi) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of loans since the initial recognition of those assets, even if the decrease cannot yet be identified with the individual financial assets in the group, including:

- adverse changes in the payment status of borrowers in the group; or
- general national or local economic conditions connected with the assets in the group.

Individually assessed loans
Impairment losses on individually assessed accounts are determined by an evaluation of the exposures on a case-by-case basis. The Bank assesses at each Balance Sheet date whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining such impairment losses on individually assessed accounts, the following factors are considered:
- the Bank’s aggregate exposure to the customer;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or Bankruptcy;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to
- which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession; and
- the likely deduction of any costs involved in recovery of amounts outstanding.

Impairment loss is calculated by comparing the present value of the expected future cash flows, discounted at the original effective interest rate of the loan, with its current carrying value and the amount of any loss is charged in the Income Statement. The carrying amount of impaired loans is reduced through the use of an allowance account. In the case of a loan at variable interest rates, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.

Collectively assessed loans
Where loans have been individually assessed and no evidence of loss has been identified, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment loss. This loss covers loans that are impaired at the Balance Sheet date but which will not be individually identified as such until some time in the future.

The collective impairment loss is determined after taking into account:
- future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash flows of the assets;
- historical loss experience in portfolios of similar risk characteristics (for example, by industry sector, loan grade or product);
- the estimated period between a loss occurring and that loss being identified and evidenced by the establishment of an allowance against the loss on an individual loan;

- future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash flows; and
- management's experienced judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

The estimated period between a loss occurring and its identification is determined for each identified portfolio.

Estimates of changes in future cash flows for groups of assets should be consistent with changes in observable data from period to period (for example, changes in property prices, payment status, or other factors indicative of changes in the probability of losses on the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Bank to minimise any differences between loss estimates and actual losses.

Loan write-offs
Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from the realisation of security have been received.

Reversals of impairment
If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed. The amount of any reversal is recognised in the Income Statement.

Assets acquired in exchange for loans
Non-financial assets acquired in exchange for loans in order to achieve an orderly realisation are recorded as assets held for sale and reported in the Balance Sheet. The asset acquired is recorded at the lower of its fair value less costs to sell and the carrying amount of the loan, net of impairment allowance amounts, at the date of exchange. No depreciation is provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included in the Income Statement. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised in the Income Statement.

b) *Impairment of goodwill*
The Bank assesses whether there is any indication of impairment of goodwill on annual basis, with expert analysis being commissioned if necessary. Goodwill is written down for impairment. Gains or losses realised on the disposal of subsidiaries include any unamortised balance of goodwill relating to the subsidiary disposed of.

c) *Calculation of recoverable amount*
The recoverable amount of the Bank's investments in financial assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at the original effective interest rate (i.e. the effective interest rate computed at initial recognition of these financial assets).

The recoverable amount of other assets is the greater of their net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

d) *Reversals of impairment*
An impairment loss in respect of financial assets carried at amortised cost is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

An impairment loss in respect of goodwill is not reversed.

In respect of other assets, an impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount.

An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

22. Income tax

Income tax on the profit or loss for the period comprises current and deferred tax. Income tax is recognised in the Income Statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the expected tax payable on the taxable income for the period, using tax rates enacted or substantially enacted at the Balance Sheet date, and any adjustment to tax payable in respect of previous years.

The deferred income tax asset / liability has been calculated and entered in the Balance Sheet. The calculation is based on the difference between Balance Sheet items as presented in the tax return on the one hand, and in the Financial Statements on the other, taking into consideration a carry-forward tax loss. This difference is due to the fact that tax assessments are based on premises that differ from those governing the Financial Statements, mostly because revenues, especially of financial assets, are recognised earlier in the Financial Statements than in the tax return. A calculated tax asset is only offset against income tax liability if they are due to tax assessment from the same tax authorities.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

23. Segment reporting

Business segment is a distinguishable component of the Bank that is engaged either in providing products or services (business segment) which is subject to risks and rewards that are different from those of other segments. The Bank defines it's business as one segment.

Critical accounting estimates and judgements in applying accounting policies

24. The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

a) *Impairment losses on loans and*

The Bank reviews its loan portfolios to assess impairment at least on a quarterly basis. In determining whether an impairment loss should be recorded in the Income Statement, the Bank makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

b) *Fair value of derivatives*

The fair value of financial instruments that are not quoted in active markets are determined by using valuation techniques. Where valuation techniques (for example, models) are used to determine fair values, they are validated and periodically reviewed by qualified personnel independent of the area that created them. All models are certified before they are used, and models are calibrated to ensure that outputs reflect actual data and comparative market prices. To the extent practical, models use only observable data, however areas such as credit risk (both own and counterparty), volatilities and correlations require management to make estimates. Changes in assumptions about these factors could affect reported fair value of financial instruments.

Notes to the Consolidated Financial Statements

Notes to the Income Statement

Net interest income

25. Interest income and expenses are specified as follows:

	2005	2004
Interest income on cash and balances with central banks	18,810	4,717
Interest income on loans and advances	2,516,459	1,929,013
Other interest income	47,303	6,740
Total interest income	2,582,572	1,940,470
Interest expense on borrowings	(1,938,238)	(1,058,747)
Net interest income	644,334	881,723

Net fee and commission income

26. Fee and commission income and expense are specified as follows:

	2005	2004
Commission from payment service	106,878	67,027
Total fee and commission income	106,878	67,027

Dividend income

27. Dividend income are specified as follows:

	2005	2004
Dividend income	11,983	0
Total dividend income	11,983	0

Net gains on financial assets designated at fair value through profit or loss

28. Net gain on assets at fair value designated through profit and loss are specified as follows:

	2005	2004
Shares	43,727	0
Net gain on assets at fair value through profit and loss	43,727	0

Other operating income

29. Other operating income is specified as follows:

	2005	2004
Gain on disposals of assets other than held for sale	201,161	82,773
Other operating income	73,937	42,011
Other net operating income, total	275,098	124,784

Personnel

30. The Bank's total number of employees is as follows:

	2005	2004
Average number of full time equivalent positions during the year	28	27
Full time equivalent positions at year-end	25	28

31. Salaries and related expenses are specified as follows:

	2005	2004
Salaries	177,255	161,974
Salary related expenses	39,920	33,551
Salaries and related expenses	217,175	195,525

Notes to the Consolidated Financial Statements

Executive employment terms

	Salaries
Managing Director:	
Kristinn Bjarnason	24,224
Directors:	
Guðmundur Hauksson, Chairman	1,780
Ólafur Haraldsson	890
Hildur Petersen	820
Árni Þór Sigurðsson	815
Kristján Harðarson	750
Ósvaldur Knudsen	15

Auditor's fee

32. Auditor's fee is specified as follows:

	2005	2004
Audit of the Financial Statements	3,047	2,421
Review of the Interim Financial Statements	1,545	947
Other service	543	229
Auditor's fee	5,135	3,597

Income tax

33. Tax liabilities recognised in the Income Statement:

	2005	2004
Current tax expenses	125,688	110,685
Deferred tax expenses	(2,601)	1,513
Total income tax expenses	123,087	112,198

Reconciliation of effective tax rate:		2005		2004
Profit before income tax		696,578		623,324
18.0% income tax calculated on the profit of the year	18.0%	125,384	18.0%	112,198
Dividends received, exempt from tax	(0.3%)	(2,157)	0.0%	0
Other changes	(0.0%)	(140)	0.0%	0
	17.7%	123,087	18.0%	112,198

Notes to the Balance Sheet

Cash and cash balances with the Central Bank

34. Cash and cash balances with the Central Bank are specified as follows:

	31.12.2005	1.1.2005
Cash and cash balances	2,564	2,360
Cash and cash balances with the Central Bank	2,564	2,360

Loans and advances

35. Loans and advances are specified as follows:

Loans to credit institutions	166,171	310,587
Loans to customers	35,870,670	17,213,731
Provision for losses	(357,558)	(371,332)
Loans and advances	35,679,283	17,152,986

36. Loans to credit institutions specified by types of loans:	31.12.2005	1.1.2005
Bank accounts	166,171	310,587

37. Loans to credit institutions specified by maturity:

On demand	166,171	310,587

38. Loans to customers specified by types of loans:

Bonds	30,549,876	14,466,252
Other loans	5,320,794	2,747,479
Loans to customers	35,870,670	17,213,731

39. Loans to customers specified by sectors:

Business enterprises:		
Commerce	2.6%	3.7%
Industry	18.2%	21.6%
Service	11.5%	11.7%
Fishing industry and agriculture	0.3%	0.7%
Individuals	67.4%	62.3%
Loans to customers	100.0%	100.0%

40. Loans to customers specified by maturity:

On demand	149,827	137,836
Up to 3 months	509,635	559,637
Over 3 months and up to a year	1,509,797	4,389,817
Over 1 year and up to 5 years	6,464,078	5,652,554
Over 5 years	27,237,333	6,473,887
Loans to customers	35,870,670	17,213,731

41. Changes in the provision on loans and advances are specified as follows:	2005
Balance at the beginning of the year	371,332
Impairment on loans and advances during the year	82,056
Write offs during the year	(80,514)
Unwind of discount of allowance	(15,316)
Provision on loans and advances	357,558

Included within interest income is ISK 15 million with respect to the unwind of the impairment provision discount.

Trading financial assets

42. Trading financial assets are specified as follows:	31.12.2005	1.1.2005
Derivatives	0	41,137
Trading financial assets	0	41,137

Financial assets designated at fair value through profit or loss

43. Financial assets designated at fair value through profit or loss are specified as follows:

Shares	110,966	171,233
Financial assets designated at fair value through profit or loss	110,966	171,233

Investments in associated companies

44. Investment in associates are specified as follows:

	2005
Carrying amount at the beginning of the year	552
Purchases of shares in associates	121,299
Share of results	(8,174)
Carrying amount at the end of the year	**113,677**

Main associates are specified as follows:	Owner-ship	(Loss)/Profit share	Nominal value	Book value
Laugavegur 103 ehf.	50.0%	(3,327)	15,800	12,473
Nesbryggja ehf., Reykjavík	33.3%	(3,346)	60,000	56,654
Ánanaust 15 ehf., Reykjavík	50.0%	(4,508)	14,700	10,192
Skipholt 11-13 ehf., Reykjavík	50.0%	(1,149)	16,500	15,351
Fasteignafélagið Nýfasteign ehf., Reykjavík	50.0%	4,017	14,300	18,316
Tolvumidstoð sparisjodanna, Reykjavík	0.3%	139	552	691
		(8,174)		113,677

Investments in subsidiaries

45. The parent's investment in its subsidiaries are as follows:

	Location	Owner-ship	Assets	Liabilities	Revenue	Results
Fasteignafélagið Hlíð ehf.	Iceland	100.0%	1,662,971	1,476,368	210,017	128,622

Intangible assets

46. Intangible assets are specified as follows:

	Goodwill	Software	Total
Intangible assets 1 January	0	3,378	3,378
Additions during the year	39,750	10,194	49,944
Amortisation during the year	0	(2,405)	(2,405)
Intangible assets 31 December	39,750	11,167	50,917

Property and equipment

47. Property and equipment are specified as follows:

	Real estate	Machinery and equipm.	Total 2005	Total 2004
Balance 1 January	0	46,569	46,569	49,462
Additions during the year	765,665	22,921	788,586	11,028
Disposals during the year	0	(15,705)	(15,705)	(13,921)
Total value 31 December	765,665	53,785	819,450	46,569
Previously depreciated	0	13,131	13,131	8,724
Depreciation during the year	4,245	15,659	19,904	6,862
Disposals during the year	0	(15,705)	(15,705)	(2,455)
Total depreciation 31 December	4,245	13,085	17,330	13,131
Book value 31 December	761,420	40,700	802,120	33,438

48. Other assets are specified as follows:	31.12.2005	1.1.2005
Properties in progress intended for future sale	740,008	168,499
Sundry assets	3,808	9,799
Other assets	743,816	178,298

Borrowings

49. Borrowings are specified as follows:

	31.12.2005	1.1.2005
Bonds issued	28,039,476	11,376,009
Money market loans	5,309,019	2,806,483
Borrowings	33,348,495	14,182,492

50. Borrowings mature as follows:

	31.12.2005	1.1.2005
On demand	11,477	9,250
Up to 3 months	1,006,006	421,049
Over 3 months and up to a year	10,851,023	1,259,047
Over 1 year and up to 5 years	14,981,391	9,686,662
Over 5 years	6,498,598	2,806,484
Borrowings	33,348,495	14,182,492

Trading financial liabilities

51. Trading financial liabilities are specified as follows:

	31.12.2005	1.1.2005
Derivatives	359	0

Tax assets and liabilities

52. Tax liabilities are specified as follows:

	31.12.2005	1.1.2005
Current tax	125,688	130,170
Deferred tax assets	(19,511)	(16,910)
Tax liabilities at the end of the year	106,177	113,260

53. Deferred tax assets are specified as follows:

	31.12.2005	1.1.2005
Deferred tax assets (liabilities) at the beginning of the year	16,910	(1,061)
Calculated income tax for the year	(123,087)	(112,199)
Income tax for the year to be paid next year	125,688	130,170
Deferred tax assets at the end of the year	19,511	16,910

54. Deferred tax assets are specified as follows:

	31.12.2005	1.1.2005
Shares in other companies	(6,480)	0
Loans	32,357	19,485
Fixed assets	(6,366)	(2,575)
Deferred tax assets at the end of the year	19,511	16,910

Other liabilities

55. Other liabilities are specified as follows:

	31.12.2005	1.1.2005
Accounts payable	129,860	25,006
Other liabilities	129,860	25,006

Equity

56. Equity at the end of the year amounts to ISK million. The equity ratio, calculated in accordance to Article 84 of the Act on Financial Undertakings, was 18.0%. According to the law the ratio may not go below 8.0%.

The ratio is calculated as follows:

	31.12.2005		31.12.2004	
	Book value	Weighted value	Book value	Weighted value
Risk I:				
Assets recorded in the Financial Statements	37,511,008	21,646,633	17,673,384	10,306,316
Assets deducted from equity		(39,750)		0
Other items not included in the Balance Sheet		17,195		8,134
		21,624,078		10,314,450
Equity:				
Tier I capital:				
Equity		3,925,718		3,441,392
Intangible assets		(39,750)		0
		3,885,968		3,441,392
Equity ratio		18.0%		33.4%

Derivatives

57. Derivatives remaining maturity date of principal and book value are specified as follows:

2005	Principal		Book value	
	Up to 3 months	Total	Assets	Liabilities
Currency derivatives, agreements unlisted:				
Forward exchange rate agreements	2,149,147	2,149,147	0	359

The objective of the above-mentioned agreements is to control currency risk of the Bank. The credit risk is valued at ISK 17 million when calculating the capital ratio of the Bank.

2004	Principal		Book value	
	Up to 3 months	Total	Assets	Liabilities
Currency derivatives, agreements unlisted:				
Forward exchange rate agreements	988,597	988,597	41,137	0

Additional information

Deposit Insurance Fund

58. According to the Act on the Deposit Insurance Fund for Owners of Saving Deposits and Investors, the total assets of the Fund shall be a minimum of 1.0% of the average insured deposits in Commercial Banks and Savings Banks for the previous year.

Pledged assets

The group has sold the rights to the cash flows of part of its loans to customers to the Housing Financing Fund. The Housing Financing Fund bears all risks associated with the loans. The difference between present value of the loans from the Housing Financing Fund and book value of the underlying loans to customers has been recognised in the Income Statement as net gain on sale of financial assets measured at amortised cost.

Assets and liabilities	31.12.2005	1.1.2005
Cash flows of loans to customers sold to the Housing Financing Fund	6,498,598	2,806,484

Related parties

59. The Bank has a related party relationship with its subsidiaries, associates, the Board of Directors of the parent company, the managing directors of the Bank, the managing directors of subsidiaries, close family members of individuals referred to herein, and entities with significant influence as the largest shareholders of Frjalsi Investment Bank hf. This definition is based on IAS 24. Information regarding related parties are as follows:

	2005	2004
Loans to associated companies	1,779	162

No unusual transactions took place with related parties in the year 2005.

Transactions with related parties have been conducted on arm's length basis.

Salaries, remuneration and salary related expenses to the executive board and the Board of Directors are shown in note 31.

Events after the Balance Sheet date

60. There have been no material post Balance Sheet events which would require disclosure or adjustment to the 31 December 2005 Financial Statements. On 20 February 2006 the Board of Directors reviewed the Financial Statements and authorised them for publication. These Financial Statements will be submitted to the Annual General Meeting of shareholders for approval.

Risk management disclosure

61. The Bank faces various types of risks related to its business as a financial institution, which arise from its day to day operations. Management devotes a significant portion of its time to the management of these risks. The mainstays of effective risk management are the identification of significant risk, the quantification of the Bank's risk exposure, actions to limit risk and the constant monitoring of risk. The most significant of these risks are discussed below. The most important types of financial risk to which the Bank is exposed are credit risk, liquidity risk and market risk. Market risk includes currency risk, interest rate risk and equity price risk.

Risk policy of Frjalsi Investment Bank hf.

The assessment of risk, in particular the determination of its true price along with actions aimed at limiting the risk with sensible credit and investments in other assets, is one of the major tasks of banks and other financial institutions. Many risk factors can adversely affect the Bank. It is the policy of the board of directors that the various risks that the Bank faces in its business are to be constantly monitored and managed. For these purposes Frjalsi utilizes SPRON´s (the parent company) centralised risk management department. In addition, the Bank's internal auditor oversees the operations in order to ensure that its rules are implemented in accordance with resolutions made by the board of directors.

The Bank operates a Lending Committee. In this regard the Bank has created Lending Guidelines which describe the acceptable levels of credit risk. The main role of the Bank´s Lending Committee is to make sound lending decisions based on risk and expected reward.

The process for risk management and risk conrol

a) *Products containing credit risk*
The Bank's primary exposure to credit risk arises through its loans and advances. The amount of credit exposure in this regard is represented by the carrying amounts of the assets on the Balance Sheet. In addition, the Bank is exposed to off Balance Sheet credit risk through commitments to extend credit and guarantees issued.

Loan portfolio: The main assets of the Bank are its loans, to maintain and further improve the quality of the loan portfolio it is imperative to scrutinise all applications and weed out potential problem loans as early as possible, as well as constantly monitor the current loan portfolio. However, it is not the policy of the Bank to solely issue credit of very low risk but it is important that the price of issued credit reflects both risk and costs incurred. This means that a detailed assessment of individual customers, their financial position and the collateral is a prerequisite for granted credits.

Derivatives trading: Derivative financial instruments used by the Bank are mainly in the form of forwards and other similar types of contracts whose value changes in response to changes in interest rates and foreign exchange rates. Limits on the net open derivative positions on these types of contracts are strictly controlled by the Bank.

Derivatives trading: Derivative financial instruments used by the Bank are mainly in the form of forwards and other similar types of contracts whose value changes in response to changes in interest rates and foreign exchange rates. Limits on the net open derivative positions on these types of contracts are strictly controlled by the Bank.

b) *Credit risk strategy*
In recent years, the Bank has emphasised maintaining a healthy loan portfolio and improving the quality of loans. An example of this is the Bank's entry into the Icelandic mortgage market, which began in the latter half of 2004. A large number of customers have opted for refinancing of their consumer loans, which generally bear higher risk, with high quality mortgage loans. Mortgage loans now constitute more than half of the retail portfolio in Iceland. However, it is not the Bank's aim to grant solely credits of very low risk but it is important that the price of the credit, i.e. the margin, offered to substantial clients reflects the risks taken. Credit analysis is therefore a prerequisite for any positive credit decision and the pricing must take into account the risks and the required return on capital.

c) *Credit process and authority*
The Bank's Lending Committee is at the pinnacle of the credit process and has overruling authority in matters related to credit. The Lending Guidelines restrict exposures to different types of entities.

d) *Credit risk monitoring*
Credit risk is monitored centrally within SPRON´s (the parent company) Risk Management Department. The department performs numerical analysis of the loan portfolio on a group level, e.g. estimates expected loss, concentrations within the loan portfolio and maps defaults in a systematic way. These findings are reported to management where possible risk concentrations toward counterparties, sectors etc. are highlighted.

The Risk Management Department focuses on distressed clients and tries to minimise or prevent loss on behalf the Bank by special monitoring of clients with deteriorating credit worthiness. The integrity of the credit process, i.e. in regard to data collection, limit compliance, application preparation, documentation and collateral registration and valuation is monitored

Loan provisioning
An allowance for credit losses is established if there is objective evidence that the Bank will be unable to collect all amounts due on a claim, i.e. a loan, commitment, guarantee etc., according to the original contractual terms or the equivalent value. An allowance for credit losses is reported as a reduction of the carrying value of a claim on the Balance Sheet, whereas for an off-Balance Sheet item, such as a commitment, a provision for credit loss is reported in Other liabilities. Additions to the allowances and provisions for credit losses are made through impairment on loans. Allowances and provisions for credit losses are evaluated at a counterparty-specific level and collectively based on the following principles:

a) *Counterparty-specific*
A claim is considered impaired when there is an object evidence that it is probable that the Bank will not be able to collect all amounts due according to the original contractual terms or the equivalent value. Individual credit exposures are evaluated based upon the borrower’s character, overall financial condition, resources and payment record; the prospects for support from any financially responsible guarantors; and, where applicable, the realisable value of any collateral.

The estimated recoverable amount is the present value, using the loan’s original effective interest rate, of expected future cash flows, which may result from restructuring or liquidation. Impairment is measured and allowances for credit losses are established for the difference between the carrying amount and the estimated recoverable amount. Upon impairment, the accrual of interest income based on the original terms of the claim is discontinued, but the increase of the present value of impaired claims due to the passage of time is reported as interest income.

All impaired claims are reviewed and analysed at least every three months. Any subsequent changes to the amounts and timing of the expected future cash flows compared to the prior estimates will result in a change in the allowances for credit losses and be charged or credited through impairment on loans.

An allowance for impairment is reversed only when the credit quality has improved such that there is reasonable assurance of timely collection of principal and interest in accordance with the original contractual terms of the claim agreement.

A write-off is made when all or part of a claim is deemed uncollectible or forgiven. Write-offs are charged against previously established allowances for credit losses or directly to credit loss expense and reduce the principal amount of a claim. Recoveries in part or in full of amounts previously written off are credited to credit loss expense.

b) *Collectively*
All loans for which no impairment is identified on a counterparty-specific level are grouped into economically homogeneous portfolios to collectively assess whether impairment exists within a portfolio. Allowances from collective assessment of impairment are recognised as credit loss expense and result in an offset to the loan position. As the allowance cannot be allocated to individual loans, interest is accrued on all loans according to contractual terms.

Monitoring and controlling liquidity risk

62. Liquidity risk is the risk of loss arising from the Bank's inability to meet its liabilities as they become due. SPRON monitors its liquidity through a maturity analysis of financial assets and liabilities in order to be able to serve and repay all maturing debts. The Bank must always have sufficient liquidity to meet both foreseeable as well as unexpected payment obligations. The Bank has in place a set of liquidity and funding policies that are intended to maintain flexibility. This includes lines of credit, overdraft facilities and highly liquid securities, such as Treasury bills and bonds.

    Additionally, liquidity risk is monitored through a risk management report on liquidity ratio, which is filed with the Central Bank of Iceland every month. The liquidity ratio measures the ratio of the liquid asset base to liabilities. To determine the liquid asset base the Central Bank assigns weights to each asset class as a conservative measure of liquidity.

63. The breakdown by contractual maturity of financial assets and liabilities, at 31 December 2005.

	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	Total
Cash and Central Bank balances	2,564					2,564
Loans and advances	315,998	509,635	1,509,797	6,464,708	27,237,333	36,037,471
Financial assets measured at fair value	110,966					110,966
Total financial assets	429,528	509,635	1,509,797	6,464,708	27,237,333	36,151,001
Borrowings	11,477	1,006,006	10,851,023	14,981,391	6,498,598	33,348,495
Trading financial liabilities	359					359
Total financial liabilities	11,836	1,006,006	10,851,023	14,981,391	6,498,598	33,348,854
Financial assets - financial liabilities	417,692	(496,371)	(9,341,226)	(8,516,683)	20,738,735	2,802,147

Interest Rate Risk

64. The Bank's operations are subject to the risk of interest rate fluctuations to the extent that interest-earning assets (including investments) and interest-bearing liabilities mature or reprice at different times or in differing amounts. In the case of floating rate assets and liabilities the Bank is also exposed to basis risk, which is the difference in repricing characteristics of the various floating rate indices, such as the savings rate and six months LIBOR and different types of interest. Risk management activities are aimed at optimising net interest income, given market interest rate levels consistent with the Bank's business strategies.

65. The table below shows the banking interest rate risk, i.e. the exposure in the banking book where profit or loss is realised over the lifetime of the exposure, by currency and maturity. Furthermore, the table only shows the net difference between loans and funding for each maturity period.

Currency:	0-1 years	1-3 years	3-6 years	6-10 years	10-20 years	Over 20 years	Total
ISK	(8,672)	(4,061)	12,960	0	0	0	227
EUR	20						20
GBP	(3)						(3)
USD	6						6
CHF	115						115
JPY	107						107

The total amount of indexed assets of the Bank amounted to ISK 31,969 million, and the total amount of indexed liabilities amounted to ISK 14,499 million at year-end.

Currency Risk

66. Currency risk is the risk of loss due to adverse movements in foreign exchange rates. Net exposures per currency are monitored closely and the Bank aims at limiting currency risk and monitors its exposure in relation to the Bank´s total equity.

67. Breakdown of assets and liabilities by currency:
The total amount of assets in foreign currencies in the Banks Financial Statement is ISK 2.517 million, and the total amount of liabilities amounted to ISK 2.250 million, respectively, at year-end. Included in these assets and liabilities are forward contracts, see note 57.

Fair value of financial instruments

68. The following table presents the fair value of financial instruments including those not reflected in the Financial Statements at fair value.

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, i.e. not during a forced sale or liquidation. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used by the Bank to measure financial assets and financial liabilities. If quoted prices for a financial instrument fail to represent actual and regularly occurring transactions in an active market transactions or if quoted prices are not available at all, fair value is established by using an appropriate valuation technique.

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, such as commodities, the fair value is derived directly from the market prices. These instruments are disclosed in following Balance Sheet items; Trading assets and Trading liabilities.

For financial instruments, for which the market is not active, the Bank applies specific working procedures and valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or other commonly accepted valuations techniques used by market participants to price the instrument.

A fair value estimate of the Bank´s assets has indicated that it´s fair value is less than it´s carrying value by an amount of ISK 67 million. Additionally, a fair value estimate of the Bank´s liabilities has indicated that they have a fair value which is less than their carrying value by an amount of ISK 60 million.

Although the Bank follows market standards and relies on well accepted methods there is still wide room for choice, both in the models themselves and the assumptions that must be supplied and cannot be derived from market data. Consequently, different assumptions and choices could lead to different estimates.

Explanation of transition to IFRS

69. **General remarks:**

As discussed in note 1 on accounting policies, this is the first time the Bank has prepared its annual accounts in accordance with the International Financial Reporting Standards (IFRS).

The accounts for the operating year 2005 are prepared in accordance with the accounting policies discussed in the notes on accounting policies. This also applies to comparative figures for 2004 and the opening Balance Sheet of 1 January 2004, as changes become effective as of that date, which is referred to as the transition date.

Amounts in the opening Balance Sheet of 1 January 2004 have been changed in accordance with IFRS, but were previously presented in accordance with legislation on annual accounts and Icelandic GAAP (Generally Accepted Accounting Principles). The following tables and notes show the effects the change from Icelandic GAAP (IS-GAAP) to IFRS has had on the financial position of the Bank, its financial results and cash flows. There are no significant changes to the cash flows summary according to IFRS compared with how it was previously under IS-GAAP.

Changes in equity from IS-GAAP to IFRS:		**Equity**
Equity according to IS-GAAP at 31 December 2004		3,441,391
Equity according to IFRS at 1 January 2005		3,352,626
Change in equity from IS-GAAP to IFRS		(88,765)
Adjustments in the beginning of the year 2005:		
Changes in impairment of loans	IAS 39	71,849
Value changes in loans because of upfront fee	IAS 39	(244,512)
Value changes in financial Assets designated at fair value through profit and loss	IAS 39	64,413
Recalculation of tax liabilities	IAS 12	19,485
Total adjustments at 1 January 2005		(88,765)
Changes from IS-GAAP		(88,765)

Origination fees

The main changes resulting from the adoption of the IFRS are as follows: origination fees will be accrued over the term of the loan instead of being recognised as income at the time of disbursement. As a result the Bank´s interest income will decrease in the short term but the long term effects will be insignificant.

In the opening Balance Sheet at the 1 January 2005, the effective rate of interest on loans has been recalculated in accordance with IAS 39. As a result equity on 1 January 2005 decreased by ISK 245 million.

Impairment of loans and advances

The Bank has performed the impairment test of loans in accordance with IAS 39. As a result the Bank´s equity increased by ISK 71 million.

According to IAS 39, the Bank is obligated to review all loans to ascertain whether there is objective evidence of impairment that affects the size of expected cash flows from the loan. The loan will then be written down to the present value of expected future cash flow.

Value changes in financial assets designated at fair value through profit and loss

The Bank sold the cash flow of part of its loan portfolio and according to the derecognition rules of IAS 39 he has to derecognise it from it Balance Sheet. Increase in the Bank´s equity by ISK 64 million.

Notes to the Consolidated Financial Statements

From IS-GAAP to IFRS

The following tables provide an overview of the effect of the transition to IFRS broken down by valuation and presentation.

Income Statement for 2004, change from IS-GAAP to IFRS

According to IS-GAAP		Change in valuation	Change in presentation		According to IFRS
Net interest income	881,723	0	0	881,723	Net interest income
Fees, commissions and other service charges	67,028	0	0	67,028	Net fee and commission net income
Trading losses	(394)	0	394	0	
		0	(394)	(394)	Foreign exchange differences
Other operating income	124,784	0	0	124,784	Other net operating income
Salaries and salary related expenses	(195,525)	0	0	(195,525)	Salaries and related expenses
Other administrative expenses	(82,233)	0	0	(82,233)	Administrative expenses
Depreciation and amortisation	(7,058)	0	0	(7,058)	Depreciation and amortisation
Provision for losses	(165,000)	0	0	(165,000)	Impairment losses on loans and andvances
Income tax	(112,199)	0	0	(112,199)	Income tax
	511,126	**0**	**0**	**511,126**	**Profit for the year**
Net profit according to IS-GAAP	**511,126**	**0**	**0**	**511,126**	**Profit attributable to shareholders of Frjalsi Investment Bank hf.**

Balance Sheet, change from IS-GAAP to IFRS

According to IS-GAAP		Change in valuation	Change in presentation		According to IFRS
Cash and Amounts due from Credit institutions	312,947	0	(310,587)	2,360	Cash and Cash Balances with the ntral Bank
Loans	17,081,790	(108,251)	179,448	17,152,987	Loans and advances
Bonds, shares and other securities	171,233	0	(130,096)	41,137	Trading financial assets
-	0		171,233	171,233	Financial assets designated at fair value through profit or loss
Shares in associated companies	552		0	552	Investments in associates
Intangible assets	3,378			3,378	
Fixed assets	33,438	0		33,438	Property and equipment
-	0	0	90,002	90,002	Non-current assets and disposal groups classified as held for sale
Other Assets	178,297	0		178,297	Other assets
Total Assets	**17,781,635**	**(108,251)**	**0**	**17,673,384**	**Total Assets**
Amounts owed to Credit Institutions	2,143,178	0	(2,143,178)	0	Deposits from credit institutions and the Central Bank
Borrowings	12,039,313	0	2,143,178	14,182,491	Borrowings
Provision for Deferred Income-Tax Liability	113,260		0	113,260	Tax liabilities
Other Liabilities	44,492	(19,485)	0	25,007	Other liabilities
Equity	3,441,392	(88,766)	0	3,352,626	Shareholders equity
Total Liabilities and Equity	**17,781,635**	**(108,251)**	**0**	**17,673,384**	**Total Liabilities and Equity**