Orkuveita Reykjavíkur

Consolidated
Financial Statements 2017*

*These Financial statements are translated from the original which is in Icelandic. Should there be discrepancies between the two versions, the Icelandic version will take priority over the translated

Orkuveita Reykjavíkur
Bæjarháls 1
110 Reykjavík

reg no. 551298-3029

Contents

Endorsement by the Board of Directors and the CEO

Orkuveita Reykjavíkur is a partnership that complies with the Icelandic law no.136/2013 on the founding of the partnership Orkuveita Reykjavíkur. The Group provides services through its subsidiaries that operate power plants, distribute electricity, hot water and cold water, operates the sewage systems in its service area as well as a fiber optic system in its service area.

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS´s) as adopted by the European Union and the additional requirements set out in the local rules and regulations regarding financial statements of companies with listed bonds. The financial consolidated statements comprise the financial statements of Orkuveita Reykjavikur and its subsidiaries.

Profit of operations of the Group for the year was ISK 16.339 million (2016: ISK 13.352 million). Comprehensive income was 23.146 million (2016: 6.705 million). According to the statement of financial position the Group's assets were ISK 311.258 million at the end of the year (31.12.2016: ISK 300.450 million), book value of equity at the end of the year was ISK 143.871 million (31.12.2016: ISK 121.476 million), resulting in equity ratio of 46,2% (31.12.2016: 40,4%).

At the beginning of the year and at the end of the year the Company´s shareholders were the following three municipalities:

	Share
Reykjavíkurborg	93,539%
Akraneskaupstaður	5,528%
Borgarbyggð	0,933%

Dividend in the amount of ISK 750 million was paid to the owners of the parent Company in the year 2017 (2016: No payment of dividend).

Corporate governance

The Board maintains and seeks to improve good corporate governance. Corporate governance is directed by law no. 136/2013, collective ownership contract, owners' policy and the Board's operating procedure. The procedures also take into account the company´s moral guidelines, Guidelines on corporate governance, which were issued by the Icelandic Chamber of Commerce, Nasdaq OMX Iceland ehf. and SA - Business Iceland and a handbook for board members, issued by KPMG. Subsidiaries have their separate company agreements and their Board´s procedures. These documents can be found on the Company´s website, www.or.is. The Board of Orkuveita Reykjavíkur has appointed a Compensation committee and has nominated a representative in Reykjavík City´s Audit committee.

The principal operations of Orkuveita Reykjavíkur (OR) are governed by Act no.136/2013. The corporate governance of OR should ensure professionalism, efficiency, cost effectiveness, transparency and responsible management. The partnership agreement and ownership policy can be viewed on OR’s website www.or.is. Moreover, the Board of Directors of OR and the boards of directors of the subsidiaries in the Group have established precise working rules and a code of conduct, which can also be found on the company’s website.

The Board of directors

In accordance with the law on undertakings, the Board of Directors of OR comprises six members, five elected by the City Council of Reykjavik and one elected by the town council of Akranes. Borgarbyggd has an observer on the board. The City Council of Reykjavik elects a chairperson and vice-chairperson to the board from a group of members of the City Council of Reykjavik. The Board of Directors is responsible for the finances and operations of OR. The board of Directors appoints two committees; The Audit Committee and The Compensation Committee.

In conjunction with the annual accounts, OR publishes the Annual Report 2017, which includes a more detailed description of OR's governance practices. The report can be found on the URL www.arsskyrsla2017.or.is

Information on the Company´s risk management can be found in notes 24-28 to the financial statements.

Endorsement by the Board of Directors and the CEO, contd.:

Non-financial information

In parallel with this annual accounts, Orkuveita Reykjavíkur issues its annual report 2017. The report is integrated and prepared in accordance with the guidelines from Nasdaq OMX Nordic. It outlines governance, environmental issues, human rights and social affairs, as required by Act no. 3/2006 on annual accounts. The report also outlines the business model of the OR Group, the main business processes and stakeholders in the operation. It describes OR´s human rights policy and how OR tracks fraud and bribery. There are also reports from the Chairman and CEO. In the Appendix with the Financial Statements p. 54 discloses more non-financial information.

The report is endorsed by independent financial, environmental, social and administrative experts, as well as the directors of Orkuveita Reykjavíkur and the CEO.

Statement by the Board of Directors

According to the best knowledge of the Board of Directors and the CEO of Orkuveita Reykjavíkur, the consolidated financial statements are in accordance with IFRS´s as they have been approved by EU and the additional requirements set out in the local rules and regulations regarding financial statements of companies with listed bonds. It is the opinion of the Board of Directors and the CEO that the financial Statements give a fair view of the Group's assets, liabilities and financial position 31 December 2017 and the Group´s operating return and changes in cash and cash equivalents in the year 2017. The Financial Statements also describe the main risk factors and uncertainties faced by the Group.

The Board of Directors and the CEO of Orkuveita Reykjavíkur hereby confirm the Group's Financial statements for the year 2017.

Reykjavík, 8 March 2018.

The Board of Directors:

Brynhildur Davíðsdóttir
Gylfi Magnússon
Sigríður Rut Júlíusdóttir
Áslaug Friðriksdóttir
Rakel Óskarsdóttir

CEO:

Bjarni Bjarnason

Independent auditor's report

To the Board of Directors and Owners of Orkuveitu Reykjavíkur.

Report on the Audit of the Consolidated Financial Statements

Opinion

We have audited the consolidated financial statements of Orkuveita Reykjavíkur (the Group), which comprise the consolidated balance sheet as at December 31, 2017, the consolidated income statement, consolidated statement of comprehensive income, consolidated statement of change in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements give a true and fair view of the financial position of the Group as at December 31, 2017, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional Icelandic disclosure requirements for companies with listed bonds.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of the Group in accordance with the Code of ethics for Icelandic auditors, which are based on the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code). We have also fulfilled other ethical requirements of that rules. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Key Audit Matters	How the matter was addressed in the audit
Valuation of production systems (electricity power plants)	
Reference is made to note 10 and 36d "Property, plant and equipment". At end of year 2017 the carrying value of property, plant and equipment amounted to ISK 277.997 million and thereof the carrying value of electricity and hot water production system, valued at fair value, amounted to ISK 101.169 million. The fair value is determined by discounting future cash flow of the cash generating units within the group where the assets belong to. On regular basis the carrying amount is compared to the fair value or recoverable amount which is calculated by performing an impairment test. When impairment tests show that fair value of production systems are considerable above or below carrying amount then the assets are adjusted to fair value taken into consideration the sensitivity of the impairment test, but never exceeding depreciated replacement cost. Due to the significance to the group's consolidated statement of financial position or 33% of total assets valuation of production systems is a key audit matter in our audit of the financial statements of the group. Also due to inherent uncertainty involved in management forecasting of changes in price level, changes of volume, price changes and other management assumptions used for discounting estimated future cash flow for the production and due to the sensitivity of the impairment tests is for changes in assumptions.	We used the service of our valuation specialists to assess the valuation models and assumptions used by management in their calculation of fair value of production systems. We assessed the management assumptions by comparing them to both internal information from the group and external industry information. We assessed if the design and implementation of the impairment tests used by management was appropriate. We assessed the reasonableness of the discount rates and risk free interest applied. We assessed the reasonableness of general assumptions as population projections, price level and future growth. Management calculation of the impairment test was compared to KPMG calculation and management sensitive analysis done for each cash generating unit where changes in EBITDA, future growth and yield are shown was also tested.

Key Audit Matters	How the matter was addressed in the audit
Timing of revenue recognition from sale and distribution of electricity and hot water.	
Reference is made to note 36k i) "Revenue from sale and distribution of electricity and hot water" and note 3 "Segment reporting". Revenue from sale and distribution of electricity and hot water are invoiced and posted to P&L based on estimated quantity. In subsequent periods the sale is corrected for the difference between measured actual delivered quantity and estimation. At end of each reporting period revenue are corrected for the difference between measured actual delivery to buyers and estimated sale. The process of analysing the difference between estimated and measured delivery of quantity is complex which gives rise to an inherent risk of error in timing of revenue recognition. The timing of revenue recognition from sale and distribution of electricity and hot water is therefore one of the key audit matters of our audit of the consolidated financial statements.	We tested controls over revenue systems. We used the service of our IT specialists to test the appropriate IT controls such as access control, change management control. We also tested non-automated controls. The purpose of the testing was to assess if the design of controls was likely to ensure right timing of the revenue recognition and to test operating effectiveness of controls to see if it was consisted with design of controls. We also evaluated management monitoring of controls. We analysed revenue and used external and internal information to set expectations which were compared to recognised revenue. We used substantive testing where we tested reconciliation between revenue systems and general ledger.

Other information

The Board of Directors and CEO are responsible for the other information. The other information comprises the information included in the annual report, but does not include the consolidated financial statements and our auditor’s report thereon. Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of the Board of Directors and CEO for the Consolidated Financial Statements

The Board of Directors and CEO are responsible for the preparation and fair presentation of the consolidated financial statements in accordance with IFRSs as adopted by the EU and additional Icelandic disclosure requirements for companies with listed bonds , and for such internal control as they determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, the Board of Directors and CEO are responsible for assessing the Group’s ability to continue as a going concern, disclosing, as applicable, matters related to going concern andusing the going concern basis of accounting unless they either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

The Board of Directors and CEO are responsible for overseeing the Group's financial reporting process.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor’s report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

Independent auditor's report, contd.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group’s internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management’s use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group’s ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor’s report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor’s report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with The Board of Directors regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide The Board of Directors with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with The Board of Directors, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor’s report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

Pursuant to the legal requirement under Article 104, Paragraph 2 of the Icelandic Financial Statement Act No. 3/2006, we confirm that, to the best of our knowledge, the report of the Board of Directors accompanying the consolidated financial statements includes the information required by the Financial Statement Act if not disclosed elsewhere in the consolidated financial statements.

The engagement partners on the audit resulting in this independent auditor’s report are Kristrún Helga Ingólfsdóttir og Guðný Helga Guðmundsdóttir.

Reykjavik 8 March 2018.

KPMG ehf.

Kristrún Helga Ingólfsdóttir *Guðný Helga Guðmundsdóttir*

Income Statement 2017

	Notes	2017	2016
Operating revenue		43.999.642	41.420.682
Profit from sale of assets		2.219	2.544
Operating revenues, total	3	44.001.861	41.423.226
Energy purchase and distribution		(5.948.661)	(6.204.799)
Salaries and salary related expenses	5	(5.495.651)	(5.240.591)
Salary related expenses - defined contribution pension expenses	5	(1.104.250)	0
Other operating expenses		(4.736.515)	(4.617.027)
Operating expenses, total		(17.285.077)	(16.062.417)
EBITDA		26.716.785	25.360.809
Depreciation and impairment	7	(9.062.842)	(10.392.479)
Results from operating activities, EBIT		17.653.943	14.968.330
Interest income		651.108	433.252
Interest expenses		(5.170.497)	(5.189.598)
Other income (expenses) on financial assets and liabilities		8.599.823	7.844.913
Total financial income and expenses	8	4.080.434	3.088.567
Share in profit (loss) of associated companies	12	1.926	(3.413)
Profit before income tax		21.736.303	18.053.484
Income tax	9	(5.396.998)	(4.701.673)
Profit for the year		16.339.305	13.351.811

The notes on pages 13 to 53 are an integral part of these Consolidated Financial Statements.

Consolidated Financial Statements of Orkuveita Reykjavikur 2017 8 Amounts are in ISK thousand

Statement of Comprehensive Income for the year ended 31 December 2017

	Notes	2017	2016
Profit for the year		16.339.305	13.351.811
Other comprehensive income			
Items moved to equity that will not be moved later to the income statement			
Revaluation reserve, increase	10	11.586.336	0
Income tax effect of revaluation	9	(1.527.875)	0
		10.058.461	0
Items moved to equity that could be moved later to the income statement			
Changes in fair value of assets available for sale	13	321.973	377.160
Translation difference	20	(3.574.183)	(7.024.272)
		(3.252.210)	(6.647.112)
Other comprehensive income, after taxes		6.806.251	(6.647.112)
Total comprehensive income for the year		23.145.556	6.704.699

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Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 9 Amounts are in ISK thousand

Statement of Financial Position
31 December 2017

	Notes	31.12.2017	31.12.2016
Assets			
Property, plant and equipment	10	277.996.688	264.822.746
Intangible assets	11	1.607.504	1.503.771
Investments in associated companies	12	61.263	59.337
Investments in other companies	13	3.607.047	3.285.074
Embedded derivatives in electricity sales contracts	14	1.877.811	0
Hedge contracts	15	738.800	365.333
Other financial assets	15	0	4.091.936
Deferred tax assets	16	1.265.410	3.714.879
Total non-current assets		287.154.523	277.843.077
Inventories	17	936.045	582.934
Trade receivables	18	5.847.289	4.596.627
Embedded derivatives in electricity sales contracts	14	346.301	0
Hedge contracts	15	36.081	393.183
Other financial assets	15	4.090.265	0
Other receivables	18	305.860	332.229
Prepaid expenses		162.174	213.209
Deposits and marketable securities	19	6.124.722	4.132.427
Cash and cash equivalents	19	6.254.983	12.356.669
Total current assets		24.103.719	22.607.277
Total assets		311.258.242	300.450.354
Equity			
Revaluation reserve		80.349.640	72.918.471
Equity reserve		16.805.347	7.000.139
Development reserve		0	59.759
Fair value reserve		3.144.133	2.822.160
Translation reserve		(5.359.795)	(1.785.611)
Retained earnings		48.932.114	40.460.965
Total equity	20	143.871.439	121.475.883
Liabilities			
Loans and borrowings	21	129.811.656	129.316.964
Pension liability	22	608.261	591.905
Embedded derivatives in electricity sales contracts	14	0	8.913.368
Hedge contracts	15	737.006	2.713.071
Deferred tax liabilities	16	11.080.041	8.345.332
Total non-current liabilities		142.236.964	149.880.640
Accounts payable		2.230.378	2.317.493
Loans and borrowings	21	14.667.114	18.322.481
Embedded derivatives in electricity sales contracts	14	0	1.405.741
Hedge contracts	15	2.898.249	2.311.883
Current tax liability	9	1.453.685	1.737.164
Other current liabilities	23	3.900.413	2.999.068
Total current liabilities		25.149.838	29.093.830
Total liabilities		167.386.803	178.974.471
Total equity and liabilities		311.258.242	300.450.354

The notes on pages 13 to 53 are an integral part of these Consolidated Financial Statements.

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 10 Amounts are in ISK thousand

Statement of Changes in Equity for the year 2017

	Revaluation reserve	Equity reserve	Develop-ment reserve	Fair value reserve	Translation reserve	Retained earnings	Total equity
The year 2017							
Equity at 1 January 2017	72.918.471	7.000.139	59.759	2.822.160	(1.785.611)	40.460.965	121.475.883
Revaluation, increase	11.586.336						11.586.336
Income tax effect of revaluation	(1.527.875)						(1.527.875)
Changes in fair value of assets available for sale				321.973			321.973
Translation difference					(3.574.183)		(3.574.183)
Profit for the year						16.339.305	16.339.305
Total comprehensive income	10.058.461	0	0	321.973	(3.574.183)	16.339.305	23.145.556
Depreciation transferred to retained earnings	(2.627.292)					2.627.292	0
Share in profit of subsidiaries and associates transf. to equity reserve		9.805.207				(9.805.207)	0
Transfer to development reserve reversed			(59.759)			59.759	0
Dividends paid						(750.000)	(750.000)
Equity at 31 December 2017	80.349.640	16.805.347	0	3.144.133	(5.359.795)	48.932.114	143.871.439
The year 2016							
Equity at 1 January 2016	75.808.678	0	0	2.445.000	5.238.661	31.278.845	114.771.184
Changes in fair value of assets available for sale				377.160			377.160
Translation difference					(7.024.272)		(7.024.272)
Profit for the year						13.351.811	13.351.811
Total comprehensive income	0	0	0	377.160	(7.024.272)	13.351.811	6.704.699
Depreciation transferred to retained earnings	(2.890.207)					2.890.207	0
Share in profit of subsidiaries and associates transf. to equity reserve		7.000.139				(7.000.139)	0
Transfer to development reserve			59.759			(59.759)	0
Equity at 31 December 2016	72.918.471	7.000.139	59.759	2.822.160	(1.785.611)	40.460.965	121.475.882

The notes on pages 13 to 53 are an integral part of these Consolidated Financial Statements.

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 11 Amounts are in ISK thousand

Statement of Cash Flows for the year 2017

	Notes	2017	2016
Cash flows from operating activities			
Profit for the year		16.339.305	13.351.811
Adjusted for:			
Financial income and expenses	8	(4.080.434)	(3.088.567)
Share in P/L of associates	12	(1.926)	3.413
Income tax	9	5.396.998	4.701.673
Depreciation, amortisation and impairment	7	9.062.842	10.392.479
Profit from sale of property, plants and equipment		(2.219)	(2.573)
Pension liability, change		16.356	49.244
Working capital from operation before interest and taxes		26.730.922	25.407.480
Inventories, (increase) decrease		(356.646)	27.072
Current assets, (increase) decrease		(1.010.949)	11.651
Current liabilities, increase (decrease)		1.544.967	(465.284)
Cash generated from operations before interests and taxes		26.908.294	24.980.920
Received interest income		572.152	460.966
Paid interest expenses		(4.185.883)	(4.145.818)
Dividend received	8	1.763	28.968
Payments due to other financial income and expenses		(881.420)	(1.116)
Paid taxes		(1.819.693)	0
Net cash from operating activities		20.595.213	21.323.920
Cash flows from investing activities			
Acquisition of property, plant and equipment net of acquired cash	10	(19.129.499)	(12.200.177)
Acquisition of intangible assets	11	(209.816)	(207.833)
Proceeds from sale of property, plant and equipment		12.332	20.394
Change in deposits		(1.000.000)	(2.445.619)
Change in marketable securities		(547.287)	375.016
Other financial assets		29.204	4.008.100
Net cash used in investing activities		(20.845.065)	(10.450.119)
Cash flows from financing activities			
Proceeds from new borrowings	21	13.935.902	8.162.142
Repayment of borrowings	21	(14.195.308)	(14.117.980)
Payments of currency hedges		(1.952.609)	(1.513.082)
Dividends paid	20	(750.000)	0
Current liabilities, change	21	(2.859.984)	3.958.074
Net cash used in financing activities		(5.822.000)	(3.510.846)
(Decrease) increase in cash and cash equivalents		(6.071.852)	7.362.955
Cash and cash equivalents at year beginning		12.356.669	5.264.079
Effect of currency fluctuations on cash and cash equivalents		(29.834)	(270.363)
Cash and cash equivalents at the end of the year	19	6.254.983	12.356.670
Investments and financing without payment effects:			
Acquisition of property, plant and equipment		649.463	(555.151)
Current liabilities, change		(649.463)	555.151
Proceeds from new borrowings		3.462.271	5.816.713
Repayment of borrowings		(3.462.271)	(5.816.713)
Other information:			
Working capital from operation	33	21.560.232	20.240.375

The notes on pages 13 to 53 are an integral part of these Consolidated Financial Statements.

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 12 Amounts are in ISK thousand

Notes

1. Reporting entity

Orkuveita Reykjavíkur "OR" is a partnership that complies with the Icelandic law no. 136/2013 on the founding of Orkuveita Reykjavíkur. OR's headquarters are at Bæjarháls 1 in Reykjavik. OR's consolidated financial statements include the financial statements of the parent company and its subsidiaries, (together referred to as "the Group") and a share in associated companies. The consolidated financial statements of Orkuveita Reykjavikur is a part of the consolidated financial statements of Reykjavik city.

The Group provides services through its subsidiaries that operate power plants, distribute electricity, hot water and cold water, operates the sewage systems in its service area as well as a fiber optic system in its service area.

2. Basis of preparation

a. *Statement of compliance*

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and the additional requirements set out in the local rules and regulations regarding financial statements of companies with listed bonds.

The consolidated financial statements were approved by the Board of Directors on 8 March 2018.

Significant accounting policies for the Group are described in note 36.

b. *Functional and presentation currency*

The consolidated financial statements are presented in Icelandic kronas, which is the Company's functional currency. All financial information has been rounded to the nearest thousand unless otherwise stated.

c. *Basis of measurement*

The consolidated financial statements have been prepared on the historical cost basis except for a part of property, plant and equipment have been revalued at fair value, derivative agreement, embedded derivatives in electricity sales contracts, assets held for sale and other financial assets and liabilities are stated at fair value. The methods used to measure fair values are discussed further in note 36.

d. *Use of estimates and judgements*

The preparation of the consolidated financial statements in conformity with IFRSs requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the year in which the estimates are revised and in any future periods affected.

In particular, information about significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amounts recognised in the financial statements is included in the following notes:

- note 10 - Property, plant and equipment (revaluation of the distribution- and production system and valuation of impairment.)
- note 13 - Investments in other companies (presumptions made when calculating fair value of assets classified as assets held for sale.)
- note 14 - Embedded derivatives in electricity sales contracts (presumptions when calculating fair value)
- note 15 - Other financial assets and other financial liabilities (presumptions when calculating fair value)
- note 16 - Deferred tax assets and liabilities (valuation of future taxable profits against carry forward tax losses)
- note 25 - Market risk

Notes

3. Segment reporting

Business divisions and sectors

The Group's service area is mainly in the Reykjavík city area, but it also extends to the southern and western parts of Iceland. The Group is divided into three separate divisions: production and Sales, Utilities and Other Operation.

The subsidiary **ON Power** generate electricity and harness hot water from the power plants, sells electricity to wholesale and retail customers as well as the new construction and operation of street lighting.

The subsidiaries **Utilities** and **OR Water and Sewage** distribute electricity, harnessing hot water from low-temperature fields and the geothermal plants and distribute it for space heating. It also collects and distributes cold water from reservoirs and runs a sewerage system.

Other operations cover the fiber optic system, rental of housing and equipment, incidental sale of specialist consultancy services and more.

The Group is income taxed and collects value added tax, except for operations regarding cold water and sewer but they are regulated by law no. 33/2004 concerning cold water suppliers of municipalities and law no. 9/2009 concerning the operations of sewer. The provision of hot water supply is subject to law no. 58/1967, concerning earnings from hot water. The distribution of electricity is subject to law no. 65/2003, which stipulates revenue caps that are decided by the National Energy Authority.

Sector	Official obligations
Hot water	Minister approves utility rates not subject to the open market. These take effect upon publication in the Ministerial Gazette.
Electricity, distribution	Price rates are subject to authorisation from The National Energy Authority. Rates are officially published.
Electricity, production	Energy sales are subject to the open market, electricity rate changes are therefore not subject to government approval.
Cold water	The legal limitation on the upper limit of the rate is 0,5% of the real estate value. Rates are officially published in the Law and Ministerial Gazette.
Sewer system	The Rates for the sewer system shall cover all costs. Rates are officially published in the Ministerial Gazette.
Fiber-optic data system	This is a competitive practice that is supervised by The Post and Telecom Administration.

Customers that have significant effect on the Group's revenues

One customer of ON Power has significant effect on the Group's revenues in the year 2017. The Group´s revenues from this customer represents approximately ISK 5.699 million or 13,0% of total revenues. (2016: ISK 5.313 million, or 12,8% of total revenue).

Notes

3. Segment reporting

Segment information is presented by the Group's internal reporting. Business segments presented are *Utilities,* that represent licensed operations in hot and cold water, distribution of electricity and sewage, *ON Power*, representing the competitive operations in producing electricity and hot water and *Other Operation,* that represents the activities of the parent company and the fiber optic operations. The parent company's main activities is rental of housing and equipment, incidental sale of specialist consultancy services and more. Reykjavik fiber network represents the fiber optic operations. Segment reporting is conducted by using the same accounting principle as the group uses and is described in note 36.

Business segments - divisions

The year 2017	**Utilities**	**ON Power**	**Other Operation**	**Adjust-ments**	**Total**
External revenue	27.539.612	13.749.632	2.712.618	0	44.001.861
Inter-segment revenue	3.436.704	4.131.164	6.136.320	(13.704.189)	(0)
Total segment revenue	30.976.316	17.880.796	8.848.938	(13.704.189)	44.001.861
Segment operation expenses	(14.862.025)	(7.893.501)	(8.233.739)	13.704.189	(17.285.077)
Segment profit EBITDA	16.114.291	9.987.295	615.199	0	26.716.785
Depreciation and amortisation	(4.887.463)	(3.028.130)	(1.147.249)	0	(9.062.842)
Segment results, EBIT	11.226.828	6.959.165	(532.050)	0	17.653.943
Financial income and expenses	(2.798.881)	(3.988.254)	(1.675.650)	12.543.221	4.080.434
Share in profit of associated companies	0	0	1.926	0	1.926
Income tax	(999.372)	(598.999)	752.518	(4.551.145)	(5.396.998)
Profit (loss) for the year	7.428.574	2.371.913	(1.453.257)	7.992.075	16.339.305

The year 2016	**Utilities**	**ON Power**	**Other Operation**	**Adjust-ments**	**Total**
External revenue	27.027.091	12.290.176	2.105.959	0	41.423.226
Inter-segment revenue	3.315.594	4.247.844	5.889.117	(13.452.555)	0
Total segment revenue	30.342.686	16.538.021	7.995.075	(13.452.555)	41.423.226
Segment operation expenses	(14.099.606)	(8.327.805)	(7.087.561)	13.452.555	(16.062.418)
Segment profit EBITDA	16.243.079	8.210.215	907.514	0	25.360.809
Depreciation and amortisation	(4.977.064)	(3.496.008)	(929.123)	0	(9.402.195)
Impairment	0	0	(990.284)	0	(990.284)
Segment results, EBIT	11.266.015	4.714.207	(1.011.893)	0	14.968.330
Financial income and expenses	(3.502.965)	(4.533.242)	8.271.721	2.873.054	3.088.567
Share of loss of associated companies	0	0	(3.413)	0	(3.413)
Income tax	(852.904)	(70.693)	(2.743.777)	(1.034.299)	(4.701.673)
Profit for the year	6.910.146	110.273	4.512.638	1.838.754	13.351.811

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 15 Amounts are in ISK thousand

3. Segment reporting, contd.

Business segments - divisions, contd.

	Utilities	ON Power	Other Operation	Adjust-ments	Total
Balance sheet (31.12.2017)					
Property, plant and equipment and intangible assets	151.079.915	101.169.408	27.354.869	0	279.604.192
Other assets	16.477.990	9.827.856	152.422.891	(147.074.687)	31.654.050
					311.258.242
Loans and borrowings	63.237.820	55.752.375	148.520.208	(123.031.634)	144.478.770
Other liabilities	10.061.653	6.873.754	30.993.447	(25.020.821)	22.908.033
					167.386.804
Investments					
Property, plant and equipment and intangible assets	6.314.920	2.627.265	9.766.211	0	18.708.396
Balance sheet (31.12.2016)					
Property, plant and equipment and intangible assets	140.907.133	106.661.900	18.757.484	0	266.326.517
Other assets	13.820.838	7.188.531	158.044.763	(144.930.295)	34.123.836
					300.450.354
Loans and borrowings	67.441.448	61.583.102	147.639.446	(129.024.550)	147.639.446
Other liabilities	8.242.316	4.966.732	27.429.313	(9.303.336)	31.335.025
					178.974.471
Investments					
Property, plant and equipment and intangible assets	6.506.192	2.967.163	3.479.974	0	12.953.328

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 16 Amounts are in ISK thousand

Notes

4. Analysis of geothermal power plant operation

Return analysis of production of electricity and hot water, cf. Article 41, paragraph 5 of law no. 65/2003:

	Electricity 2017	Hot water 2017	Electricity 2016	Hot water 2016
Geothermal power plant				
Revenue	8.843.657	3.499.470	9.205.438	3.600.872
Operating expenses	(1.798.868)	(832.216)	(1.927.328)	(789.570)
Depreciation and amortisation	(2.562.145)	(745.373)	(2.649.013)	(829.947)
Profit before financial expenses	4.482.644	1.921.881	4.629.097	1.981.355
Return on investment	5,7%	8,8%	5,4%	7,0%

The power plants at Hellisheiði and Nesjavellir are mixed production plants, where both hot water and energy are produced.
The cost allocation is based on ON Power´s methods, that the National Energy Authority "NEA" has not approved. NEA is obligated to set new cost allocation rules after having disapproved ON Power´s proposal, NEA has not yet carried this out. Until NEA sets new rules for cost allocation, the return of the sectors are reported using ON Power's methods.

5. Salaries and salary related expenses

Salaries and salary related expenses are specified as follows:

	2017	2016
Salaries	5.178.623	4.802.257
Defined contribution pension expenses	690.885	633.931
Defined contribution pension expenses paid to Bru Pension Fund	1.104.250	0
Defined benefit pension expenses	42.206	76.744
Other salary related expenses	493.704	463.473
Total salaries and salary related expenses	7.509.667	5.976.406

Salaries and salary related expenses are stated in the financial statements as follows:

	2017	2016
Expensed in the income statement	6.599.901	5.240.591
Capitalised on projects	909.767	735.815
Total salaries and salary related expenses	7.509.667	5.976.406

Number of employees:

	2017	2016
Number of annual working units	520	503

Management's salaries and benefits for the parent company and subsidiaries are specified as follows:

	2017	2016
Salaries to the Board of Directors of the Parent Company	15.629	15.265
Salaries of the CEO of the Parent Company	28.641	27.657
Salaries of three Managing Directors of the Parent Company	64.439	56.059
Salaries to the Board of Directors of three subsidiaries	25.745	24.101
Salaries of three Managing Directors of subsidiaries	73.030	67.777
Termination expenses, pension expenses included 1)	0	20.697
	207.483	211.557

1) The manager of Orka náttúrunnar ohf. left his position at year-end 2016. Salaries and salary related expenses were all expensed in P/L upon his departure.

Charter revision of Division A in Bru Pension Fund

Act nr. 1/1997 on the Pension Funds of State Employees was amended with Act nr. 127/2016, but the amendment has implications on earned rights in Division A which Bru Pension Fund operates and many employees of Orkuveita Reykjavíkur pay their pension fees to that fund. Revised charter came into force on 1 June 2017. Revision and actuarial assessment was finalized in the 4th quarter 2017 and as a result the Group paid ISK 1.104 million to Bru Pension Fund 15 February 2018. The payment is expensed through P/L.

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 17 Amounts are in ISK thousand

6. Auditors fee

	2017	2016
Audit of financial statements and review of interim financial statements	20.789	15.288
Other services	11.974	4.254
Total auditors fee	32.763	19.542

7. Depreciation, amortisation and impairment

	2017	2016
Depreciation, amortisation and impairment is specified as follows:		
Depreciation of property, plant and equipment cf. note 10	8.956.759	9.332.096
Impairment of assets under construction cf. note 10	0	990.284
Amortisation of intangible assets, cf. note 11	106.083	70.099
Depreciation, amortisation and impairment expensed in income statement	9.062.842	10.392.479

8. Financial income and expenses

	2017	2016
Financial income and expenses are specified as follows:		
Interest income	651.108	433.252
Interest expense and paid indexation	(3.560.464)	(3.272.849)
Indexation	(851.326)	(905.734)
Guarantee fee to owners 1)	(758.706)	(1.011.015)
Total interest expenses	(5.170.497)	(5.189.598)
Fair value changes of embedded derivatives in electricity sales contracts	12.543.221	2.873.054
Fair value changes of financial assets and financial liabilities through P/L	27.534	(616.075)
Fair value changes of hedge contracts	1.406.064	(1.438.956)
Hedge contracts	(2.732.072)	(1.506.134)
Foreign exchange difference	(2.646.685)	8.504.058
Dividends	1.763	28.968
Total of other income (expenses) on financial assets and liabilities	8.599.823	7.844.913
Total financial income and expenses	4.080.434	3.088.567

1) The Group paid a guarantee fee to current and former owners of the company for guarantees they have made on the Groups loans and borrowings according to a decision made on the annual meeting of Orkuveita Reykjavikur in 2005. The fee on yearly basis for its licensed operations is 0,87% (2016: 0,95%) and 0,58% (2016: 0,57%) regarding loans due for operations in the open market. The guarantee fee is calculated on total loans quarterly. The guarantee fee amounted to ISK 759 million in the year 2017 (2016: ISK 1.011 million) and is accounted for among interest expenses.

Fair value changes through P/L

Generally accepted valuation methods are used to determine the fair value of certain financial assets and financial liabilities, further discussed in note 36. Change in fair value that is recognized in the income statement amounts to ISK 13.977 million (2016: income ISK 818 million). Fair value changes on financial assets and liabilities defined at level 3 amounts to ISK 12.571 million (2016: income ISK 2.260 million).

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 18 Amounts are in ISK thousand

9. Income tax

The Group's companies are tax liable according with Article 2 of law no. 90/2003 on income tax. The part of the Group's operation concerning operation of cold water supply and sewer is though exempt from income tax. The parent Company´s tax rate is 36%, other taxable subsidiaries have a 20% tax rate.

In December 2017, a change in the Income Tax Act was approved, which included an increase in the income tax rate, from 36% to 37,6%, and this amendment became effective as from 1 January 2018. The effect of the increased tax rate on the income tax liability at the beginning of the year amounts to ISK 18,3 million, and the increase is accounted for in the income statement.

Income tax recognised in the income statement is specified as follows:	**2017**	**2016**
Current income tax	1.453.685	1.737.164
Change in deferred income tax	3.943.314	2.964.509
Income tax recognised through P/L	5.396.998	4.701.673

Reconciliation of effective tax rate:		**2017**		**2016**
Profit before income tax		21.736.303		18.053.484
Income tax according to tax ratio of parent	36,0%	7.825.069	36,0%	6.499.254
Effect of tax rates of subsidiaries	(5,9%)	(1.281.364)	(3,9%)	(700.268)
Effect of valuation of impairment of deferred tax losses	0,5%	98.000	0,7%	133.132
Non-taxable operation of water supply and sewer	(5,7%)	(1.235.196)	(7,0%)	(1.259.401)
Effect of different functional currencies in the Group	0,02%	4.813	1,2%	38.503
Effect of change in tax rate	(0,1%)	(18.261)	0,0%	0
Other items	0,02%	3.938	(0,1%)	(9.548)
Effective income tax	24,8%	5.396.998	27,0%	4.701.673

Income tax recognised in other comprehensive income

Deferred tax

Due to income and expenses moved direct to equity	**2017**	**2016**
Tax effect of revaluation	1.527.875	0
Deferred tax, total	1.527.875	0

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 19 Amounts are in ISK thousand

Notes

10. Property, plant and equipment

The year 2017	Production system	Utility system	Other real estates	Other equipment	Total
Cost or deemed cost					
Balance at year beginning	223.906.578	272.482.897	1.957.032	2.210.408	500.556.916
Reclassification of assets	61.223	61.195	(122.418)	0	0
Additions during the year	3.846.101	8.069.198	6.082.072	501.211	18.498.581
Translation difference	(11.354.448)	0	(872)	(8.879)	(11.364.199)
Sold or disposed of	0	(11.465)	0	(27.556)	(39.021)
Revaluation, increase	9.151.311	16.234.184	0	0	25.385.495
Balance at year end	225.610.766	296.836.009	7.915.813	2.675.184	533.037.772
Depreciation					
Balance at year beginning	88.296.093	145.943.833	355.851	1.138.391	235.734.169
Reclassification of assets	2.093	3.055	(5.149)	0	0
Depreciated during the year	4.203.987	4.434.957	51.216	266.600	8.956.759
Translation difference	(3.429.934)	0	(322)	(1.304)	(3.431.560)
Sold or disposed of	0	0	0	(17.443)	(17.443)
Revaluation, increase	4.516.488	9.282.671	0	0	13.799.159
Balance at year end	93.588.728	159.664.516	401.597	1.386.244	255.041.084
Carrying amounts					
At 1.1. 2017	135.610.485	126.539.064	1.601.181	1.072.017	264.822.746
At 31.12. 2017	132.022.038	137.171.493	7.514.216	1.288.940	277.996.688
Thereof assets under construction at year end	2.234	293.054	0	0	295.288

The year 2016	Production system	Utility system	Other real estates	Other equipment	Total
Cost or deemed cost					
Balance at year beginning	242.676.320	264.376.762	1.512.548	1.986.046	510.551.676
Reclassification of assets	(276.822)	(107.740)	81.295	(17.465)	(320.732)
Additions during the year	3.848.583	8.213.874	364.930	317.590	12.744.977
Additions of assets in constr.	518	0	0	0	518
Translation difference	(22.342.020)	0	(1.741)	(8.870)	(22.352.631)
Sold or disposed of	0	0	0	(66.893)	(66.893)
Balance at year end	223.906.578	272.482.897	1.957.032	2.210.408	500.556.916
Depreciation					
Balance at year beginning	89.424.779	141.539.321	292.548	983.861	232.240.509
Reclassification of assets	(301.712)	(44.685)	43.290	(17.625)	(320.732)
Depreciated during the year	4.638.729	4.449.197	20.635	223.536	9.332.096
Impairment of assets in constr.	990.284	0	0	0	990.284
Translation difference	(6.455.987)	0	(621)	(2.309)	(6.458.916)
Sold or disposed of	0	0	0	(49.072)	(49.072)
Balance at year end	88.296.093	145.943.833	355.851	1.138.391	235.734.169
Carrying amounts					
At 1.1. 2016	153.251.540	122.837.442	1.220.000	1.002.185	278.311.167
At 31.12. 2016	135.610.485	126.539.064	1.601.181	1.072.017	264.822.746
Thereof assets under construction at year end	346.299	1.790.524	0	0	2.136.823

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 20 Amounts are in ISK thousand

10. Property, plant and equipment, contd.

Revaluation

When revaluating, the relevant asset groups are measured at fair value. The aforementioned revaluation is recognised in a revaluation reserve among equity taken into account effects of deferred income tax as further explained in note 36 d. The revaluation is carried out by experts within the Group.

Revaluation was carried out for production system in hot water and distribution systems in hot and cold water, sewage and electricity at year-end 2017 as part of regular revaluation of the assets of the Group. The revaluation led to an increase in book value of assets amounting to ISK 11.600 million.

Revaluation was last conducted according to the following table:

	Date of Revaluation
Production systems	
Hot water	31.12.2017
Cold water	31.12.2017
Electricity	31.12.2014
Distribution systems	
Hot water	31.12.2017
Cold water	31.12.2017
Sewage	31.12.2017
Electricity	31.12.2017
Fiber-optic cable system	31.12.2015

The fair value of these assets is determined on the basis of the depreciated replacement cost. This consists in that an assessment is made on changes in the construction cost of comparable assets and both cost and accumulated depreciations are revaluated in accordance with those changes. The calculation is based on official information and actual statistics from the Group's books on value changes of cost of items and takes into account an estimate on the weight of each cost item in the total cost of construction of comparable assets. Cost items and their proportional weight were determined by experts within the Group. The impairment test of assets is also taken into consideration and revaluation is not recognised beyond the expected future cash flow of the assets. Distribution systems for hot water, cold water, sewage and electricity are licensed operations and subject to official revenue targets that are based mostly on changes in the construction cost index. This is taken into consideration when revaluating these systems. Revaluation is classified as level 3 of the hierarchy of fair value, further explained in note 29.

Information on revalued assets at year end

	Production system	Distribution system	Total
31.12.2017			
Revalued carrying amount	132.022.038	137.171.493	269.193.531
Thereof effect of revaluation	(39.192.135)	(53.740.138)	(92.932.273)
Carrying amount before effect of revaluation	92.829.903	83.431.356	176.261.258
31.12.2016			
Revalued carrying amount	135.610.485	126.539.064	262.149.549
Thereof effect of revaluation	(35.532.280)	(48.341.332)	(83.873.612)
Carrying amount before effect of revaluation	100.078.205	78.197.731	178.275.936

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 21 Amounts are in ISK thousand

10. Property, plant and equipment, contd.

Impairment tests

Impairment tests were performed at the end of September in order to confirm both carrying amounts of assets and main assets under construction would meet estimated future cash flows of these assets. The impairment tests are carried out for every sector in the utilities and production systems.

The recoverable amount of each sector was evaluated based on value in use. The value in use was determined by discounting the expected future cash flows at the continued use in each sector. Cash flows were based on the future cash flow of the next five years. In assessing value in use, management make the plan for business development, based on both internal and external information.

The following criteria was used in assessing the value in use:

	Year 2017				
	Distribution system				Prod. systems
	Hot water	Electricity	Cold water	Sewage	Power plants
Revenue CAGR 2017-2022	1,2%	0,5%	1,6%	1,2%	2,2%
CAGR w.r.t. to price changes	1,2%	1,1%	0,7%	0,8%	0%-7,3%
EBITDA CARG 2016-2022	1,8%	-1,2%	1,5%	1,2%	1,9%
WACC	5,0%	5,0%	6,0%	5,3%	5,0%-8,8%

	Year 2016				
	Distribution system				Prod. systems
	Hot water	Electricity	Cold water	Sewage	Power plants
Revenue CAGR 2016-2021	2,0%	0,8%	-0,1%	1,7%	3,7%
CAGR w.r.t. to price changes	1,2%	0,9%	0,9%	0,9%	0,0% til 6,8%
EBITDA CARG 2016-2021	2,6%	1,8%	-0,5%	1,5%	4,0%
WACC	5,4%	5,2%	6,3%	5,7%	5,3%- 8,8%

Impairment for distribution system for utilities or hot water production is unlikely because of considerable additional value. However the test for electricity in power plants is sensitive to changes in key assumptions. If the required rate of ROCE increased by 0,25 percentage points, and other criteria are kept unchanged the calculated impairment in electricity for power plants would be ISK 2.700 million. If the projected EBITDA is 5% lower during the planning period and other terms are unchanged, calculated impairment would be ISK 10.400 million.

Assets under construction

Assets under construction have been not been impaired during the year 2017 (2016: 990 million). There is no indication for further impairment for other assets under constructions for the book value of ISK 295 million at year-end 2017 (2016: 2.100 million). Further explanation on impairment test is in note 36 h.

Company headquarters at Bæjarháls 1

In 2013, Orkuveita Reykjavíkur's headquarters at Bæjarháls 1 was sold to Foss fasteignafélag slhf. ("Foss") for ISK 5.100 million. At the same time, a 20-year lease agreement between OR and Foss was concluded with the option of OR on the real estate. There was no intention of the management of OR to exercise the right to buy, and therefore the real estate was transferred from the OR accounts, as sold assets and lease payments expensed through P/L from 2013 to 2017. In mid-2017, water damage occurred at OR headquarters and the cost of repairs estimated to be between 1.500 and 2.380 million. There was uncertainty related to the responsibility of the deficit and it was decided at the end of November 2017 to acquire the assets by acquiring all the shares of Foss and the acquisition of bonds issued by Foss, from their owners. The bonds were paid by issuing new bonds in OR090546, a total of ISK 4.105 million. after deduction of borrowing fees and for all shares in Foss, ISK 1.399 million was paid. with cash. The total purchase price was ISK 5.504 million. which is divided into a purchase price of real estate amounting to ISK 5.498 million and acquisition of cash and short-term debt amounting to ISK 6 million. A part of the real estate is not in a useful condition. In Note 34 is a further discussion on the restoration options and the cost for the restoration of the headquarters.

The main purpose of the acquisition is an investment in real estate in the headquarters of OR at Bæjarháls 1 and there is no activity in the company. This investment is treated as an asset deal in the consolidated financial statements in accordance with IFRS. Since the beginning of December 2017, the real estate is recognized in the Consolidated Financial Statements as tangible fixed assets and depreciated over the life of the assets.

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 22 Amounts are in ISK thousand

10. Property, plant and equipment, contd.

Rateable value and insurance value

The rateable value of the Group's assets measured in the rateable value assessment amounted to ISK 28.154 million at year end 2017 (2016: ISK 22.808 million). The fire insurance value of the company's assets amounted to ISK 30.401 million at the same time (2016: ISK 30.175 million). Among those assets are real estates capitalised among production and distribution systems. The insurance value of the Group's assets amounted to ISK 352.359 million at year end 2017 (2016: ISK 365.225 million).

Obligations

Negotiations on the cancellation of the last two 45MW turbines according to the contract with producers from the year 2008 were successful during the year 2017. There was no additional cost for the Group due to the cancellation. The Group has entered into contracts and placed purchase orders with suppliers and developers concerning work on production and distribution systems. The balance of these contracts and purchase orders at year end is estimated at ISK 3.945 million (31.12.2016: ISK 2.100 million).

11. Intangible assets

Intangible assets are specified as follows:

The year 2017	**Heating rights**	**Software**	**Total**
Cost			
Balance at year beginning	1.427.031	1.492.499	2.919.530
Additions during the year	0	209.816	209.816
Balance at end of the year	1.427.031	1.702.315	3.129.346
Amortisation			
Balance at year beginning	457.768	957.990	1.415.759
Amortisation during the year	0	106.083	106.083
Balance at end of the year	457.768	1.064.073	1.521.842
Carrying amounts			
At 1.1. 2017	969.263	534.509	1.503.771
At 31.12. 2017	969.263	638.242	1.607.504
The year 2016			
Cost			
Balance at year beginning	1.427.031	1.284.666	2.711.697
Additions during the year	0	207.833	207.833
Balance at year end	1.427.031	1.492.499	2.919.530
Amortisation			
Balance at year beginning	457.768	887.892	1.345.660
Amortisation during the year	0	70.099	70.099
Balance at year end	457.768	957.990	1.415.759
Carrying amounts			
At 1.1. 2016	969.263	396.774	1.366.037
At 31.12. 2016	969.263	534.509	1.503.772

12. Investments in associated companies

	2017		**2016**	
	Share	**Carrying amount**	**Share**	**Carrying amount**
Íslensk Nýorka ehf.	28,95%	24.681	28,95%	27.670
Netorka hf.	38,41%	30.514	38,41%	25.521
Reykjavik Energy Grad. School hf.	45,00%	6.068	45,00%	6.146
Total		61.263		59.337

The Group's share in the profit of its associated companies amounted to ISK 1,9 million in 2017 (2016: loss of ISK 3,4 million).

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 23 Amounts are in ISK thousand

Notes

13. Investments in other companies

Investments in other companies are specified as follows:	Share	2017	2016
Landsnet hf. 1)	6,8%	3.544.133	3.222.160
Other shares in companies		62.914	62.914
Other shares in companies, total		3.607.047	3.285.074

Fair value of financial assets available for sale is based on generally accepted valuation methods performed by independent experts and internal experts. Fair value change of Landsnet hf. amounted to ISK 322 million (2016: 377 million) and the increase was transferred to a fair value reserve among equity. See further discussion in note 29.

1) According to provisions in the Energy laws no. 65/2003 only current owners of shares in Landsnet are allowed to assign their shares to other owners of Landsnet and are not allowed to sell their shares to other parties.

14. Embedded derivatives in electricity sales contracts

	2017	2016
Fair value of embedded derivatives at the beginning of the year	(10.319.109)	(13.192.163)
Fair value changes during the year	12.543.221	2.873.054
Fair value of embedded derivatives at year-end asset/(liability)	2.224.111	(10.319.109)

The allocation of embedded derivatives in electricity sales contracts is specified as follows:

	2017	2016
Non-current embedded derivatives asset/(liability)	1.877.811	(8.913.368)
Current embedded derivatives, asset/(liability)	346.301	(1.405.741)
Total embedded derivatives at year-end	2.224.111	(10.319.109)

Further discussion regarding embedded derivatives can be found in note 25 c.

15. Other financial assets and financial liabilities

Financial assets at fair value through profit or loss:	2017	2016
Non-current assets		
Other financial assets	0	4.091.936
Hedge contracts	738.800	365.333
	738.800	4.457.269
Current assets		
Other financial assets	4.090.265	0
Hedge contracts	36.081	393.183
	4.126.346	393.183
Non current liabilities		
Hedge contracts	(737.006)	(2.713.071)
Current liabilities		
Hedge contracts	(2.898.249)	(2.311.883)

In September 2016 an agreement was signed between Orkuveita Reykjavíkur and Magma Energy Sweden, the parent company of HS Orka, to reschedule payments on the bond which was to fully mature in December 2016. According to the agreement, half of the bond´s amount was paid when the agreement was confirmed and the other half will be paid in early 2018. Shares in HS Orka will continue to be pledged to secure payments and the interest rate will increase from 1,5% to 5%. Derivatives are not separated from the bond. The fair value of the bond is measured from future prices of aluminium, discounted by the interest rate of the relevant currency, plus premium due to counter-party risk. Attention is drawn to the discussion of the bond in note 35, subsequent events. All of the Group´s bonds are determined to be third level in the fair value hierarchy as further is explained in note 29.

Hedge contracts are measured by discounted future cash flow and market observable data is used in the price determination.

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 24 Amounts are in ISK thousand

16. Deferred tax assets and liabilities

Deferred tax assets and liabilities is specified as follows:

2017	Tax assets	Tax liabilities	Net amount
Deferred tax assets/liabilities at the beginning of the year	3.714.879	(8.345.332)	(4.630.453)
Exchange difference on current tax liability	0	93.728	93.728
Calculated income tax for the year	(3.714.879)	(1.682.119)	(5.396.998)
Current tax liability	1.265.410	188.274	1.453.685
Tax effect on the revaluation account	0	(1.527.875)	(1.527.875)
Other changes	0	193.282	193.282
Deferred tax assets/liabilities at end of the year	1.265.410	(11.080.041)	(9.814.631)
2016			
Deferred tax assets/liabilities at the beginning of the year	5.458.992	(7.619.438)	(2.160.445)
Calculated income tax for the year	(3.654.661)	(1.047.012)	(4.701.673)
Current tax liability	1.621.717	115.446	1.737.164
Other changes	288.831	205.670	494.501
Deferred tax assets/liabilities at end of the year	3.714.879	(8.345.332)	(4.630.453)

Deferred tax assets and liabilities are attributable to the following:

	31.12.2017		31.12.2016	
	Tax assets	Tax liabilities	Tax assets	Tax liabilities
Property, plant and equipment	757.334	(10.969.340)	0	(8.495.648)
Embedded derivatives	0	(836.266)	3.714.879	0
Other items	508.077	426.270	0	(897.554)
Effect of carry forward taxable loss	0	715.184	0	1.365.758
Effect of write-down of taxable loss	0	(415.889)	0	(317.889)
Deferred tax assets/liabilities at year end	1.265.410	(11.080.041)	3.714.879	(8.345.332)

Carry forward taxable loss

Based on current tax law, a carry forwards taxable loss can be used against taxable profit within 10 years from when it was incurred. Carry forwards taxable loss at year end can be used as follows:

	2017	2016
Carry forward taxable loss for the year 2008, usable until year 2018	2.069.720	4.147.939
Carry forward taxable loss for the year 2009, usable until year 2019	1.062.389	2.475.484
Carry forward taxable loss for the year 2016, usable until year 2026	205.368	205.368
Carry forward taxable loss for the year 2017, usable until year 2027	238.443	0
Carry forwards taxable loss at year end	3.575.921	6.828.791
Carry forward taxable loss for the year 2008, write-down	2.069.720	1.589.445
Carry forward taxable loss for the year 2009, write-down	9.725	0
	2.079.445	1.589.445

Management has evaluated the utilization of income tax losses and made plans for taxable profit for the next years. Deferred tax assets due to the taxable loss carried forward is recognized to the extent that it is believed to be useful. Loss carried forward in the amount of ISK 2.079 million is not capitalised at the end of 2017, but at the beginning of the year it was ISK 1.589 million due to uncertainty of utilization of the tax losses. Effect of changes in the assessment of utilization of the tax losses in the year 2017 is ISK 98 million (2016: ISK 133 million).

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 25 Amounts are in ISK thousand

17. Inventories

	2017	2016
Inventory of materials	936.045	582.934

The Group's material inventories consist of material for maintenance, renewal and construction of the Group's production and distribution systems. A part of the inventories is defined as safety inventories, i.e. inventories that are necessary to have on hand in case of malfunction or maintenance even though their turnover is low. The value of inventories is estimated regularly. Inventories for renewal and new constructions are accounted for among property, plant and equipment as part of building cost of assets under construction.

18. Receivables

Trade receivables is specified as follows at year end:	2017	2016
Trade receivables, industrial consumers	749.112	670.120
Trade receivables, retail	5.221.828	4.075.708
Trade receivables, total	5.970.940	4.745.828
Allowance for doubtful accounts	(123.651)	(149.201)
	5.847.289	4.596.627

Other current receivables are specified as follows at year end:

Capital income tax	155.999	102.606
Accrued interest income	80.366	47.617
Receivables from employees	3.669	3.807
Other receivables	65.826	178.199
	305.860	332.229

19. Cash and cash equivalents, deposits and marketable securities

Cash and cash equivalents and deposits at year end are specified as follows:	2017	2016
Bank deposits, available from three to twelve months	4.000.000	3.000.000
Marketable securities	2.124.722	1.132.427
	6.124.722	4.132.427
Bank balances available within three months	6.254.983	12.356.669

20. Equity

Equity ratio of the Group at year end 2017 is 46,2% (2016: 40,4%). Return on equity was positive by 13,1% in the year 2017 (2016: positive by 12,0%).

Revaluation reserve

Revaluation reserve comprises of increase in the value of properties, plant and equipment after taking tax effects into account. Depreciation of the revaluated price are expensed in the income statement and transferred at the same time from the revaluation reserve account to retained earnings.

Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of financial statements of operations with other functional currency than ISK.

Fair value reserve

Fair value reserve comprises change of the value of assets categorised as available for sale after taking tax effects into account.

Equity reserve

According tothe Financial Statements Act no. 3/2006, share in profit of subsidiaries and associates, which exceeds the dividends received or the dividend decided of retained earnings, is accounted for on a restricted reserve account among equity.

Development reserve

According to the law no. 3/2006 companies that capitalize developmental cost should account for the same amount on a restricted reserve account among equity.

Retained earnings

Dividend in the amount of ISK 750 million was paid to the owners of the parent Company in the year 2017. (2016: No payment of dividend).

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 26 Amounts are in ISK thousand

21. Loans and borrowings

Interest bearing loans are recorded using the method of amortised cost. Further information on the Group's exposure to interest rate, foreign currency and liquidity risk, see note 25. Loans and borrowings are detailed as follows:

Non-current liabilities	**31.12.2017**	**31.12.2016**
Bank loans	99.310.645	106.326.779
Subordinated loan from owners of the Company	12.565.579	13.293.025
Bond issuance	32.602.546	25.159.658
	144.478.770	144.779.461
Current portion on non-current liabilities	(14.667.114)	(15.462.497)
	129.811.656	129.316.964
Current liabilities		
Current portion on non-current liabilities	14.667.114	15.462.497
Short-term bank loans	0	2.859.984
	14.667.114	18.322.481
Total interest bearing loans and borrowings	144.478.770	147.639.446

Terms of interest-bearing loans and borrowings

Liabilities in foreign currencies:		**31.12.2017**		**31.12.2016**	
	Date of maturity	**Average interest rate**	**Carrying amount**	**Average interest rate**	**Carrying amount**
Liabilities in CHF	5.10.2027	0,00%	10.465.138	0,00%	12.148.428
Liabilities in EUR	19.12.2027	0,70%	35.068.085	0,65%	37.619.335
Liabilities in USD	8.11.2030	2,50%	24.971.612	2,18%	30.554.614
Liabilities in JPY	10.5.2027	0,03%	4.813.282	0,00%	5.868.767
Liabilities in GBP	26.2.2024	1,43%	2.259.781	1,53%	2.544.687
Liabilities in SEK	5.10.2027	0,00%	3.406.964	0,00%	3.747.424
			80.984.862		92.483.255
Liabilities in Icelandic kronas:					
Indexed	9.5.2046	3,88%	54.662.696	4,13%	45.696.207
Non-indexed	5.4.2035	5,55%	8.831.212	6,90%	9.459.984
			63.493.908		55.156.191
Total interest-bearing loans and borrowings			144.478.770		147.639.446

Repayment on non-current liabilities are specified as follows on the next years:

31.12.2017	
The year 2018	14.667.114
The year 2019	13.482.250
The year 2020	13.745.315
The year 2021	13.016.833
The year 2022	15.463.311
Later	74.103.947
Total non-current liabilities, including next year's repayment	144.478.770

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 27 Amounts are in ISK thousand

21. Loans and borrowings, contd.,

31.12.2016

The year 2017	18.322.481
The year 2018	14.605.156
The year 2019	13.467.078
The year 2020	13.224.740
The year 2021	12.160.142
Later	75.859.848
Total non-current liabilities, including next year's repayment	147.639.445

Changes in loans and borrowings in the year are specified as follows:	2017	2016
Total interest bearing loans and borrowings 1. January	147.639.446	165.635.337
New borrowings	17.398.172	13.978.855
Repayment of borrowings	(17.657.579)	(19.934.693)
Currency fluctuation	(881.102)	(17.047.658)
Indexation	839.817	1.049.531
New current liabilities and repayment of current liabilities	(2.859.984)	3.958.074
Total interest bearing loans and borrowings 31. December	144.478.770	147.639.446

Guarantees and pledges

The owners of the parent company are responsible, pro rata, for majority of all liabilities and obligations. The Group has not pledged its assets as guarantee for its liabilities.

Covenants

Loans for the amount of ISK 30.025 million have certain covenants that regard repayment time as a proportion of EBITDA and as interests as a proportion of EBITDA as well as reviewing that budgets are within set limits (31.12.2016: ISK 23.443 million). Management regularly evaluate the covenants and in their view there is not risk of them being breached. At the end of the year the Group measured up to all financial covenants of loan agreements.

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 28 Amounts are in ISK thousand

22. Retirement benefit obligation

The Group has retirement benefit obligation due to benefits of current and former employees in pension benefit plans.

The Group's accrued retirement benefit obligation amounted to ISK 633 million at year end 2017, discounted based on 2% interests and taken into account the share in the net asset of the pension fund (2016: ISK 617 million). The Group updates the obligation according to an assessment from an actuary each year when that assessment is available. Premises for life expectancy are in accordance with provisions of Regulation no. 391/1998 on obligatory insurance of pension benefits and operation of pension funds. The estimated increase in the obligation in the year is based on general increase in salaries taken into account interests. The increase of the obligation during the year is expensed in the income statement among salaries and salary related expenses. The part of the obligation that is estimated to be payable in the year 2018 is recognised among current liabilities.

	2017	2016
Retirement benefit obligation at the beginning of the year	616.905	567.661
Contribution due to pension payments during the year	(25.850)	(27.500)
Increase in the pension fund obligation during the year	42.206	76.744
Retirement benefit obligation at year end	633.261	616.905
Non-current component of retirement benefit obligation	608.261	591.905
Current component of retirement benefit obligation	25.000	25.000
Retirement benefit obligation at year end	633.261	616.905

23. Current liabilities

Other current liabilities is specified as follows:	2017	2016
Unpaid taxes	285.394	497.163
Unpaid salaries and salary related items	1.122.568	1.029.443
Unpaid salary related items to Bru Pension Fund, see note 5	1.104.250	0
Accrued interest expenses	573.448	554.415
Current component of retirement benefit obligation	25.000	25.000
Derivative contracts in default, see note 34	740.000	740.000
Other liabilities	49.753	153.047
	3.900.413	2.999.068

24. Risk management and financial instruments

The risk policy was updated and approved by the Board of Directors of OR at the end of year 2016. The Board´s policy is that in all of the Group´s operations, risks are to be considered and by that implementing efficient decision making and governance. The risk policy explains the overview and main targets of the Board in this matter. The risk policy also defines the main risk factors, measurement indicators, objectives and risk limits in the daily risk management. One of the main foundation in the risk policy is to define the risk factors which are of relevance, measure their impact and define acceptable limits when controlling them.

Decision making and control on the execution of the risk management is in the hands of a risk council. The risk council consists of the CEO, CFO, Head of risk management, Head of treasury, planning and analysis and Deputy to the CFO. It overviews for instance:

• that suitable methods are used to recognise and measure risk
• that risk monitoring systems are in place and efficient
• that the risk policy of the Board is complied with in the operations of the Group

The Risk management department oversees and controls risk. The objective of the department is to monitor, analyse and control the financial risks of the Group.

Financial risk is divided into:

• Market risk, further discussed in note 25
• Liquidity risk, further discussed in note 26
• Credit risk, further discussed in note 27
• Operational risk, further discussed in note 28

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 29 Amounts are in ISK thousand

25. Market risk

Market risk is the risk that changes in the exchange rate of foreign currencies, aluminium price, interests and other price changes will affect the Group's income or the value of its financial instruments. With regards to the current Balance Sheet, market risk is mainly due to changes in interest, exchange rates, CPI and aluminium price but risk regarding portfolio assets such as shares in companies and bonds is minimal. This is the risk that weighs the most in the Group is divided into:

a. Currency risk due to assets and liabilities in the balance sheet and cash flow in foreign currencies.
b. Interest rate risk due to loans and contracts made by the Group
c. Risk due to changes in the world market price of aluminium.

a. *Currency risk*

Currency risk is the risk of changes in exchange rates having a negative effect on the Group's income. Currency risk is measured in the difference between assets and liabilities in each currency where taken into consideration all assets, liabilities and derivatives. The Risk Management department is permitted to use forward contracts and currency swaps to mitigate risk due to currency fluctuations. Limits on the minimum/maximum currency

The Group is exposed to currency risk on sales, purchases and borrowings. Main currency exposures are in Euro (EUR), Swiss Francs (CHF), Japanese Yens (JPY), United States dollar (USD) and Swedish kronas (SEK) and Icelandic kronas (ISK).

Approx. 56% of the Group's interest bearing loans are in foreign currencies. The Group has entered into long term electricity sales contracts in foreign currency (USD). The expected future revenues from these contracts on the accounting date amount to approx. ISK 85.197 million (2016: ISK 81.059 million). That amount is based on the future price of aluminium on LME (London Metal Exchange) and expectations of price development of aluminium for the next 25 years according to, an independent evaluation party CRU, as available on the accounting date.

	2017	2016	31.12.2017	31.12.2016
	Average exchange rate		Exchange rate at year end	
CHF	108,429	122,504	107,070	110,810
EUR	120,537	133,591	125,050	119,130
USD	106,780	120,673	104,420	112,820
JPY	0,951	1,112	0,928	0,966
GBP	137,452	163,803	140,980	138,910
SEK	12,515	14,128	12,712	12,432
TWI	160,356	179,629	162,850	161,668

Consolidated Financial Statements of Orkuveita Reykjavíkur 2017 30 Amounts are in ISK thousand

25. Market risk, contd.

a. *Currency risk, contd.*

Balance sheet currency risk

The Group's exposure to currency risk is specified as follows:

31.12.2017	**CHF**	**EUR**	**USD**	**JPY**	**SEK**	**ISK**	**Other currencies**	**Total**
Loans and borrowings	(10.465.138)	(35.068.085)	(24.971.612)	(4.813.282)	(3.406.964)		(2.259.781)	(80.984.862)
Trade receivables (accounts payables)	(3.881)	(90.224)	496.016	(9)	(36)	795.591	(4.183)	1.193.275
Bank deposits	405.469	491.349	713.899	153.171	41.662	65.672	70.219	1.941.440
Embedded derivatives			2.224.111					2.224.111
Hedge contracts	602.578	3.688.596	(3.388.163)	703.434	603.581		706.749	2.916.775
Financial assets at fair value through P/L			4.090.265					4.090.265
Receivables/(payables) within the Group*		(89.425)	(1.488.675)			(5.310.028)		(6.888.129)
Loans and borrowings to related parties*			42.050.358			13.702.018		55.752.375
Risk of Financial instruments	(9.460.972)	(31.067.790)	19.726.200	(3.956.685)	(2.761.757)	9.253.252	(1.486.997)	(19.754.749)
Subsidiaries equity in USD**			48.371.135					48.371.135
Total risk in equity	(9.460.972)	(31.067.790)	68.097.335	(3.956.685)	(2.761.757)	9.253.252	(1.486.997)	28.616.386

(*) The functional currency of ON Power is in USD and exchange gains/losses from assets and liabilities in ISK are accounted for through P/L. In addition the exchange gains/losses for foreign assets and liabilities of the parent company towards it´s subsidiary, ON Power, are accounted through P/L .

(**) The functional currency of ON Power is in USD and translational differences are accounted though equity due to changes in the USD/ISK exchange rate.

Consolidated Financial Statements of Orkuveita Reykjavikur 2017 31 Amounts are in ISK thousand

25. Market risk, contd.

a. *Currency risk, contd.*

Balance sheet currency risk, contd.

31.12.2016	CHF	EUR	USD	JPY	SEK	ISK	Other currencies	
Loans and borrowings	(12.148.428)	(37.619.335)	(30.554.614)	(5.868.767)	(3.747.424)		(2.544.687)	(92.483.255)
Trade receivables (accounts payables)	(102)	7.230	457.005	67	3	734.618	43	1.198.865
Bank deposits	200.958	228.385	462.009	50.957	32.841	57.926	31.952	1.065.027
Embedded derivatives			(10.319.109)					(10.319.109)
Hedge contracts	951.952	6.511.505	(5.301.761)	1.084.754	901.206		1.049.601	5.197.257
Financial assets at fair value through P/L			4.091.936					4.091.936
Receivables/(payables) within the group*		(71.497)	(825.633)			(4.072.957)		(4.970.087)
Loans and borrowings to related parties*			47.596.551			13.986.551		61.583.102
Risk of Financial instruments	(10.995.619)	(30.943.712)	5.606.384	(4.732.990)	(2.813.374)	10.706.138	(1.463.090)	(34.636.264)
Subsidiaries equity in USD**			47.300.597					47.300.597
Total risk in equity	(10.995.619)	(30.943.712)	52.906.981	(4.732.990)	(2.813.374)	10.706.138	(1.463.090)	12.664.333

Sensitivity analysis

Appreciation by 10% of the Icelandic krona against the following currencies at year-end would have increased (decreased) equity and profit or (loss) by the amounts shown below, taking into account tax effects. This analysis assumes that all other variables, in particular interest rates and aluminium prices, remain constant. Depreciation by 10% of the Icelandic krona against the above currencies would have had the equivalent, but opposite effect on the above currencies to the amounts shown above, on the basis that all other variables remain constant.

	CHF	EUR	USD	JPY	SEK	ISK	Other currencies	Total
				Profit or (loss)				
The year 2017	946.097	3.106.779	(1.972.620)	395.669	276.176	(925.325)	148.700	1.975.475
The year 2016	1.099.562	3.094.371	(560.638)	473.299	281.337	(1.070.613)	146.309	3.463.626
				Equity				
The year 2017	946.097	3.106.779	(6.809.733)	395.669	276.176	(925.325)	148.700	(2.861.639)
The year 2016	1.099.562	3.094.371	(5.290.698)	473.299	281.337	(1.070.614)	146.309	(1.266.433)

Consolidated Financial Statements of Orkuveita Reykjavikur 2017 32 Amounts are in ISK thousand

25. Market risk, contd.

b. *Interest rate risk*

Interest rate risk is the risk of changes in interest rates having a negative effect on the Group's income. The Group is exposed to interest rate risk due to interest bearing assets, liabilities and financial instruments measured at fair value. The Group´s liabilities both have fixed and variable interest rates, majority being subject to variable interest rates. The risk management department monitors that interest rate risk is within preset limits and has permission to control interest rate risk with derivatives for the next 5 financial years within approved limits. On the accounting date hedges covered 89% of loans, taking into account hedges, with fixed interest rates 1 year ahead.

Interest-bearing financial assets and liabilities are specified as follows:

Fixed rate instruments	**31.12.2017**	**31.12.2016**
Financial liabilities	(55.788.123)	(48.978.590)
Variable rate instruments		
Financial liabilities	(88.690.648)	(98.660.856)
Financial instruments at fair value		
Bonds	4.090.265	4.091.936
Marketable securities	2.124.722	1.132.427
Hedge contracts	(2.860.374)	(4.266.438)
	3.354.613	957.925

The following table shows the calculated effect of changes in interest on one year cash flows and on the value of financial instruments measured at fair value, taken into account the effect of taxes. The analysis was done in the same way for the year 2016.

	Cash flow sensitivity analysis		**Fair value sensitivity analysis**	
31.12.2017	**100 p increase**	**100 p decrease**	**100 p increase**	**100 p decrease**
Embedded derivatives	0	0	(84.620)	94.158
Other financial assets	0	0	(7.889)	7.988
Investments in other companies	0	0	(1.260.016)	2.069.455
Hedge contracts	216.737	(216.737)	740.447	(773.291)
Interest bearing liabilities	(567.620)	567.620	0	0
	(350.883)	350.883	(612.079)	1.398.310

31.12.2016	**100 p increase**	**100 p decrease**	**100 p increase**	**100 p decrease**
Embedded derivatives	0	0	333.163	(356.307)
Other financial assets	0	0	(31.822)	32.526
Investments in other companies	0	0	(1.095.344)	1.721.984
Hedge contracts	213.621	(213.621)	733.475	(765.307)
Interest bearing liabilities	(624.389)	624.389	0	0
	(410.769)	410.769	(60.528)	632.896

Consolidated Financial Statements of Orkuveita Reykjavikur 2017 33 Amounts are in ISK thousand

25. Market risk, contd.

c. *Aluminium risk*

Aluminium risk is the risk that changes in the price of aluminium has a negative impact on the income of the Group.

Four electricity sales contracts have been made, originally to 20 years. One is with Landsvirkjun with regards of Norðurál and three with Norðurál in regards of the aluminium plant at Grundartangi, in addition contracts have been made with Landsnet hf. on distribution of electricity. Orkuveita Reykjavíkur and Norðurál have also made an electricity sales contract due to sale of electricity to a pending aluminium plant in Helguvík, where delivery of electricity has begun, but the contract is for the next 25 years. These electricity sales contracts are denominated in USD and the price of the electricity is connected to the market price of aluminium. Income of electricity contracts that is effected by price of aluminium is 13,9% of total revenue in the reporting year 2017 (2016: 13,8%).

To reduce risk due to aluminium prices the Group has entered into derivative contracts to reduce the fluctuation of income affected by aluminium prices. The risk management department has permission to hedge this risk within approved limits for the nest 5 financial years. At the accounting date hedges amounted to 49% of expected income affected by aluminium price until 31 December 2018 (31.12 2016: 50,0%).

Embedded derivatives in electricity sales contracts

The aforementioned electricity sales contracts include embedded derivatives as income thereon is subject to changes in the future world market price of aluminium. In accordance with provisions of IAS 39 on financial instruments, the fair value of embedded derivatives for Grundartangi has been measured and recognised in the financial statements and partly for the contracts with Helguvík.

As the market value of the embedded derivatives is not available their fair value has been measured with generally accepted evaluation methods. The expected net present value of the cash flow of a contract on the accounting date has been measured, based on the future price of aluminium on LME (London Metal Exchange) on the accounting date and expectations of price development of aluminium for the next 25 years according to the assessment of CRU, an independent evaluation party, as available on the accounting date. From the expected net present value of cash flow of the contract on the accounting date the expected net present value based on premises on aluminium price on the initial date of the contract is deducted. The difference is the fair value change of the derivative. The valuation is based on the premises that the derivative has no value at the initial date of the contract.

Embedded derivatives of the electricity sales contracts recognised in the financial statements are capitalised in the balance sheet at fair value at the accounting date and fair value changes during the year are recognised in the income statement among income on financial assets and liabilities.

25. Market risk, contd.

c. *Aluminium risk, contd.*

In the following table shows the calculated effect on financial instruments measured at fair value due to change in aluminium price, taking tax effect into account.

Sensitivity analysis on the price of aluminium

31.12.2017	Sensitivity of Fair value 10% decrease	10% increase
Embedded derivatives	(4.718.630)	4.718.630
Aluminium hedges	283.041	(306.677)
Financial assets at fair value through P/L	(38.164)	38.164
Total	(4.473.753)	4.450.117

31.12.2016	Sensitivity of Fair value 10% decrease	10% increase
Embedded derivatives	(3.911.703)	3.911.701
Aluminium hedges	219.732	(210.218)
Financial assets at fair value through P/L	0	100.188
Total	(3.691.971)	3.801.671

d. *Other market risk*

Other market risk such as interest spread and risk in shares in other companies is limited, as investments in such securities is an insubstantial part of the Group's operation.

26. Liquidity risk

Liquidity risk is the risk that the Group will not be able to meet its financial obligations as they fall due. The Group’s approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due.

The Group's cash and cash equivalents at end of the year amounted to ISK 6.300 million and deposits available in three to twelve months amounting to ISK 4.000 million as well as marketable securities amounting to ISK 2.100 million. Therefore the Group owned ISK 12.400 million in bank deposits. Furthermore, the Group had unused loan authorisations and a open credit line to the total amount of approx. ISK 18.785 million. The Group had thus in total ensured capital at year-end to the amount of approx. ISK 31.265 million. The corresponding amount at year end 2016 amounted to ISK 25.500 million.

Consolidated Financial Statements of Orkuveita Reykjavikur 2017 35 Amounts are in ISK thousand

26. Liquidity risk, contd.

Contractual payments due to financial liabilities, including estimated interest payments, are specified as follows:

31.12.2017

	Carrying amount	Contractual cash flows	Less than 1 year	After 1 - 2 years	After 2 - 5 years	More than 5 years
Non-derivative financial instruments						
Other financial assets	0	4.090.265	4.090.265	0	0	0
Trade receivables	5.847.289	5.847.289	5.847.289	0	0	0
Other receivables	305.860	305.860	305.860	0	0	0
Deposits	4.000.000	4.000.000	4.000.000	0	0	0
Marketable securities	2.124.722	2.124.722	2.124.722	0	0	0
Cash and cash equivalents	6.254.983	6.254.983	6.254.983	0	0	0
Interest-bearing liabilities	(144.478.770)	(171.916.024)	(17.749.092)	(16.749.923)	(50.733.669)	(86.683.341)
Accounts payable	(2.230.378)	(2.230.378)	(2.230.378)	0	0	0
Other liabilities	(3.900.413)	(3.900.413)	(3.900.413)	0	0	0
	(132.076.707)	(155.423.696)	(1.256.764)	(16.749.923)	(50.733.669)	(86.683.341)
Derivative financial instruments, net financial assets and financial liabilities						
Embedded derivatives	2.224.111	85.196.978	7.064.112	6.837.217	20.920.136	50.375.513
Hedge contracts	(2.860.374)	(3.765.866)	(3.033.864)	(751.331)	19.329	0
	(636.263)	81.431.112	4.030.248	6.085.886	20.939.465	50.375.513

31.12.2016

	Carrying amount	Contractual cash flows	Less than 1 year	After 1 - 2 years	After 2 - 5 years	More than 5 years
Non-derivative financial instruments						
Other financial assets	4.091.936	4.370.083	205.897	4.164.186	0	0
Trade receivables	4.596.627	4.596.627	4.596.627	0	0	0
Other receivables	332.229	332.229	332.229	0	0	0
Deposits	3.000.000	3.000.000	3.000.000	0	0	
Marketable securities	1.132.427	1.132.427	1.132.427	0	0	0
Cash and cash equivalents	12.356.669	12.356.669	12.356.669	0	0	0
Interest-bearing liabilities	(147.639.446)	(171.312.426)	(20.972.291)	(17.260.769)	(45.971.194)	(87.108.172)
Accounts payable	(2.317.493)	(2.317.493)	(2.317.493)	0	0	0
Other liabilities	(2.999.068)	(2.999.068)	(2.999.068)	0	0	0
	(127.446.119)	(150.840.952)	(4.665.003)	(13.096.583)	(45.971.194)	(87.108.172)
Derivative financial instruments, net financial assets and financial liabilities						
Embedded derivatives	(10.319.109)	81.059.017	5.650.004	5.737.529	16.972.067	52.699.416
Hedge contracts	(4.266.438)	(4.608.745)	(1.838.156)	(2.167.519)	(603.069)	0
	(14.585.547)	76.450.272	3.811.848	3.570.010	16.368.998	52.699.416

If non-current loans are refinanced in order to prolong the loan terms, it can be assumed that the distribution of the repayments will be different from the above.

Consolidated Financial Statements of Orkuveita Reykjavikur 2017 36 Amounts are in ISK thousand

27. Credit risk

Credit risk is the risk of financial loss to the Group if a customer or counterparty to a financial instrument fails to meet its contractual obligations. Credit risk is mainly due to whole sale electricity contracts and derivatives that the Group has entered into for hedging purposes. Possible losses due to unpaid receivables are insubstantial and have limited effect on the Group's return.

When entering into contracts it shall be insured, as possible, that the counterparty is trustworthy and settlement with large counterparties shall be looked into regularly as well as their credit rating.

The carrying amount of financial assets represents the maximum credit exposure, which is specified as follows:

	31.12.2017	31.12.2016
Trade receivables	5.847.289	4.596.627
Other current receivables	305.860	332.229
Other financial assets	4.090.265	4.091.936
Hedge contracts	774.880	758.516
Deposits	4.000.000	3.000.000
Marketable securities	2.124.722	1.132.427
Cash and cash equivalents	6.254.983	12.356.669
Total	23.398.000	26.268.404

Financial assets as stated above are categorised as loans and receivables except for a part of other financial assets and hedge contracts. Their categorisation can be seen in note 30.

The maximum exposure to credit risk for trade receivables at the reporting date by type of customer was:

Trade receivables, industrial consumers	749.112	670.120
Trade receivable, retail	5.098.177	3.926.507
	5.847.289	4.596.627

Impairment of accounts receivables

	31.12.2017		31.12.2016	
	Gross balance	Allowance	Gross balance	Allowance
Not past due receivables	5.763.197	102.152	4.413.268	97.551
Past due, 1 to 30 days	61.242	5.972	77.876	6.459
Past due, 31 to 90 days	57.528	8.341	77.010	19.308
Past due, 91 days and older	88.973	7.186	177.674	25.883
Total	5.970.940	123.651	4.745.828	149.201

Allowance due to receivables is valuated at each reporting date by management. Collectability is valuated both in general using historic evidence and also specifically for receivables that are in default. Allowance is only deemed necessary for trade receivables.

Receivables due to sewage and cold water have statutory lien in properties and therefore allowance is not considered for those claims.

The Customer Services department governs the collection of receivables and supplies customers with information regarding claims. Collection is done in a well defined process where among other things, consistency in procedures is maintained as much as possible.

Consolidated Financial Statements of Orkuveita Reykjavikur 2017 37 Amounts are in ISK thousand

28. *Operational risk*

Operational risk is the risk of negative impact on income as the result of natural disasters, weather, sabotage, terrorism, riots, war, poisoning, pollution, breakdowns, fires, accidents, inadequate information systems, administrative error, inadequate controls, prosecutions, fraud and human error. The risk management department assesses operational risk and monitors known operational risks of the Group and measures on a regular basis, if possible.

29. *Fair value*

Comparison of fair value versus carrying amounts

The carrying amounts of financial assets and financial liabilities is equal to their fair value with the exception that interest bearing loans are stated at amortised cost. The fair values of interest bearing liabilities, together with the carrying amounts are specified as follows:

	31.12.2017		31.12.2016	
	Carrying amount	Fair value	Carrying amount	Fair value
Interest-bearing liabilities	144.478.770	139.681.314	147.639.446	140.598.094

The fair value of interest bearing liabilities is calculated based on present value of future principal and interest cash flows, discounted at the interest rate plus appropriate interest rate risk premium at the reporting date. The fair value of interest bearing liabilities is defined at Level 2.

Interest rates used for determining fair value

Where applicable, the interest yield curve at the reporting date is used in discounting estimated cash flow. The interests are specified as follows:

	31.12.2017	31.12.2016
Embedded derivatives in electr. sales contr.	3,12% to 6,31%	2,34% to 8,11%
Financial assets at fair value through P/L	5,34%	5,16% to 5,22%
Hedge contracts	-0,9% to 6,9%	-0,8% to 7,0%
Interest bearing liabilities	2,09% to 13,02%	2,20% to 9,77%

Fair value hierarchy

The table below analysis financial instruments carried at fair value, by valuation method. The different levels have been defined as follows:

Level 1: Quoted prices (unadjusted) in active markets for identical assets and liabilities.

Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e., as prices) or indirectly (i.e., derived from prices).

Level 3: Inputs for the asset or liability that are not based on observable market data (unobservable inputs). Valuation of shares in other companies is prepared by specialists within the company and other specialists and based on the results and official data on future earnings and investments in underlying assets

31.12.2017	Level 1	Level 2	Level 3	Total
Shares in companies	0	0	3.607.047	3.607.047
Embedded derivatives in sales contracts	0	0	2.224.111	2.224.111
Other financial assets	0	774.880	4.090.265	4.865.146
Other financial liabilities	0	(3.635.255)	0	(3.635.255)
Marketable securities	2.124.722	0	0	2.124.722
	2.124.722	(2.860.374)	9.921.423	9.185.771
31.12.2016				
Shares in companies		0	3.285.074	3.285.074
Embedded derivatives in sales contracts		0	(10.319.109)	(10.319.109)
Other financial assets		758.516	4.091.936	4.850.452
Other financial liabilities		(5.024.954)	0	(5.024.954)
Marketable securities	1.132.427	0	0	1.132.427
	1.132.427	(4.266.438)	(2.942.100)	(6.076.111)

Embedded derivatives in electric sales contracts that have more than ten years duration is classified under level 3 due to the fact that the forward market for aluminium only reaches maximum of ten years.

Consolidated Financial Statements of Orkuveita Reykjavikur 2017 38 Amounts are in ISK thousand

29. Fair value, contd.

Fair value measurement

A part of the Group´s financial assets and financial liabilities are measured at fair value. Fair value of these assets and liabilities are determined by market data or price in recent transactions if that is available. Otherwise, accepted valuation methods are used. Further information on fair value calculations can be found in the discussion of the relevant assets and liabilities in notes 13, 14 and 15.

30. Overview of financial instruments

Financial assets and financial liabilities are specified in the following financial groups:

	31.12.2017			31.12.2016		
	Loans and receivables	Financial asset/ financial liability at fair value through P/L	Available for sale	Loans and receivables	Financial asset/ financial liability at fair value through P/L	Available for sale
Shares in other companies			3.607.047			3.285.074
Embedd. contr. ...		2.224.111			(10.319.109)	
Bonds		4.090.265			4.091.936	
Hedge contr.		774.880			758.516	
Trade receivabl. ..	5.847.289			4.596.627		
Other receivabl. ..	305.860			332.229		
Prepaid exp.	162.174			213.209		
Bank deposits ..... and marketable securities	4.000.000	2.124.722		3.000.000	1.132.427	
Cash	6.254.983			12.356.669		
Interest-bearing .. liabilities	(144.478.770)			(147.639.446)		
Hedge contr.		(3.635.255)			(5.024.954)	
Account payabl. ..	(2.230.378)			(2.317.493)		
Other current liabilities	(3.900.413)			(2.999.068)		
	(134.039.255)	5.578.724	3.607.047	(132.457.273)	(9.361.184)	3.285.074

Consolidated Financial Statements of Orkuveita Reykjavikur 2017 39 Amounts are in ISK thousand

Notes

31. Related parties

Definition of related parties

Reykjavik city, institutions and companies ruled by the city, associated companies, Board members, Directors and key management are considered as the Group's related parties. Spouses of the before mentioned and financially dependent children are also considered as related parties as well as companies owned by or directed by those in question.

Transactions with related parties

The parties mentioned here above have had transactions with the Group within the last year. Terms and conditions of these transactions were equivalent with transactions with unrelated parties.

The following gives an overview of the transactions with related parties during the last two years as well as a statement of receivables and payables. Transactions and positions with subsidiaries are eliminated in the financial statement, therefore that information is not provided. This information does not include sale of conventional household supplies to the related parties.

	2017	2016
Sale to related parties:		
Reykjavik City	1.652.428	1.216.136
Institutions and companies controlled by Reykjavik City	575.157	559.789
	2.227.584	1.775.925
Purchases from related parties:		
Reykjavik City	49.204	39.986
Institutions and companies controlled by Reykjavik City	10.472	14.607
Associates	52.143	161.499
	111.818	216.092
Receivables for related parties:		
Reykjavik City	143.222	117.763
Institutions and companies controlled by Reykjavik City	38.090	43.585
	181.311	161.349
Payables for related parties:		
Reykjavik City	175.622	208.716
Institutions and companies controlled by Reykjavik City	3.050	360
	178.673	209.076
Interest bearing loans from owners of the parent Company:		
Reykjavik City	11.753.717	12.434.163
Akranes town	694.625	734.838
Borgarbyggð, municipality	117.237	124.024
	12.565.579	13.293.025
Interest expense on loans from owners of the parent Company:		
Reykjavik City	1.176.746	1.138.036
Akranes town	69.133	66.849
Borgarbyggð, municipality	11.668	11.283
	1.257.547	1.216.168

Guarantee fee to owners

Orkuveita Reykjavíkur paid a guarantee fee to Reykjavík City and other owners of the company for guarantees they have granted on the Groups loans and borrowings. For further information regarding amounts and the guarantee fee, see note 8. Management´s salaries and benefits are listed in note 5

Consolidated Financial Statements of Orkuveita Reykjavikur 2017 40 Amounts are in ISK thousand

Notes

32. Group entities

Subsidiaries	Main operation	Share 31.12.2017	Share 31.12.2016
Gagnaveita Reykjavíkur ehf.	Data transfer	100,0%	100,0%
OR Eignir ohf.	Holding company	100,0%	100,0%
Veitur ohf.	Distribution of electricity and hot water	100,0%	100,0%
Orka náttúrunnar ohf.	Sale of electricity	100,0%	100,0%
OR vatns- og fráveita sf.	Cold water and sewage	100,0%	100,0%
Reykjavík Energy Invest ehf.	Investments	100,0%	100,0%
Úlfljótsvatn frítímabyggð ehf.	Preparation company	100,0%	100,0%
Foss faseignafélag slhf.	Operation of real estate	100,0%	0,0%

At the end of November 2017, OR acquired the real estate company Foss slhf. ("Foss"). The main purpose of the acquisition is an investment in real estate in the headquarters of OR at Bæjarháls 1 and there is no activity in the company. This investment is treated as an asset deal in the consolidated financial statements in accordance with IFRS. Since the beginning of December 2017, the real estate is recognized in the Consolidated Financial Statements as tangible fixed assets and depreciated over the life of the assets. Further details on the purchase of Foss are discussed in Note 10.

33. Statement of cash flows

Working capital from operation is specified as follows:	2017	2016
Profit for the year	16.339.305	13.351.811
Operating items that do not affect cash flow:		
Depreciation	9.062.842	10.392.479
Profit from sale of assets	(2.219)	(2.544)
Share in profit (loss) of associated companies	(1.926)	3.413
Pension liability change	16.356	49.244
Write-down of bonds	(27.534)	613.036
Currency fluctuation and indexation	5.275.950	(6.806.311)
Embedded derivatives in electricity contracts	(8.027.661)	(1.838.754)
Deferred tax liability	(678.051)	1.820.583
Hedge contracts	23.010	2.559.989
Fair value changes	(445.008)	(153.549)
Effects of currency fluctuation on cash and cash equivalents	23.435	250.620
Other items	1.734	359
Working capital from operation	21.560.232	20.240.375

34. Other matters

Derivative contracts in default

Among other current liabilities are derivative contracts accounted for that are in default. The contracts have not been settled and Orkuveita Reykjavíkur has recently been sued regarding the claims. Great uncertainties is on how to settle them. In previous periods ISK 740 million have been expensed. This action is in no way an admittance of the debt on Orkuveita Reykjavikur's behalf and the amount can either increase or decrease when the contracts are settled. The contracts are accounted for among other current liabilities. See in note 23.

Consolidated Financial Statements of Orkuveita Reykjavikur 2017 41 Amounts are in ISK thousand

34. Other matters, contd.

Repair at headquarters

At the end of August 2015, severe water damage occurred at the company's headquarters on Bæjarháls 1. Various options are being considered for renovations of the house and the estimated cost for the different options are estimated ISK 1.500-2.380 million. No decision has been made on the different alternatives.

35. Subsequent events

Magma bond paid up

Bond issued by Orkuveita Reykjavíkur, issued in 2009 in connection with the sale of a 31.23% stake in HS Orka, have now been fully paid up. The final maturity date of the letter was April 2018, but on 6 February 2018, Orkuveita Reykjavíkur received advance payments from the new owners of the parent company Magma Energy Sweden on the total outstanding amount of principal and accrued interest totaling 38,7 million USD. The book value of the bond in the annual financial statements is ISK 4.090 million. or 39,1 million USD.

Fire at Hellisheiði power plant

In January there was a fire at the Hellisheiði power plant. No one was injured in the fire and there was little interruption in the operation of the power plant. The damage of the fire is being assessed, but according to insurance terms, it is assumed that the financial loss will be in line with OR's deductible or one million USD.

36. Significant accounting policies

The accounting policies set out below have been applied consistently to all periods presented in these consolidated financial statements, and have been applied consistently by Group entities.

a. *Basis of consolidation*

i) Subsidiaries

Subsidiaries are entities controlled by the Group. Control exists when the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

ii) Associates

Associates are those entities in which the Group has significant influence, but not control, over the financial and operating policies. Significant influence is presumed to exist when the Group holds between 20 and 50 percent of the voting power of another entity.

Associates are entered in the Group's financial statements by using the equity method.
Associated companies are reported at original cost, including business cost. After the original transaction the share of the Company is reported until significant influence ceases or joint control is concluded.

iii) Transactions eliminated on consolidation

Intra-group balances and transactions, and any unrealised income and expenses arising from intra-group transactions, are eliminated in preparing the consolidated financial statements. Unrealised gains arising from transactions with equity accounted investees are eliminated against the investment to the extent of the Group’s interest in the investee. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

b. *Foreign currency*

i Trade in foreign currencies

Trade in foreign currencies is reported into each consolidation company at the rate of the business day. Monetary assets and debts in foreign currencies are reported in the rate of the reporting date. Other assets and debts reported at fair value in foreign currency are reported at the rate of the day the fair value was set. Exchange difference due to foreign trade is reported through P/L.

ii Subsidiary with other currencies than the Icelandic krona

Assets and debts in the operations of a company of the consolidated financial statements that has USD as its functional currency are calculated into Icelandic kronas at the rate of the reporting date. Income and expenses of this companies operation is calculated into Icelandic kronas at the average exchange rate of the year. The exchange difference due to this is reported in a special account in the statement of comprehensive income. When operations with another functional currency than the Icelandic krona are sold, partly or in full, the accommodating exchange difference is recognised in P/L.

36. Significant accounting policies, contd.

c. *Financial instruments*

i) Non-derivative financial assets

Loans, receivables and cash in bank are recognised when received. All other financial instruments are recognised in the financial statements when the Company becomes a party of contractual provisions of the relevant financial instruments.

Financial assets are eliminated from the financial statements if the Company's contractual right to cash flow due to the financial asset expires or if the Group transfers the assets to another party without retaining control or nearly all risk and gain inherent with their ownership. Any interest in transferred financial assets that is created or retained by the group is recognized as a separate asset or liability.

Non-derivative financial instruments comprise of; available for sale, financial instruments at fair value through P/L and loans and receivables.

Available-for sale financial assets

The Group's investments in equity securities are classified as available-for-sale financial assets. Subsequent to initial recognition, they are measured at fair value and changes therein, other than impairment losses and foreign exchange gains and losses on available-for-sale monetary items are recognised directly in equity. When an investment is derecognised, the cumulative gain or loss in equity is transferred to profit or loss. Fair value changes recognised under equity are derecognised when the available-for-sale asset is derecognised.

Financial assets at fair value through profit or loss

An instrument is classified at fair value through profit or loss if it is held for trading or is designated as such upon initial recognition. Financial instruments are designated at fair value through profit or loss if purchase and sale decisions are based on their fair value in accordance with the Company´s risk policy or investment plan. Financial instruments at fair value through profit or loss are measured at fair value, and changes therein are recognised in profit or loss. Direct transaction cost is recognised in the income statement as it is incurred.

Loans and receivables

Loans and receivables are financial assets with certain or determinable payments and are not listed in active markets. Such assets are recognised initially at fair value plus, for instruments not at fair value through profit or loss, any directly attributable transaction costs. Subsequent to initial recognition loans and receivables are measured at amortised cost using the effective interest method, less any impairment losses.

Loans and receivables comprise of receivables and other current assets.

Cash and cash equivalents comprise cash balances and call deposits.

ii) Non-derivative financial liabilities

Financial liabilities are eliminated from the financial statements when the contractual agreements of the instrument are no longer valid.

The Group classifies non-derivative financial liabilities as other financial liabilities. Such liabilities are recognised initially at fair value plus, for instruments not at fair value through profit or loss, any directly attributable transaction costs. Subsequent to initial recognition financial liabilities are measured at amortised cost using the effective interest method.

Other non-derivative financial liabilities comprise of borrowings, accounts payable and other current liabilities.

36. Significant accounting policies, contd.

c. *Financial instruments, contd.*

iii) Derivative financial instruments

Derivatives are recognised initially at fair value; attributable transaction costs are recognised in profit or loss when incurred. Subsequent to initial recognition, derivatives are measured at fair value in the balance sheet and fair value changes are recognised in the income statement.

iv) Embedded derivatives

Embedded derivatives are separated from the host contract and accounted for separately if the economic characteristics and risks of the host contract and the embedded derivative are not closely related, a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative, and the combined instrument is not measured at fair value through profit or loss.

d. *Property, plant and equipment*

i) Recognition and measurement

Items of property, plant and equipment, except distribution and production systems, are measured at cost less accumulated depreciation and accumulated impairment losses.

Cost includes expenditure that is directly attributable to the acquisition of the asset. The cost of self-constructed assets includes the cost of materials and direct labour, any other costs directly attributable to bringing the asset to a working condition for its intended use, and the costs of dismantling and removing the items and restoring the site on which they are located. Purchased software that is integral to the functionality of the related equipment is capitalised as part of that equipment.

Interest expenses on loans used to finance cost of buildings in construction are capitalised over the construction period. Interest is not calculated on preparation cost. After the assets have been taken into use interest expenses are expensed in the income statement.

When parts of an item of property, plant and equipment have different useful lives, they are accounted for as separate items (major components) of property, plant and equipment and depreciated over their useful lives.

The Group's distribution- and production systems, are stated at revalued carrying amount in the balance sheet, which is their fair value at the revaluation date less additional depreciation from that date. Revaluation of those assets is made on a regular basis. Value surplus due to the revaluation is recognised in a revaluation reserve among equity after taking the effect on deferred tax liability into consideration. Depreciation on the revalued carrying amount is recognised in the income statement. Upon sale or discontinuance of the asset the part of the revaluation reserve belonging to the asset is transferred from the revaluation reserve to retained earnings after taking tax effect into consideration. No recognition takes place from the revaluation reserve to retained earning unless the relevant asset is sold or discontinued.

The fair value of these assets is determined on the basis of the depreciated replacement cost. This consists in that an assessment is made on changes in the construction cost of comparable assets and both cost and accumulated depreciations are revaluated in accordance with those changes. The calculation is based on official information and actual statistics from the Company's books on value changes of cost of items and takes into account an estimate on the weight of each cost item in the total cost of construction of comparable assets. Cost items and their proportional weight were determined by experts within and outside of the Company. The impairment test of assets is also taken into consideration and revaluation is not recognised beyond the expected future cash flow of the assets. Distribution systems for hot water, cold water, sewage and electricity are licensed operations and subject to official revenue targets that are based mostly on changes in the Construction cost index. This is taken into consideration when revaluating these systems.

Gains and losses on disposal of an item of property, plant and equipment are determined by comparing the proceeds from disposal with the carrying amount of property, plant and equipment and are recognised net within “other income” in the income statement. When revalued assets are sold, the amounts included in the revaluation surplus reserve are transferred to retained earnings.

36. Significant accounting policies, contd.

d. *Property, plant and equipment, contd.*

ii) Subsequent costs

The cost of replacing part of an item of property, plant and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Group and its cost can be measured reliably. All other cost is expensed in the income statement when incurred.

iii) Depreciation

Depreciation is recognised in profit or loss on a straight-line basis over the estimated useful lives of each part of an item of property, plant and equipment. Land is not depreciated. Estimated useful lives are specified as follows:

Production system	7-60 years
Electricity distribution systems	15-80 years
Heating distribution systems	15-60 years
Cold water distribution systems	15-90 years
Sewer distribution system	15-60 years
Fiber-optic distribution system	9-41 years
Other real estate	25-50 years
Other equipment	3-25 years

Depreciation methods, useful lives and scrap value are reviewed on the accounting date.

e. *Intangible assets*

i) Heating rights

Heating rights are recognised in the balance sheet at amortised cost as intangible assets. Heating rights are separated from land up on purchase.

ii) Other intangible assets

Other intangible assets are measured at cost less accumulated depreciation and impairment losses.

iii) Subsequent expenditure

Subsequent expenditure is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is recognised in profit or loss as incurred.

iv) Amortisation

Amortisation is recognised in profit or loss on a straight-line basis over the estimated useful lives of intangible assets from the date that they are available for use. The estimated useful lives is determined as follows:

Software	3-7 years

f. *Leased assets*

i) The Company as a lessee

Payments of leases are expensed on straight-line basis in the lease term period unless another systematic method describes the usage of the leased item better. Uncertain lease payments from lease agreements are expensed in the period they occur.

ii) The Company as a lessor

Payments received from leases, both own property as well as lease-back properties, are booked on straight-line basis in the lease term period.

36. Significant accounting policies, contd.

g. *Inventories*

Inventories are measured at the lower of cost and net realisable value. The cost of inventories is based on the first-in first-out principle, and includes expenditure incurred in acquiring the inventories, production or conversion costs and other costs incurred in bringing them to their existing location and condition. Net realisable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses.

h. *Impairment*

i) Financial assets

A financial asset is assessed at each reporting date to determine whether there is any objective evidence that it is impaired. A financial asset is considered to be impaired if objective evidence indicates that one or more events have had a negative effect on the estimated future cash flows of that asset.

An impairment loss in respect of a financial asset measured at amortised cost is calculated as the difference between its carrying amount, and the present value of the estimated future cash flows discounted at the original effective interest rate. An impairment loss in respect of an available-for-sale financial asset is calculated by reference to its fair value at each time. The Group defines decrease in fair value below cost as a subjective indication of impairment of available-for-sale financial assets when:

- decrease is 15% below cost or
- fair value decrease lasts for at least six months.

Individually significant financial assets are tested for impairment on an individual basis. The remaining financial assets are assessed collectively in groups that share similar credit risk characteristics.

All impairment losses are recognised in profit or loss. Any cumulative loss in respect of an available-for-sale financial asset recognised previously in equity is transferred to profit or loss.

An impairment loss is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognised. For financial assets measured at amortised cost and available-for-sale financial assets that are debt securities, the reversal is recognised in profit or loss. For available-for-sale financial assets that are equity securities, the reversal is recognised directly in equity.

ii) Non-financial assets

The carrying amounts of the Group’s non-financial assets, other than inventories and deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the asset’s recoverable amount is estimated.

Impairment is recognized if the carrying amount of an asset or a cash generating unit exceeds its estimated recoverable amount. A cash generating unit is the smallest separable group of assets that form a cash flow that is mostly independent of other units or groups of units. Impairment loss of revalued operating assets is recognized in equity under revaluation reserve.

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and its fair value less costs to sell. 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.

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 amortization, if no impairment loss had been recognized.

36. Significant accounting policies, contd.

i. *Employee benefits*

i) Defined contribution plans

Obligations for contributions to defined contribution pension plans are recognised in the income statement when they are due.

ii) Defined benefit plans

The Group's net obligation in respect of defined benefit pension plans is calculated separately for each plan by estimating the amount of future benefit that current and former employees have earned in return for their service in the current and prior periods. The benefit is discounted to determine its present value and any unrecognised past service costs and the fair value of any plan assets are deducted. The calculation is performed annually by a qualified actuary using the projected unit credit method. Changes in the obligation are recognised in the income statement as incurred.

j. *Obligations*

An obligation is recognised in the balance sheet when the Group has the legal right or has entered into an obligation due to previous events and it is likely that it will incur cost upon settling the obligation. The obligation is measured on the basis of the estimated future cash flow, discounted based on interests reflecting market interests, and the risk inherent with the obligation.

k. *Revenue*

i) Revenues from sale and distribution of electricity and hot water

Revenue from the sale and distribution of electricity and hot water is recognised in the income statement according to measured delivery to purchasers during the year plus a fixed fee.

The rate for the distribution of electricity has a revenue cap set by the National Energy Authority in accordance with laws on energy number 65/2003. The revenue cap is based on actual figures from prior years from the operation of distribution utilities, the depreciation of assets, real losses in the distribution system and return on equity. When setting the revenue cap financial income and expenses are not taken into account. The rate is decided from the revenue cap and projections of sale of electricity in the Group´s utilities area.

ii) Revenues from sale of cold water and sewage

Revenue from the sale of cold water and sewage are based on the size of properties plus a fixed fee and are set forth linearly in the income statement. In addition revenue is stated for cold water according to measurement from specific industries.

iii) Connection revenues

Upon connection of new users to distribution systems of electricity, water and sewage or upon renewal of connection an initial fee is charged. The initial fee meets cost due to new distribution systems or their renewal. Income on connection fees is recognised in the income statement upon delivery of the service.

iv) Rental income

Rental income is recorded as income in the income statement linearly over the lease term.

v) Other revenues

Other revenue is recognised when generated or upon delivery of goods or services.

36. Significant accounting policies, contd.

l. *Financial income and expenses*

Finance income comprises interest income on funds invested, dividend income, changes in the fair value of financial assets at fair value through profit or loss, foreign exchange gain and gains on hedging instruments that are recognised in the income statement. Interest income is recognised as it accrues in the income statement, using the effective interest method. Dividend income is recognised in the income statement on the date that the Group’s right to receive payment is established.

Finance expenses comprise interest expense on borrowings, unwinding of the discount on provisions, foreign exchange losses, impairment losses recognised on financial assets, and losses on hedging instruments that are recognised in the income statement. Borrowing cost is recognised in the income statement based on effective interests.

Effective interest is the required rate of return used when discounting estimated cash flow over the estimated useful life of a financial instrument or a shorter period when applicable, so that it equals to the book value of the financial asset or liability in the balance sheet.

Currency gains and losses are reported on a net basis as either finance income or finance cost depending on whether foreign currency movements are in a net gain or net loss position.

m. *Income tax*

Income tax expense comprises current and deferred tax. Income tax expense 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 year, using tax rates enacted or substantively enacted at the reporting date, and any adjustment to tax payable in respect of previous years. The income tax ratio for the parent company is 36,0% and the tax ratio for the subsidiaries is 20,0%. Cold water supply and sewage is exempt from tax.

Deferred tax is recognised using the balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is measured at the tax rates that are expected to be applied to the temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date. Deferred tax was measured in accordance with the current tax rate, which is 36,0% for the parent company that is a partnership and 20,0% for the subsidiaries that are companies with limited liability.

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

n. *Segment reporting*

A segment is a distinguishable component of the Group that is engaged in business and is capable to earn revenues and accept cost, both within and outside of the Group. The return of all segments is overviewed by management to value their performance.

Segment results and their assets include items directly attributable to a segment as well as those that can be allocated on a reasonable basis.

Segment investments are investments in property, plant and equipment and intangible assets.
Inter-segment pricing is determined on an arm’s length basis.

36. Determination of fair values

o. *Determination of fair value*

A number of the Group's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities.

The Group´s CFO is responsible for overseeing all significant fair value measurements, including Level 3 fair values. Risk management, led by the CFO, regularly reviews significant unobservable inputs and valuation adjustments. If third party information, such as broker quotes or pricing services, is used to measure fair values, then that information is used to support the conclusion that such valuations meet the requirements of IFRS, including the level in the fair value hierarchy in which such valuations should be classified.

When measuring the fair value of an asset or a liability, the Group uses market observable data as far as possible.

Fair values are categorised into different levels in a fair value hierarchy based on the inputs used in the valuation techniques as follows.

Level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2: inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

Level 3: inputs for the asset or liability that are not based on observable market data (unobservable inputs).

If the inputs used to measure the fair value of an asset or a liability might be categorised in different levels of the fair value hierarch, then the fair value measurement is categorised in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement.

The Group recognises transfers between levels of the fair value hierarchy at the end of the reporting period during which the change has occurred.

Further information about the assumptions made in measuring fair values can be found in relevant notes and in note 29 regarding fair value.

p. *Property, plant and equipment*

The fair value of production- and fiber-optic systems that have undergone a revaluation is determined on the basis of the depreciated replacement cost, which consists in the assessment of changes in construction cost of comparable assets and both cost and accumulated depreciation are revalued in accordance with those changes. The results of the impairment tests are also taken into consideration and revaluation is not recognised beyond the expected future cash flow of those assets.

q. *Investments in equity and debt securities*

The fair value of financial assets at fair value through profit or loss is determined on the basis of their market value at the reporting date. If the market value is not known the valuation is based on generally accepted valuation methods. Valuation methods can be based on known recent financial transactions between unrelated parties. In applying these valuation methods factors are considered which would be used in the respective market concerning calculation of fair value and the methods are in accordance with generally accepted methods concerning valuation of financial assets.

36. Determination of fair values, contd.

r. *Derivatives*

The fair value of derivatives is based on their market value, if available. If the market value is not available the fair value is determined on the basis of generally accepted valuation methods.

Valuation methods may be based on prices in recent transactions between unrelated parties. The measurement is based on the value of other financial instruments comparable to the instrument in question, methods in order to evaluate the present value of cash flow or other valuation methods, which may be applied in order to reliably assess the real market value. When valuation methods are applied all factors are used, which market parties would use in price evaluations, and the methods are in accordance with generally accepted methods for the price evaluation of financial instruments. The Group verifies on a regular basis its valuation methods and tests them by using a price obtained in a transaction on an active market with the same instrument, without adjustments and changes, or are based on information from an active market.

The fair value of derivative agreements not listed in active markets is determined by use of valuation methods, which are regularly reviewed by qualified employees. All valuation models used must be approved and tested in order to ensure that the results reflect the data used.

The most reliable indication of the fair value of derivative agreements at the beginning is the purchase value, unless the fair value of the instruments is verifiable in comparison with other listed and recent market transactions with the same financial instrument or based on a valuation method where variables are only based on market data. When such data is available the Group recognises profit or loss at the initial registration date of the instruments.

The fair value of interest rate swaps is based on broker quotes. Those quotes are tested for reasonableness by discounting estimated future cash flows based on the terms and maturity of each contract and using market interest rates for a similar instrument at the measurement date.

s. *Trade and other receivables*

The fair value of trade and other receivables, is estimated at the present value of future cash flows, discounted at the market rate of interest at the reporting date if applicable. This fair value is determined for disclosure purposes.

t. *Non-derivative financial liabilities*

Fair value, which is determined for disclosure purposes, is calculated based on the present value of future principal and interest cash flows, discounted at the market rate of interest at the reporting date.

37. New accounting standards not yet adopted

Several new international accounting standards and improvement of the standards applicable to accounting year beginning after 1 January 2016 and are permissible for early adoption The company has not utilized the permission for early adoption in preparing these annual accounts. Management believes that the adoption of these standards will not have a significant impact on the consolidated financial statements excluding the effects of the transition to IFRS 15 effective for annual periods beginning 1 January 2018 and IFRS 16 effective for fiscal year beginning January 1, 2019. Possible effect of the implementation of the standards have not yet been evaluated. The application of IFRS 15 is scheduled in the year 2017 and IFRS 16 will apply to financial statements of the company if it will be adopted by the EU.

38. Standards issued but not yet effective

A number of new standards are effective for annual periods beginning after 1 January 2017 and earlier application is permitted; however, the Group has not early adopted the new or amended standards in preparing these consolidated financial statements.

The following standards are expected to have an impact on the Group's financial statements in the period of initial application.

i) IFRS 15 Revenue from Contracts with Customers

IFRS 15 establishes a comprehensive framework for the users of the financial statements about nature, amounts, timing and uncertainty of revenue and cash flow from contracts with customers. IFRS 15 does not applies for income from financial instruments and lease contracts. The standard replaces IAS 18 Revenue, IAS 11 Construction Contracts and related interpretations for periods beginning 1 January 2018 or later.

The principle of IFRS 15 is that revenue shall be recognised in a way which reflects the transfer of goods and service to customers in relation to the amount which OR expects to receive in trade for those goods and service. Revenues shall be recognised according to that principle by applying the five step model of the standard in order to determine when to recognise revenues and by which amount.

The Group has adopted IFRS 15 from 1 January 2018. OR's management has assessed that the initial application of IFRS 15 will have immaterial effect on the consolidated financial statements except that the standard requires for extensive new disclosures in consolidated financial statements.

ii) IFRS 9 Financial Instruments

IFRS 9 Financial Instruments sets out requirements for classification, recognising and measuring financial assets, financial liabilities and changes IFRS 7 in respect to requirement of extensive new disclosures for financial instruments. This standard replaces IAS 39 and is effective for annual periods beginning 1 January 2018 or later.

IFRS 9 contains a new classification and measurement approach for financial assets. IFRS 9 contains three principal classification categories for financial assets: measured at amortised cost, FVOCI and FVTPL. The standard eliminates the existing IAS 39 categories of held to maturity, loans and receivables and available for
At IFRS 9 adoption and initial recognition given certain condition it is allowed to classify financial assets at FVTPL or at FVOCI. After that the classification can to be changed.

The Group classifies shares in companies at FVOCI. At IFRS 9 adoption it is allowed to continue with the classification and OR's management have decided to take advantage of that option and continue with unchanged classification. Classification of shares in companies at FVOCI results in fair value change to be only recorded in OCI and not reclassified to P&L when sold.

The bond matures in 2018. The bond's terms do not only include a repayment of principal and interest as market variables will affect fair value of the bond and the amount that will be collected at the mature date. Based on that it is required to continue to classify the bond at FVTPL.

Marketable securities are classified at FVTPL. Marketable securities do not have known future cash flow and therefore it is required to continue to classify them at FVTPL.

Based on its assessment, the Group does not believe that the new classification requirements will have a material impact on its accounting.

38. Standards issued but not yet effective, cont.

ii) IFRS 9 Financial Instruments, cont.

IFRS 9 replaces the ‘incurred loss’ model in IAS 39 with a forward-looking ‘expected credit loss’ (ECL) model. This will require considerable judgement about how changes in economic factors affect ECLs, which will be determined on a probability-weighted basis. Under IFRS 9, loss allowances will be measured on either of the 12-month ECLs: these are ECLs that result from possible default events within the 12 months after the reporting date or lifetime ECLs: these are ECLs that result from all possible default events over the expected life of a financial instrument.

Group's asset classified at amortised cost consist of account receivable and contract assets, other receivable, restricted cash and cash and cash equivalents. Account receivable and other receivable are without material financing component and the risk is immaterial and the loss allowances will be measured on lifetime ECLs.

Based on OR's management estimate the change in requirement for loss allowance measurement not have material effect on measure of Group's financial assets as part of the financial assets are measured at FVTPL and the standard's requirements for loss allowance measurement does not apply to them. Financial assets measured at amortised cost according to IFRS 9 are either short term receivable with expected life less than 12 months or receivable with low credit risk.

IFRS 9 requirements does not change the current treatment of embedded derivatives in electricity sales contracts, hedge contracts designated at FVTPL and financial liabilities at amortised cost.

IFRS 9 will require extensive new disclosures, in particular about hedge accounting, credit risk and ECLs. The Group’s assessment included an analysis to identify data gaps against current processes and the Group is in the process of implementing the system and controls changes that it believes will be necessary to capture the required data. The Group does not apply hedge accounting and does not plan to implement hedge accounting for 2018. Due to that the effect on disclosure only relates to credit risk.

OR's management has assessed that the initial application of the standard will have immaterial effect on the consolidated financial statements except that the standard requires for extensive new disclosures in consolidated financial statements.

iii) IFRS 16 Leases

IFRS 16 introduces a single, on-balance sheet lease accounting model for lessees. A lessee recognises a right-of-use asset representing its right to use the underlying asset and a lease liability representing its obligation to make lease payments. There are recognition exemptions for short-term leases and leases of low-value items. Lessor accounting remains similar to the current standard - i.e. lessors continue to classify leases as finance or operating leases.

IFRS 16 replaces existing leases guidance, including IAS 17 Leases, IFRIC 4 Determining whether an Arrangement contains a Lease, SIC-15 Operating Leases-Incentives and SIC-27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease.

The standard is effective for annual periods starting 1 January 2019 or later. OR's management are expecting no significant impact is expected for the Group's finance leases.

Non-Financial Information (unaudited)

OR Values
The values of OR are foresight, efficiency and integrity and serve as the guiding principles of all of the activities of the company.

Environment
Orkuveita Reykjavíkur is trusted for the resources it utilizes. The responsibility involves working on the ideology of sustainable development and ensuring sustainable utilization, namely that generations have the same opportunities as present-day generations to exploit the resources and that it can be verified that this is done. OR commits itself to seeking successful solutions where public resource utilization is weighed and evaluated in relation to other interests. OR will protect the resources from hazards and imposition, due to the responsibility of the company. OR operates according to the environmental and the resource policy, published on the company's website, www.or.is, and is subject to independent certification under ISO 14001. A detailed article is prepared for environmental aspects of the operation in 2017 in the annual report of OR 2017, at the URL www.arsskyrsla2017.or.is.

Social issues
Orkuveita Reykjavíkur is a large company nationwide and has extensive knowledge and experience in the utilization of geothermal energy and other aspects of the company's operations. OR disseminates knowledge and encourages responsible environmental and positive impacts on society. Transparency is a key element in OR's business and makes the company fully aware of the social aspects of the business in 2017 in the annual report, OR 2017, at the URL www.arsskyrsla2017.or.is.

Human resources
At Orkuveita Reykjavíkur, people have the skills needed to perform the tasks that the company's activities require. On the OR web site, www.or.is, you can find employee policy, remuneration policy and the employee KPI. OR ensures that employees enjoy equal rights, in accordance with the Gender Equality Policy and Equal Opportunities. OR´s employee Policy is based on the company´s values and overall policies and is set in accordance with the Company's corporate governance policy. The company reports on human resources in 2017 in the annual report, OR 2017, at www.arsskyrsla2017.or.is

Corruption, bribery and human rights
At OR there are registered work procedures for the processing of issues when a staff member is alleged to have violated company rules or committed fraud at work. The rules of procedure are accessible to all employees on the company’s intranet. These specify what are considered to be deviations or violations at work. If an employee becomes aware of possible breaches committed by another employee(s) at work or there are grounds to suspect fraudulent activities or incidents, the immediate superior must be notified. It is also possible to notify the company's internal auditor of any potential breaches or frauds. Those who receive indications of possible violations or fraud have a duty to report it, but to treat the information with complete confidentiality. OR’s lawyer can also provide legal advice or assistance as the case may be. The management of OR, managing directors and directors are responsible for the internal supervision of their specific divisions. Quality Control is responsible for ensuring that OR’s internal monitoring system is effective. OR's quality control system is independently certified by external entities.
OR attaches great importance to gender equality, and the Equal Opportunities Policy of the Company implements a commitment for continuous improvement on equality at the workplace. The company adopts the human rights provisions of the Constitution on the basis of the equality policy aimed at evaluating individuals for their own merit and for equal rights. The equality policy is based on OR values and overall policies and is set in accordance with the company's corporate governance policy.

More information on non-financial information
In conjunction with the annual accounts, OR publishes the Annual Report 2017, which includes More detailed information about non-financial information. The report is available at www.arsskyrsla2017.or.is