Icelandair Group hf.

Consolidated Financial Statements
for the period from 1 October to 31 December 2006

ISK

Icelandair Group hf.
Reykjavíkurflugvöllur
101 Reykjavík
Iceland
Reg. no. 631205-1780

Contents

Endorsement and Signatures of the Board of Directors and the CEO

Icelandair Group hf. was a subsidiary of FL GROUP hf. until October 2006, when it was acquired by Icelandair Group Holding hf., a company incorporated in Iceland in October 2006. The acquisition of Icelandair Group hf. is accounted for by applying the purchase method, where Icelandair Group hf. is the acquiree and Icelandair Group Holding hf. is the acquirer. After the acquisition, Icelandair Group hf. legally merged with Icelandair Group Holding hf. on 1 November 2006, with Icelandair Group hf. as the continuing company. The acquisition and subsequent merger result in that the consolidated income statement and statement of cash flows only cover the three months period from 1 October 2006 to 31 December 2006.

To provide users of the Group´s consolidated financial statements with more appropriate information of the Group's operations and cash flows, audited pro forma figures based on audited financial statements of all subsidiaries of Icelandair Group hf. for the whole year 2006 are presented in the income statement and statement of cash flows with relevant disclosures in the notes. The basis for preparation of the pro forma figures is described further in note 2e.

The consolidated financial statements of Icelandair Group hf. for the period from 1 October to 31 December 2006 have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by EU. The financial statements comprise the consolidated financial statements of Icelandair Group hf. and its subsidiaries, which were fourteen at the end of December 2006.

According to the income statement net loss for the period from 1 October to 31 December 2006 amounted to ISK 550 million. According to the balance sheet, equity at the end of the year amounted to ISK 26,004 million, including share capital in the amount of ISK 1,000 million. At year-end the shareholders were 1,507 and three of them held more then 10% in the Company, Langflug ehf. 32.0%, Naust ehf. 14.8% and Fjárfestingafélagið Máttur ehf. 11.1%.

The Board of Directors proposes that no dividend will be paid to shareholders in the year 2007.

The Board of Directors and the CEO of Icelandair Group hf. hereby confirm the Company's consolidated financial statements for the period from 1 October to 31 December 2006 by means of their signatures.

Reykjavík, 20 February 2006.

Board of Directors:

Finnur Ingólfsson
Ómar Benediktsson
Helgi S. Guðmundsson
Hermann S. Guðmundsson
Jóhann Magnússon
Jón Benediktsson
Martha Eiríksdóttir

CEO:

Jón Karl Ólafsson

Independent Auditors' Report

To the Board of Directors and Shareholders of Icelandair Group hf.

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of Icelandair Group hf. and its subsidiaries, ("the Group"), which comprise the consolidated balance sheet as at December 31, 2006, and the consolidated income statement, consolidated statement of changes in equity and consolidated statement of cash flows for the three months period from 1 October 2006 to 31 December 2006, and a summary of significant accounting policies and other explanatory notes.

We have also audited the pro forma financial information presented in the consolidated income statement and consolidated statement of cash flows and the related disclosures made in the notes to these consolidated financial statements, which have been compiled on the basis described in Note 2e to these consolidated financial statements, for illustrative purposes only, to provide information about how the Group's operations and cash flows might have been if the acquisition of Icelandair Group hf. had been effected at the beginning of the year 2006.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the EU. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatements, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances. Management is also responsible for the preparation and fair presentation of the pro forma financial information presented in these consolidated financial statements on the basis described in note 2e to these consolidated financial statements.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit and to express an opinion as to the proper compilation of the pro forma financial information. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with relevant ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements 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 entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We planned and performed our work so as to obtain the information and explanations we considered necessary in order to provide us with reasonable assurance that the pro forma financial information has been properly compiled on the basis stated.

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

Opinion

In our opinion, the consolidated financial statements give a true and fair view of the financial position of the Group as at 31 December 2006, and of its financial performance and its consolidated cash flows for the three months period then ended in accordance with International Financial Reporting Standards as adopted the EU.

In our opinion, the pro forma financial information has been properly compiled on the basis stated in Note 2e to these consolidated financial statements. Without qualifying our opinion, we draw attention to Note 2e, which states that the pro forma financial information is not necessarily indicative of the operations and cash flows that would have been attained if the acquisition of Icelandair Group hf. had indeed taken place at the beginning of the year 2006.

Reykjavík, 20 February 2006

KPMG hf.

Jón S. Helgason
Sæmundur Valdimarsson

Consolidated Income Statement
for the period from 1 October to 31 December 2006

	Notes	2006 1.10.-31.12.	**Pro forma** 2006 1.1.-31.12.
Operating income:			
Transport revenue	7	7,306	34,954
Aircraft and aircrew lease		2,900	10,675
Other operating revenue	8	2,384	10,514
		12,590	56,143
Operating expenses:			
Salaries and other personnel expenses	9	4,753	17,761
Aircraft fuel		2,135	9,524
Aircraft and aircrew lease		1,619	5,207
Aircraft servicing, handling and communication		1,163	4,110
Aircraft maintenance expenses		746	3,111
Other operating expenses	10	1,836	10,372
		12,252	50,085
Operating profit before depreciation (EBITDA)		338	6,058
Depreciation and amortisation	12	(732)	(2,732)
Operating (loss) profit before net finance cost (EBIT)		(394)	3,326
Finance income	13	447	1,599
Finance expense	13	(879)	(2,025)
Net finance costs		(432)	(426)
Share of profit of associates		69	160
(Loss) profit before income tax		(757)	3,060
Income tax	14-15	207	(445)
(Loss) profit for the period		(550)	2,615
Attributable to:			
Equity holders of the Company		(544)	2,621
Minority Interest		(6)	(6)
(Loss) profit for the period		(550)	2,615
Earnings per share:			
Basic and diluted earnings per share (ISK)	31	(0.54)	2.62

The notes on pages 10 to 38 are an integral part of these consolidated financial statements.

Financial Statements of Icelandair Group hf. 2006 Amounts are in ISK million

Consolidated Balance Sheet
as at 31 December 2006

	Notes	2006
Assets:		
Operating assets	17-20	22,935
Intangible assets	21-22	27,845
Investments in associates	23	2,058
Prepaid aircraft acquisitions	24	9,669
Long-term receivables and deposits	25	2,689
Total non-current assets		65,196
Inventories	26	1,131
Trade and other receivables	27	7,243
Prepayments	28	271
Cash and cash equivalents	29	2,776
Total current assets		11,421
Total assets		76,617
Equity:		
Share capital		1,000
Share premium		26,090
Reserves		(584)
Accumulated deficit		(544)
Total equity attributable to equity holders of the Company	30	25,962
Minority interest		42
Total equity		26,004
Liabilities:		
Loans and borrowings	32-35	21,607
Deferred income tax liability	36	360
Total non-current liabilities		21,967
Loans and borrowings	32	4,614
Loans to finance prepaid aircraft acquisition	32	8,545
Trade and other payables	37	12,428
Deferred income	38	3,059
Total current liabilities		28,646
Total liabilities		50,613
Total equity and liabilities		76,617

The notes on pages 10 to 38 are an integral part of these consolidated financial statements.

Financial Statements of Icelandair Group hf. 2006 7 Amounts are in ISK million

Consolidated Statement of Changes in Equity

for the period from 1 October to 31 December 2006

	Attributable to equity holders of the Company							
			Reserves					
	Share capital	Share premium	Hedging reserve	Translation reserve	Accumulated deficit	Total	Minority Interest	Total equity
Issued and sold share capital	1,000	26,000				27,000		27,000
Foreign currency translation differences for foreign operations				(418)		(418)		(418)
Net loss on hedge of net investment in foreign operation				(7)		(7)		(7)
Effective portion of changes in fair value of cash flow hedges, net of tax			(159)			(159)		(159)
Net income and expense recognised directly in equity			(159)	(425)		(584)		(584)
Loss for the period					(544)	(544)	(6)	(550)
Total recognised income			(159)	(425)	(544)	(1,128)	(6)	(1,134)
Issue of convertible notes, net of tax		90				90		90
Minority, change							48	48
Equity 31.12.2006	1,000	26,090	(159)	(425)	(544)	25,962	42	26,004

The notes on pages 10 to 38 are an integral part of these consolidated financial statements.

Amounts are in ISK million

Consolidated Statement of Cash Flows
for the period from 1 October to 31 December 2006

	Notes	2006 1.10.-31.12.	**Pro forma** 2006 1.1.-31.12.
Cash flows from operating activities:			
(Loss) profit for the period		(550)	2,615
Adjustments for:			
Depreciation	12	732	2,732
Other operating items	46	(384)	(434)
Working capital (used in) from operations		(202)	4,913
Net change in operating assets and liabilities	47	177	1,455
Net cash (used in) from operating activities		(25)	6,368
Cash flows from investing activities:			
Acquisition of operating assets		(3,424)	(7,671)
Proceeds from the sale of operating assets		1,580	3,476
Acquisition of intangible assets		(87)	(232)
Acquisition of subsidiaries, net of cash acquired		(15,548)	(15,953)
Long-term receivables, increase		(288)	(660)
Net cash used in investing activities		(17,767)	(21,040)
Cash flows from financing activities:			
Proceeds from issue of share capital		13,600	13,600
Proceeds from long term borrowings		15,915	19,961
Repayment of long term borrowings		(10,996)	(18,186)
Proceeds from short term borrowings		1,945	1,945
Net cash used in financing activities		20,464	17,320
(Decrease) increase in cash and cash equivalents		2,672	2,648
Effect of exchange rate fluctuations on cash held		104	128
Cash and cash equivalents at beginning of period		0	0
Cash and cash equivalents at 31 December 2006	29	2,776	2,776
Investment and financing without cash flow effect:	6		

The notes on pages 10 to 38 are an integral part of these consolidated financial statements.

Amounts are in ISK million

Notes

1. Reporting Entity

Icelandair Group hf. ("the Company") is a limited liability company incorporated and domiciled in Iceland. The address of the Company´s registered office is at Reykjavíkurflugvöllur in Reykjavík, Iceland. The consolidated financial statements of the Company as at and for the three months period ended 31 December 2006 comprise the Company and its subsidiaries (together referred to as the "Group") and the Group´s interests in associates. The Group´s operations are in the airline transportation and tourism industry. The Group was listed on the Iceland Stock Exchange in December 2006.

Icelandair Group hf. was a subsidiary of FL GROUP hf. until October 2006, when it was acquired by Icelandair Group Holding hf., a company incorporated in Iceland in October 2006. The acquisition of Icelandair Group hf. is accounted for by applying the purchase method, where Icelandair Group hf. is the acquiree and Icelandair Group Holding hf. is the acquirer. After the acquisition, Icelandair Group hf. legally merged with Icelandair Group Holding hf. on 1 November 2006, with Icelandair Group hf. as the continuing company. The acquisition and subsequent merger result in that the consolidated income statement and statement of cash flows only cover the three months period from 1 October 2006 to 31 December 2006.

To provide users of the Group´s consolidated financial statements with more appropriate information of the Group's operations and cash flows, audited pro forma figures based on audited financial statements of all subsidiaries of Icelandair Group hf. for the whole year 2006 are presented in the income statement and statement of cash flows with relevant disclosures in the notes. The basis for preparation of the pro forma figures is described further in note 2e.

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 EU.

The financial statements were approved by the Board of Directors on 20 February 2006.

b. *Basis of measurement*

The consolidated financial statements are prepared on the historical cost basis except that derivative financial instruments are stated at their fair value.

c. *Functional and presentation currency*

The consolidated financial statements are prepared in Icelandic krona (ISK), which is the Company's functional currency. All financial information has been rounded to the nearest million.

d. *Use of estimates and judgements*

The preparation of financial statements 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 period in which the estimate is revised and in any future periods affected.

Significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amount recognised in the financial statements are: business combinations, measurement of the recoverable amounts of cash-generating units, utilisation of tax losses, accounting for an arrangement containing a lease, provisions and valuation of financial instruments.

e. ***Pro forma information***

As stated in note 1, audited pro forma figures for the whole year 2006 are presented in the income statement and statement of cash flows with certain disclosures in the notes. The pro forma figures consist of the consolidated income statement and statement of cash flows of the Group for the whole year 2006, as if the acquisition of Icelandair Group hf. had been effected at the beginning of the year 2006. For this purpose, the consolidated pro forma income statement and statement of cash flows of the Group for the whole year 2006 have been prepared in accordance with the accounting policies disclosed in these consolidated financial statements and are based on the audited financial statements of all subsidiaries of Icelandair Group hf. for the whole year 2006, whereby depreciation and amortisation have been calculated for the whole year 2006 based on the fair values of operating and intangible assets determined as at the acquisition date in October 2006. This adjustment resulted in an increase of depreciation and amortisation for the amount of ISK 122 million and decrease in income tax expense amounting to ISK 22 million.

3. Significant accounting principles

a. ***Basis of consolidation***

(i) *Subsidiaries*

Subsidiaries are entities controlled by the Company. Control exists when the Company has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that presently are exercisable or convertible are taken into account. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

(ii) *Associates*

Associates are those entities in which the Group has significant influence, but not control, over the financial and operating policies. Associates are accounted for using the equity method. The consolidated financial statements include the Group's share of the total recognised gains and losses of associates on an equity accounted basis, from the date that significant influence commences until the date that significant influence ceases. When the Group's share of losses exceeds its interest in an associate, the Group's carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of an associate.

(iii) *Transactions eliminated on consolidation*

Intra-group balances 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 associates are eliminated against the investment to the extent of the Group's interest in the entity. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

b. ***Foreign currency***

(i) *Foreign currency transactions*

Transactions in foreign currencies are translated to the respective functional currency of Group entities at exchange rates ruling at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are translated to the functional currency at the exchange rate ruling at that date. Foreign currency differences arising on re-translation are recognised in the income statement.

3.b. Contd.:

(ii) *Foreign operations*

The assets and liabilities of foreign operations including goodwill and fair value adjustments arising on acquisitions are translated to Icelandic kronas at exchange rates at the reporting date. The income and expenses of foreign operations are translated to Icelandic kronas at the average exchange rate for the period. Foreign currency differences arising on re-translation are recognised directly in a separate component of equity.

(iii) *Hedge of net investment in foreign operations*

Foreign currency differences arising on the retranslation of a financial liability designated as a hedge of a net investment in foreign operation are recognised directly in equity, to the extent that the hedge is effective. To the extent that the hedge is ineffective, such differences are recognised in profit or loss. When the hedged net investment is disposed of, the cumulative amount in equity is transferred to profit or loss as an adjustment to the profit or loss on disposal.

c. *Financial instruments*

(i) *Non-derivative financial instruments*

Non-derivative financial instruments comprise trade and other receivables, cash and cash equivalents, loans and borrowings, and trade and other payables.

Non-derivative financial instruments are recognised initially at fair value plus, for instruments not at fair value through profit or loss, any directly attributable transaction costs, except as described below. Subsequent to initial recognition non-derivative financial instruments are measured as described below.

A financial instrument is recognised if the Group becomes a party to the contractual provisions of the instrument. Financial assets are derecognised if the Group's contractual rights to the cash flows from the financial assets expire or if the Group transfers the financial asset to another party without retaining control or substantially all risks and rewards of the asset. Regular way purchases and sales of financial assets are accounted for at trade date, i.e. the date that the Group commits itself to purchase or sell the asset. Financial liabilities are derecognised if the Group's obligations specified in the contract expire or are discharged or cancelled.

Cash and cash equivalents comprise cash balances and call deposits.

Accounting for finance income and expense is discussed in note 3(m).

Other non-derivative financial instruments.

Other non-derivative financial instruments are measured at amortised cost using the effective interest method, less any impairment losses.

(ii) *Derivative financial instruments*

The Group holds derivative financial instruments to hedge its foreign currency, fuel price and interest rate risk exposures. 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, and changes therein are accounted for as described hereafter.

Cash flow hedges

Changes in the fair value of the derivative hedging instrument designated as a cash flow hedge are recognised directly in equity to the extent that the hedge is effective. To the extent that the hedge is ineffective, changes in fair value are recognised in profit or loss.

3.c. Contd.:

If the hedging instrument no longer meets the criteria for hedge accounting, expires or is sold, terminated or exercised, then hedge accounting is discontinued prospectively. The cumulative gain or loss previously recognised in equity remains there until the forecast transaction occurs. When the hedged item is a non-financial asset, the amount recognised in equity is transferred to the carrying amount of the asset when it is recognised. In other cases the amount recognised in equity is transferred to profit or loss in the same period that the hedged item affects profit or loss.

Economic hedges
Hedge accounting is not applied to derivative instruments that economically hedge monetary assets and liabilities denominated in foreign currencies. Changes in the fair value of such derivatives are recognised in profit or loss as foreign currency gains and losses.

(iii) *Compound financial instruments*

Compound financial instruments issued by the Group comprise convertible notes that can be converted to share capital at the option of the holder, and the number of shares to be issued does not vary with changes in their fair value.

The liability component of a compound financial instrument is recognised initially at the fair value of a similar liability that does not have an equity conversion option. The equity component is recognised initially at the difference between the fair value of the compound financial instrument as a whole and the fair value of the liability component. Any directly attributable transaction costs are allocated to the liability and equity components in proportion to their initial carrying amounts.

Subsequent to initial recognition, the liability component of a compound financial instruments is measured at amortised cost using the effective interest method. The equity component of a compound financial instruments is not remeasured subsequent to initial recognition.

(iv) *Share capital*

Incremental costs directly attributable to issue of shares are recognised as a deduction from equity.

Repurchase of share capital
When share capital recognised as equity is repurchased, the amount of the consideration paid, including directly attributable costs, is recognised as a deduction from equity. Repurchased shares are classified as treasury shares and are presented as a deduction from total equity.

Dividends
Dividends are recognised as a decrease in equity in the period in which they are declared.

d. *Operating assets*

(i) *Aircrafts and flight equipment*

Aircrafts and flight equipment, e.g. aircraft engines and aircraft spare parts, are measured at cost less accumulated depreciation and impairment losses. When aircrafts are acquired the purchase price is divided between the aircraft itself and engines. Aircrafts are depreciated over the estimated useful life of the relevant aircraft until a residual value is met. Engines are depreciated according to flown hours. When an engine is overhauled the cost of the overhaul is capitalised and the remainder of the cost of the previous overhaul that has not already been depreciated, if there is any, is expensed in full.

3.d. Contd.:

(ii) *Buildings and other operating assets*

Buildings and other operating assets are stated at cost less accumulated depreciation and impairment losses.

(iii) *Subsequent costs*

The cost of replacing part of an item of operating asset is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied with the item will flow to the Group and the cost of the item can be measured reliably. All other costs are recognised in the income statement as an expense as incurred.

(iv) *Depreciation*

Depreciation is recognised in the income statement on a straight-line basis over the estimated useful lives of each item of operating assets. The estimated useful lives are as follows:

	Useful life
Aircrafts and flight equipment	10-14 years
Engines	Flying hrs.
Buildings	15-50 years
Other property and equipment	3-8 years

The depreciation method, useful lives and residual values are reassesed at each reporting date.

e. ***Intangible assets***

(i) *Goodwill and other intangible assets with indefinite useful lives*

All business combinations are accounted for by applying the purchase method. Goodwill represents amounts arising on acquisition of subsidiaries. In respect of business acquisitions goodwill represents the difference between the cost of the acquisition and the fair value of the net identifiable assets acquired.

Goodwill, trademarks and slots with indefinite useful lives are stated at cost less accumulated impairment losses.

(ii) *Other intangible assets*

Other intangible assets are measured at cost less accumulated amortisation and impairment losses. Amortisation is recognised in the income statement on a straight-line basis over the estimated useful lives as follows:

Software	3 years
Customer relations	7-10 years
Favourable aircraft lease contracts	2-3 years
Other intangible assets	6-10 years

(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 expensed as incurred.

f. ***Prepaid aircraft acquisitions***

Prepaid aircraft acquisitions consist of pre-payments on Boeing aircrafts that are still to be delivered. Borrowing cost related to these pre-payments is capitalised based on the interest rate on the directly related financing.

g. ***Inventories***

Goods for resale and supplies are measured at the lower of cost and net realisable value. The cost of inventories is based on first-in first-out principle and includes expenditure incurred in acquiring the inventories and 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. Aircraft equipment is capitalised at the foreign exchange rate ruling at the date of acquisition.

h. ***Impairment***

(i) *Financial assets*

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.

Individually significant financial assets are tested for impairment on a 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, the reversal is recognised in profit or loss.

(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. For goodwill and intangible assets that have indefinite lives or that are not yet available for use, recoverable amount is estimated at each reporting date.

An impairment loss is recognised if the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. A cash-generating unit is the smallest identifiable asset group that generates cash flows that largely are independent from other assets and groups. Impairment losses are recognised in profit or loss. Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amount of the other assets in the unit (group of units) on a pro rata basis.

3.h. Contd.:

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 in respect of goodwill is not reversed. In respect of other assets, impairment losses recognised in prior periods are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset’s carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

i. ***Provisions***

A provision is recognised in the balance sheet when the Group has a present legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability.

(i) *Frequent flyer program*

Frequent flyer points earned or sold are accounted for as a liability on a fair value basis of the services that can be purchased for the points. The points are recognized as revenue when they are utilized or when they expire.

(ii) *Overhaul commitments relating to aircrafts under operating lease*

With respect to the Group´s operating lease agreements, where the group has a commitment to maintain the aircraft, provision is made during the lease term for the obligation based on estimated future cost of major airframe and certain engine maintenance checks by making appropriate charges to the income statement calculated by reference to the number of hours or cycles operated during the year.

j. ***Deferred income***

Sold unused tickets and other prepayments are presented as deferred income in the balance sheet.

k. ***Operating income***

(i) *Transport revenue*

Passenger ticket sales are not recognised as revenue until transportation has been provided. Sold documents not used within nine months from the month of sale are recognised as revenue. Revenue from mail and cargo transportation is recognised in the income statement after transportation has been provided.

(ii) *Aircraft and aircrew lease*

Revenue from aircraft and aircrew lease is recognised in the income statement when the service has been provided at the end of each charter flight.

3.k. Contd.:

(iii) *Other operating revenue*

Revenue from other services rendered is recognised in the income statement when the service has been provided.

Gain on sale of operating assets is recognised in the income statement after the risks and rewards of ownership have been transferred to the buyer.

l. ***Expenses***

(i) *Operating lease payments*

Payments made under operating leases are recognised in the income statement on a straight-line basis over the term of the lease.

m. ***Finance income and expenses***

Finance income comprises interest income on funds invested, dividend income, foreign currency gains, and gains on hedging instruments that are recognised in profit or loss. Interest income is recognised as it accrues, using the effective interest method. Dividend income is recognised 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 currency losses, impairment losses recognised on financial assets, and losses on hedging instruments that are recognised in profit or loss.

n. ***Income tax expense***

Income tax on the profit or loss for the year comprises only deferred tax.

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

Deferred tax is provided 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. The following temporary differences are not provided for: goodwill not deductible for tax purposes, the initial recognition of assets or liabilities that affect neither accounting nor taxable profit, and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the reporting date.

o. ***Earnings per share***

The Group presents basic and diluted earnings per share (EPS) data for its ordinary shares. Basic EPS is calculated by dividing the profit attributable to ordinary shareholders of the Company by the weighted average number of ordinary shares outstanding during the year. Diluted EPS is determined by adjusting the profit or loss attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding for the effects of all dilutive potential ordinary shares.

p. ***Segment reporting***

A segment is a distinguishable component of the Group that is engaged in providing products or services (business segments) and which is subject to risks and rewards that are different from those of other segments. The Group´s primary format for segment reporting is based on business segments. The major revenue-earning asset of the Group is the aircraft fleet, the majority of which are registered in Iceland. Since the Group's aircraft fleet is employed flexibly across its route network, there is no suitable basis of allocating such assets and related liabilities to geographical segments.

q. ***New standards and interpretaions not yet adopted***

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2006, and have not been applied in preparing these consolidated financial statements:

IFRS 7 Financial Instruments: Disclosures and the Amendment to IAS 1 Presentation of Financial Statements: Capital Disclosures require extensive disclosures about the significance of financial instruments for an entity's financial position and performance, and qualitative and quantitative disclosures on the nature and extent of risks. IFRS 7 and amended IAS 1, which become mandatory for the Group's 2007 financial statements, will require extensive additional disclosures with respect to Group's financial instruments and share capital.

IFRS 8 Operating Segments sets out requirements for disclosure of information about an entity's operating segments and also about the entity's products and services, the geographical areas in which it operates, and its major customers. If adopted by the EU, IFRS 8, which becomes mandatory for the Group's 2009 financial statements, is not expected to have any impact on the consolidated financial statements.

IFRIC 7 Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies addresses the application of IAS 29 when an economy first becomes hyperinflationary and in particular the accounting for deferred tax. IFRIC 7, which becomes mandatory for the Group's 2007 financial statements, is not expected to have any impact on the consolidated financial statements.

IFRIC 8 Scope of IFRS 2 Share-based Payment addresses the accounting for share-based payment transactions in which some or all of goods or services received cannot be specifically identified. IFRIC 8 will become mandatory for the Group's 2007 financial statements, with retrospective application required. The Group has not yet determined the potential effect of the interpretation.

IFRIC 9 Reassessment of Embedded Derivatives requires that a reassessment of whether embedded derivative should be separated from the underlying host contract should be made only when there are changes to the contract. IFRIC 9, which becomes mandatory for the Group's 2007 financial statements, is not expected to have any impact on the consolidated financial statements.

IFRIC 10 Interim Financial Reporting and Impairment prohibits the reversal of an impairment loss recognised in a previous interim period in respect of goodwill, an investment in an equity instrument or a financial asset carried at cost. IFRIC 10 will become mandatory for the Group's 2007 financial statements.

IFRIC 11 IFRS 2 Group and Treasury Share Transactions deals with how certain types of agreements on securities related payments shall be recognized in the financial statements of a company and its subsidiaries. If adopted by the EU, IFRIC 11 applies for accounting periods starting as of March 1, 2007.

IFRIC 12 Service Concession Arrangements. If adopted by the EU, IFRIC 12 will become mandatory for the Group's 2007 financial statements. IFRIC 12 is not expected to have any impact on the consolidated financial statements of the Group.

4. Determination of fair values

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. Fair values have been determined for measurement and / or disclosure purposes based on the following methods. Where applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

(i) *Operating assets*

The fair value of operating assets recognised as a result of a business combination is based on market values. The market value of aircrafts and properties is the estimated amount for which they could be exchanged on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion. The market value of items of equipment, fixtures and fittings is based on the quoted market prices for similar items.

(ii) *Intangible assets*

The fair value of intangible assets acquired in a business combination is based on the discounted estimated royalty payments that have been avoided as a result of the parent or trademark being owned. The fair value of other intangible assets is based on the discounted cash flows expected to be derived from the use and eventual sale of the assets.

(iii) *Inventory*

The fair value of inventory acquired in a business combination is determined based on its estimated selling price in the ordinary course of business less the estimated costs of completion and sale, and a reasonable profit margin based on the effort required to complete and sell the inventory.

(iv) *Trade and other receivables*

The fair value of trade and other receivables is estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date.

(v) *Derivatives*

The fair value of forward exchange contracts and are based on their listed market price, if available. If a listed market price is not available, then fair value is estimated by discounting the difference between the contractual forward price and the current forward price for the residual maturity of the contract using a risk-free interest rate (based on government bonds).

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.

(vi) *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. In respect of the liability component of convertible notes, the market rate of interest is determined by reference to similar liabilities that do not have a conversion option.

Segment reporting

5. Segment information is presented in the consolidated financial statements in respect of the Group's business segments, which are the primary basis of segment reporting. The business segment reporting format reflects the Group's management and internal reporting structure and is divided into four segments, scheduled airline operations, global capacity solutions and aircraft trading, travel and tourism infrastructure and shared services.

Scheduled airlines operations

Four companies are categorized as being part of the Scheduled Airline Operation focus of the Group: Icelandair, the international full-service airline with a hub in Iceland; Icelandair Cargo, a full-service air-freight company; Icelandair Ground Services, which handles airlines and passenger services at Keflavik Airport and Icelandair Technical Services, which provides maintenance for Icelandair and other airlines. These companies work closely together and have long historical ties.

Global capacity solutions and aircraft trading

The four companies forming this part of Icelandair Group hf. are Loftleiðir-Icelandic, a capacity provider for the international airline and tour operator industry, Bluebird Cargo, a transportation services provider and Icelease, which handles the buying, selling and leasing of aircraft using IG Invest as its holding company. The four companies are grouped together to emphasize Icelandair Group’s increased focus on international expansion in this field. Their role is to capitalize on internal know-how by offering aircraft operation services to third parties and taking advantage of trading opportunities in a fast-growing world market, as well as looking for opportunities for mergers and acquisitions.

Travel and tourism infrastructure

Three companies; Iceland Travel, a tour operator and travel agency in in-coming tourism, Icelandair Hotels, which markets and operates two hotel chains, Icelandair Hotels and Edda Hotels, and Air Iceland a scheduled domestic carrier which also offers regular flights to Greenland and the Faeroe Islands form the travel and tourism part of the Group. These companies all provide strategic support to the international scheduled operations, their main focus is on profitable operations.

Shared services

This segment comprises IceCap Guernsey and Icelandair Shared Services ehf. besides operations of the Parent Company. Icelandair Shared Services handles the accounting, reporting and salary processing for the companies within Icelandair Group. Icecap underwrites a part of Icelandair Group’s insurance risk.

Notes, cont.:

5. Contd.:

Business segments for the period from 1 October to 31 December 2006:

	Scheduled airline operations	Global capacity and aircraft trading	Travel and tourism infrastructure	Shared services	Eliminations	Consolidated
External revenue	11,806	3,033	1,481	148	(3,878)	12,590
Intersegment revenue	(2,512)			(2)	2,514	
Total segment revenue	9,294	3,033	1,481	146	(1,364)	12,590
Segment EBITDA	(216)	675	(45)	(76)		338
Segment results	(625)	589	(169)	(189)		(394)
Net finance cost	109	(113)	(74)	(354)		(432)
Share of profit of associates	0	67	2	0		69
Income tax	126	(52)	46	87		207
(Loss) profit for the period	(390)	491	(195)	(456)		(550)
Segment assets	33,997	19,965	5,232	48,539	(33,174)	74,559
Investments in associates	0	2,058	0	0		2,058
Total assets	33,997	22,023	5,232	48,539	(33,174)	76,617
Segment liabilities	27,750	19,682	4,202	21,882	(22,903)	50,613
Capital expenditure	3,698	915	1,130	(23)		5,720
Depreciation	380	70	120	3		573
Amortisation of intangible assets	57	90	8	4		159

Amounts are in ISK million

Business Combination

6. On acquisition date in October 2006 Icelandair Group Holding hf. took over operations of Icelandair Group hf. and its subsidiaries listed in note 45. On 1 November 2006 the two companies legally merged with Icelandair Group hf. as the continuing company. The acquisition is accounted for using the purchase method in accordance with IFRS 3, where Icelandair Group hf. is the acquiree based on the balance sheet 1 October 2006.

   If the acquisitions had occurred on 1 January 2006, management estimates that consolidated revenue would have been ISK 56,143 million and consolidated profit for the year 2006 would have been ISK 2,615 million as stated in the pro forma figures in the consolidated income statement.

   The acquisitions, accounted for according to the purchase method, had the following effect on the Group's balance sheet:

	Pre-acquisition carrying amounts	Fair value adjustments	Recognised values on acquisition
Operating assets	22,684	(2,132)	20,552
Intangible assets	4,743	2,069	6,812
Investments in associates	1,744		1,744
Prepaid aircraft acquisitions	11,499		11,499
Long-term receivables and deposits	2,071		2,071
Inventories	1,156		1,156
Trade and other receivables	7,793		7,793
Cash and cash equivalents	4,976		4,976
Loans and borrowings	(27,855)		(27,855)
Deferred income tax liability	(988)	384	(604)
Trade and other payables	(11,658)		(11,658)
Deferred income	(4,009)		(4,009)
Net assets			12,477
Goodwill on acquisition			21,447
Total purchase consideration			33,924
Consideration satisfied by share issue at fair value			(13,400)
Consideration satisfied by cash payment			20,524

   The share issue equals 496 million shares at the price of ISK 27 per share.

   Included in the consideration satisfied by cash are acquisition related expenses, i.e. expert advisors fees and other fees amounting to ISK 424 million.

   Pre-acquisition carrying amounts were determined based on applicable IFRSs immediately before the acquisition. The values of assets, liabilities, and contingent liabilities recognised on acquisition are their estimated fair values (see note 4 for methods used in determining fair values).

   The goodwill recognised on the acquisition is attributable mainly to the location of Iceland in the North Atlantic between North America and Europe as the key to the Group´s network strategy and operations. Part of the goodwill is also attributable to the skills and technical talent of the acquired business’s work force.

   The purchase price allocation has not been completed.

Financial Statements of Icelandair Group hf. 2006 22 Amounts are in ISK million

Notes, contd.:

Operating income

	2006 1.10.-31.12.	Pro forma 2006 1.1.-31.12.
7. Transport revenue is specified as follows:		
Passengers	5,907	29,975
Cargo and mail	1,399	4,979
Total transport revenue	7,306	34,954
8. Other operating revenue is specified as follows:		
Sale at airports and hotels	559	2,127
Revenue from tourism	127	2,276
Other operating revenue	1,227	5,116
Gain on sale of operating assets	471	995
Total other operating revenue	2,384	10,514

Operating expenses

9. Salaries and other personnel expenses are specified as follows:		
Salaries	3,226	11,937
Salary-related expenses	751	2,746
Other personnel expenses	776	3,078
Total salaries and other personnel expenses	4,753	17,761
10. Other operating expenses are specified as follows:		
Operating cost of real estates and fixtures	317	1,468
Communication expenses	299	1,144
Advertising expenses	294	1,155
Booking fee and commission expenses	302	1,633
Customer services	278	1,133
Tourism expenses	45	1,545
Other operating expenses	301	2,294
Total other operating expenses	1,836	10,372

Auditors' fees

11. Fees to the Groups auditors is specified as follows:		
Audit of financial statements	14	29
Review of interim accounts	0	10
Other services	10	16
Total auditors' fees	24	55

The abovementioned figures include fees to the auditors of all companies within the Group. Fees to auditors, other than the auditors of the Parent Company amounted to ISK 10 million during the year 2006.

Financial Statements of Icelandair Group hf. 2006 23 Amounts are in ISK million

Depreciation and amortisation

12. The depreciation and amortisation charge in the income statement is specified as follows:

	2006 1.10.-31.12.	2006 1.1.-31.12.
Depreciation of operating assets, see note 17	573	2,177
Amortisation of intangible assets, see note 21	159	555
Depreciation and amortisation recognised in the income statement	732	2,732

Finance income and finance expense

13. Finance income and finance expense are specified as follows:

Interest income on bank deposits	369	688
Other interest income	78	398
Net foreign exchange gain	0	513
Finance income total	447	1,599
Interest expense on loans and borrowings	446	1,014
Other interest expenses	350	1,011
Net foreign exchange loss	83	0
Finance expense total	879	2,025
Net finance costs	(432)	(426)

Income tax expense

14. Income tax recognised in the income statement is specified as follows:

Deferred tax expense		
Origination and reversal of temporary differences	(207)	445
Total income tax (income) expense in income statement	(207)	445

15. Reconciliation of effective tax rate:

		2006 1.10.-31.12.		2006 1.1.-31.12.
(Loss) profit before tax		(757)		3,060
Income tax according to current tax rate	18.0%	(136)	18.0%	551
Tax exempt revenues	0.9%	(7)	(0.3%)	(9)
Non-deductible expenses	(0.4%)	3	0.2%	6
Deferred tax assets of subsidiaries	9.2%	(70)	(2.8%)	(87)
Other items	(0.4%)	3	(0.5%)	(16)
Effective tax	27.3%	(207)	14.5%	445

16. Income tax recognised directly in equity:

Derivatives	(35)
Convertible notes	20
Total income tax recognised directly in equity	(15)

Amounts are in ISK million

Operating assets

17. Operating assets are specified as follows:

Gross carrying amounts	Aircraft and flight equipment	Buildings	Other property and equipment	Total
Additions through business combinations	16,998	2,063	1,491	20,552
Additions during the period	3,023	363	363	3,749
Exchange rate difference	273	0	4	277
Sales and disposals during the period	(983)	0	(237)	(1,220)
Balance 31.12.2006	19,311	2,426	1,621	23,358
Depreciation				
Depreciation	438	29	106	573
Exchange rate difference	3	0	0	3
Sales and disposals during the period	(106)	0	(47)	(153)
Balance 31.12.2006	335	29	59	423
Carrying amounts				
1.10.2006	16,998	2,063	1,491	20,552
31.12.2006	18,976	2,397	1,562	22,935

Mortgages and commitments

18. The Group's operating assets are mortgaged to secure debt. The remaining balance of the debt amounted to ISK 26,034 million at the end of the year 2006.

Insurance value of aircraft and flight equipment

19. The insurance value and book value of aircraft and related equipment of the Company at year-end 2006 are specified as follows:

	Insurance value	Carrying amount
Boeing - 9 aircrafts	25,433	14,984
Other aircrafts	4,938	1,622
Flight equipment	3,582	2,370
Total aircraft and flight equipment	33,953	18,976

Amounts are in ISK million

Insurance value of other operating assets

20. The principal buildings owned by the Group at 31 December 2006 are the following:

	Official assessment value	Insurance value	Carrying amount
Maintenance hangar, Keflavík Airport	1,370	2,045	658
Freight building, Keflavík Airport	364	543	397
Office building, Reykjavík Airport	720	839	317
Service building, Keflavík Airport	355	561	263
Hangar 4 and other buildings, Reykjavík Airport	546	732	272
Other buildings	377	816	490
Buildings total	3,732	5,536	2,397

Official valuation of the Group's leased land for buildings at 31 December 2006 amounted to ISK 583 million and is not included in the Balance Sheet.

The insurance value of the Group's other operating assets and equipment amounted to ISK 2,991 million at the end of the year 2006. The carrying amount at the same time was ISK 1,562 million.

Intangible assets

21. Intangible assets are specified as follows:

Gross carrying amounts	Goodwill	Slots and trademarks	Customer relations	Other intangibles	Total
Additions through business combinations	21,447	4,637	1,137	1,037	28,258
Additions during the period	0	0	0	87	87
Exchange rate difference	(333)	(50)	11	32	(340)
Balance 31.12.2006	21,114	4,587	1,148	1,156	28,005
Amortisation					
Amortisation	0	0	31	128	159
Exchange rate difference	0	0	1	0	1
Balance 31.12.2006	0	0	32	128	160
Carrying amounts					
1.10.2006	21,447	4,637	1,137	1,037	28,258
31.12.2006	21,114	4,587	1,116	1,028	27,845

Amounts are in ISK million

Impairment test

22. Goodwill and other intangible assets that have indefinite live are tested for impairment at each reporting date. These assets were recognized at fair value when Icelandair Group Holding hf. acquired the Company in October 2006. Goodwill and other intangible assets with indefinite live are specified as follows:

Goodwill	21,117
Trademarks and slots	4,587
Total	25,704

These assets were tested for impairment by comparing their carrying amounts to their fair value less cost to sell. Trademarks are tested by using the royalty relief method. The main assumption consist of royalty rate 0.7 - 1.5% and the discount rate 14 -18% and revenue growth rate of 2.5 - 5.0%.

For the purpose of impairment testing on goodwill, goodwill is allocated to the Group´s segments which represents the lowest level within the Group at which the goodwill is monitored for internal management purposes. The aggregate carrying amount of goodwill allocated to each unit are as follows:

Scheduled airline operations	10,777
Global capacity and aircraft trading	6,841
Travel and tourism infrastructure	2,310
Shared services	1,189
Total goodwill	21,117

For the purpose of impairment testing on goodwill, fair value less cost to sell is determined by discounting the future cash flows generated from the continuing use of each unit and was based on the following key assumptions:

Cash flows were projected based on actual operating results and the 5-year business plan. Cash flows were extrapolated for determining the residual value using a constant growth rate which was consistent with the long-term average growth rate for the industry. Management believes that this forecast period was justified due to the long-term nature of the business. The anticipated annual revenue growth included in the cash flow projections was 5.0 - 10.0% for the years 2007 to 2011. A post-tax discount rate of 12.5 - 18.0% was applied in determining the recoverable amount of the units. The discount rate was estimated based on an industry average weighted average cost of capital, which was based on a possible range of debt leveraging of average 40 percent at a market interest rate of 7.5 - 9.5%.

The values assigned to the key assumptions represent management's assessment of future trends in the airline, transportation and the tourism industry and are based on both external sources and internal sources (historical data).

Financial Statements of Icelandair Group hf. 2006 27 Amounts are in ISK million

Investments in associates

23. Summary of aggregate financial information for the year 2006 for significant associates, not adjusted for the percentage ownership held by the Group:

	Share
Barkham Associates SA	49%
China Ice No 1 ehf.	40%
China Ice No 1 slf.	40%
China Ice No 2 ehf.	40%
China Ice No 2 slf.	40%
China Ice No 3 ehf.	40%
China Ice No 3 slf.	40%
China Ice No 4 ehf.	40%
China Ice No 4 slf.	40%
China Ice No 5 ehf.	40%
China Ice No 5 slf.	40%
China Ice No 6 ehf.	40%
China Ice No 6 slf.	40%
Icesing ehf.	49%
Siglo FIJ Ltd.	49%
Siglo FIR Ltd.	49%
Siglo FIU Ltd.	49%
Assets	29,774
Liabilities	25,261
Revenues	2,259
Expenses	1,909
Net profit	350
Proforma share of profit of associates	160

All of the associates are structured around ownership of aircrafts. None of them has quoted published price and all of them have the same accounting period as the Group.

Prepaid aircraft acquisitions

24. Prepaid aircraft acquisitions in the balance sheet is for the purchase of six Boeing 737-800 aircrafts which will be delivered to the Company in the year 2007. The intention is to lease or sell all of the aforementioned aircrafts. The Company also has agreements with Boeing regarding the purchase of four Boeing 787 Dreamliner aircrafts to be delivered in the year 2010. The Company has capitalised borrowing cost amounting to ISK 508 million related to these prepayments based on the interest rate on the directly related financing which was 6.6% at year-end. The Company also has an option to purchase three additional 787 Dreamliner aircrafts with delivery after the year 2012.

Financial Statements of Icelandair Group hf. 2006 28 Amounts are in ISK million

Long-term receivables

25. Long-term receivables and deposits are specified as follows:

Loans, effective interest rate 7.6%	1,012
Deposits	757
Other long-term receivables	943
	2,712
Current maturities of long-term receivables	(23)
Long-term receivables and deposits total	2,689

Long-term receivables contractual repayments are specified as follows:

Repayments in 2007	23
Repayments in 2008	23
Repayments in 2009	24
Repayments in 2010	25
Repayments in 2011	26
Subsequent	891
Total long-term receivables, including current maturities	1,012

Inventories

26. Inventories are specified as follows:

Spare parts	872
Other inventories	259
Inventories total	1,131

In 2006 the write-down of inventories to net realisable value amounted to ISK 21 million. The write-down is included in other operating expenses.

Trade and other receivables

27. Trade and other receivables are specified as follows:

Trade receivables	6,103
Derivatives	215
Current maturities of long term-receivables	23
Other receivables	902
Trade and other receivables total	7,243

At 31 December 2006 trade receivables are shown net of an allowance for doubtful debts of ISK 257 million arising from the likely bankruptcy of a significant customer.

Receivables denominated in currencies other than the functional currency comprise ISK 2,616 million of trade receivables.

Financial Statements of Icelandair Group hf. 2006 29 Amounts are in ISK million

Prepayments

28. Prepaid expenses which relates to subsequent periods amounted to ISK 271 million at year end. The prepayments consist mainly of insurance expenses and prepaid rental expenses.

Cash and cash equivalents

29. Cash and cash equivalents are specified as follows:

Bank deposits	2,757
Cash on hand	19
Cash and cash equivalents total	2,776

Equity

30. The Company's share capital amounts to ISK 1,000 million as decided in its Articles of Association. The holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share of one ISK.

On a shareholders meeting 29 December 2006 the Board of Directors received authority to purchase own shares of maximum 10% of the total nominal value of the ordinary shares for a 18 month period. Furthermore the meeting agreed upon authorisation to the Board of Directors to increase the share capital by 6% for issue against share option plan to employees. Early January 2007 the Board of Directors granted options to key employees amounting to ISK 60 millions with the exercise price 27.5.

Share premium

Share premium represents excess of payment above nominal value (ISK 1 per share) that shareholders have paid for shares sold by the Company. According to Icelandic Companies Act, 25% of the nominal value of share capital must be held in reserve which can not be paid out as dividend to shareholders.

Hedging reserve

The hedging reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that have not yet occurred.

Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations as well as from the translation of liabilities that hedge net investment in a foreign subsidiary.

Financial Statements of Icelandair Group hf. 2006 30 Amounts are in ISK million

Earnings per share

31. Basic earnings per share is calculated by dividing the net profit attributable to equity holders of the Parent by the weighted average outstanding number of shares during the period and shows the earnings per each share. The calculation of diluted earnings per share takes into consideration the issued convertible notes when calculating the share capital.

	2006
Basic earnings per share:	
Loss for the period attributable to equity holders of the parent	(544)
Average share capital	1,000
Earnings per share of ISK 1	(0.54)

Diluted earnings per share is equal to earnings per share as the conversion of convertible notes is not dilutive.

Loans and borrowings

32. Loans and borrowings are specified as follows:

Non-current borrowings from credit institutions	30,961
Convertible notes	1,860
Short-term loans from credit institutions	1,945
Total loans and borrowings	34,766
Current maturities and short-term loans	(4,614)
Loans to finance prepaid aircraft acquisition	(8,545)
Non-current loans and borrowings total	21,607

33. Non-current borrowings from credit institutions are specified as follows:

	Average interest rates	Total Remaining Balance
Debt in USD	6.1%	24,430
Debt in EUR	6.3%	2,623
Debt in GBP	8.6%	353
Debt in NOK	7.2%	167
Debt in JPY	3.7%	124
		27,697
Debt in ISK indexed	6.5%	781
Debt in ISK not indexed	17.5%	2,483
Total non-current borrowings		30,961

The Company is working on restructuring unfavourable loans in the amount of ISK 5,000 millions. The loan will be in different compositions of currencies and the restructuring will be finalized at the end of February.

Financial Statements of Icelandair Group hf. 2006 31 Amounts are in ISK million

34. Contractual repayments of non-current borrowings are specified as follows:

Financing of prepaid aircraft acquisition	8,545
Other repayments	2,669
Repayments in 2007	11,214
Repayments in 2008	3,526
Repayments in 2009	2,025
Repayments in 2010	7,211
Repayments in 2011	3,394
Subsequent repayments	3,591
Total non-current borrowings	30,961

Convertible notes

35. Convertible notes were issued in October 2006. They are specified as follows:

Proceeds from issue of convertible notes - nominal amount	2,000
Transaction cost	(39)
Net proceeds	1,961
Amount classified as equity	(110)
Expenced transaction cost	9
Carrying amount of liability at 31 December 2006	1,860

The nominal amount will be paid in a single amount in 2011. They are convertible at the option of the holder into ordinary shares over the 5 year period at the rate 29.7, 20% each year. The effective interest rate was 19.5% at year-end.

Deferred income tax liability

36. The deferred income tax liability is specified as follows:

Additions through business combination	604
Exchange rate difference	(22)
Income tax recognised in income statement	(207)
Income tax recognised in equity	(15)
Deferred income tax liability 31.12.	360

Financial Statements of Icelandair Group hf. 2006 Amounts are in ISK million

36. Contd.:

The deferred income tax liability is attributable to the following items:

	Assets	Liabilities	Net deferred income tax liability
Operating assets	427	0	427
Intangible assets	30	0	30
Derivatives	0	35	(35)
Convertible notes	20	0	20
Trade receivables	104	0	104
	581	35	546
Tax loss carry-forwards	0	265	(265)
Other items	79	0	79
Deferred income tax	660	300	360

	Additions through business combination	Recognised in income statement	Exchange rate difference	Recognised in equity	31 December
Operating assets	611	(162)	(22)		427
Intangible assets	33	(3)			30
Derivatives				(35)	(35)
Convertible notes				20	20
Trade receivables	16	88			104
Tax loss carry-forwards	4	(269)			(265)
Other items	(60)	139			79
	604	(207)	(22)	(15)	360

Trade and other payables

37. Trade and other payables are specified as follows:

Trade payables	5,009
Derivatives	409
Other payables	7,010
Total trade and other payables	12,428

Deferred income

38. Sold unused tickets and other prepayments are presented as deferred income in the balance sheet. These deferred revenues amounted to ISK 3,059 million at year end 2006.

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Financial instruments

39. Exposure to various risks arises in the normal course of the Group's business. Companies held by Icelandair Group hf. operate on international markets and therefore the Company is subject to risks of fluctuation in currency, interest rates and fuel prices.

Foreign currency risk

The Group seeks to reduce its foreign exchange exposure arising from transactions in various currencies through a policy of matching, as far as possible, receipts and payments in each individual currency. Nevertheless, the USD cash inflow falls short of dollar outflow by around USD 100 million due to fuel costs and capital related payments which are to a large extent denominated in USD. This shortage is financed by a surplus of European currencies, most importantly EUR but also ISK and SEK. The Group follows a hedging policy of 40-90%, 12 months in advance and uses a portfolio of instruments, mainly collar options, but also barrier options and forwards.

Interest rate risk

The largest share of outstanding loans are directly related to aircraft financing and denominated in USD. That is a consequence of the fact that the most liquid market for commercial aircraft denominates prices in USD. The Group follows a policy of hedging 40-70% of interest rate exposure of long-term financing, 3-5 years in advance. Currently, only the aircraft loans are hedged against interest rate fluctuations with swap contracts, where the 6 month floating rate is exchanged for fixed interest rates. Forward rate agreements and options have occasionally also been used to that end. The contracts amount up to USD 100 million and are currently considerably favourable, as the floating rate has been increasing in recent years. The average fixed interest rate is 3.59% compared to the 6 month floating rate, mid year 2006 of 5.11%

Fuel price risk

The jet fuel price has proved to be increasingly volatile in recent years. Not only has the price development been characterized by a steep upward trend, generated by excessive world demand, but also periodic cycles. Moreover, swap prices have for the past two years followed a positive curvature as opposed to the “backwardation”, which used to be the case. In 2006, the monthly average of jet fuel prices reached a record level of USD 735 per tonne in July with swaps trading at USD 850 per tonne, but in August oil prices fell by 20% reaching a low in November. Due to the volatility and expensive swaps, the Group exchanged the traditional instruments of swaps and collars for capped swaps and related types of options to acquire improved prices and reduce the downside risk. The Group follows a policy of 40-80% hedging ratio, 12-18 months in advance and has recently maintained its ratio closer to the lower boundaries to benefit from lower prices.

Liquidity risk

It is the Company's policy to keep the equivalent of 20-25% of the Group’s estimated annual fixed costs in the form of liquid assets.

39. Contd.:

Credit risk

Credit risk is linked to both investment of liquid assets, the management of those assets and agreements with financial institutions related to financial operations, e.g. hedging. The risk involved is directly related to the fulfilment of outstanding obligations of the Group's counterparties. The Group is aware of potential losses related to credit risk exposure and chooses its counterparties subject to business experience and satisfactory credit ratings. The Company is committed to only trade derivatives with trusted parties. The counterparty risk that arises from trading derivatives, used in risk management, is therefore minimised.

Financial instruments and fair values

40. The fair values of financial assets and liabilities is not significantly different than the carrying amounts shown in the balance sheet.

Off-balance sheet items

41. As a lessee the Company has in place operating leases for 24 aircrafts at the end of December 2006. The leases are for seventeen Boeing 757 aircrafts, three Boeing 767 aircrafts and four smaller aircrafts. The Company also has in place operating leases for storage facilities, accommodations, equipment and fixtures for its operations, the longest until the year 2015. At the end of the year 2006 the leases are payable as follows:

	Real estate	Aircrafts	Other	Total
In the year 2007	913	3,957	109	4,979
In the year 2008	890	3,711	108	4,709
In the year 2009	859	3,293	70	4,222
In the year 2010	797	2,803	0	3,600
In the year 2011	775	2,422	0	3,197
Subsequent	1,532	2,069	0	3,601
Total	5,766	18,255	287	24,308

Capital commitments

42. The Company has entered into contracts with Boeing with an obligation to purchase 6 Boeing 737-800 aircraft in the year 2007. The intention is to lease or sell all of the aforementioned aircrafts.

43. One of the Groups company, Icelandair Ground Services ehf., has paid ISK 60 million penalty to the Competition Authorities due to an alleged breach of the competition law. The case has been appealed and there is considerable chance that the amount will be returned in part or in full. The payment, which has not been charged to the Income Statement is entered among receivables in the Balance Sheet. The case is considered to be brought to court in 2008-2009.

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Related parties

Identity of related parties

44. The Group has a related party relationship with its subsidiaries, associates, and with its directors and executive officers.

Transaction with associates

During the year 2006 the Group purchased services from associates amounting to ISK 410 million, but the Group did not sell them any services. Transactions with associates are priced on an arm's length basis.

Transactions with management and key personnel

Salaries and benefits of management paid for their work for Group companies during the year 2006, stock option agreements and shares in the Company are specified as follows:

	Salaries and benefits	Shares held at year-end 2006
Board of Directors:		
Finnur Ingólfsson, Chairman of the Board	1.6	0
Ómar Benediktsson	1.2	56
Hermann S.Guðmundsson	0.6	0
Helgi S. Guðmundsson	0.6	0
Einar Sveinsson	0.8	0
Martha Eiríksdóttir	0.6	0
Jóhann Magnússon	0.6	0
CEO:		
Jón Karl Ólafsson, CEO of Icelandair Group hf.	29	19
Managing directors:		
Thirteen MD of subsidiaries and two within the parent	236	21

Included in the above mentioned list of shares held by management and directors are shares held by companies controlled by them and derivative agreements entered into regarding shares in the Company.

Group entities

45. The Company holds fourteen subsidiaries which are all included in the consolidated financial statements. They are:

	Share
Scheduled airline operations:	
Icelandair ehf.	100%
Icelandair Cargo ehf.	100%
Icelandair Technical Services ehf. (ITS)	100%
Icelandair Ground Services ehf. (IGS)	100%

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Notes, contd.:

45. Contd.:

Global capacity solutions and aircraft trading:	
Blue Cargo ehf.	100%
Bluebird Cargo ehf.	100%
IceLease ehf.	100%
IG Invest ehf.	100%
Loftleidir - Icelandic ehf.	100%
Travel and tourism infrastructure:	
Air Iceland ehf.	100%
Iceland Travel ehf.	100%
Icelandair Hotels ehf.	100%
Shared services:	
IceCap Ltd., Guernsey	100%
Icelandair Shared Services ehf.	100%

The subsidiaries own 20 subsidiaries that are also included in the consolidated financial statements.

Statement of cash flows

46. Other operating items in the statement of cash flows are specified as follows:

	2006 1.10.-31.12.
Gain on the sale of operating assets	(471)
Exchange rate difference and indexation of liabilities and assets	363
Share of profit of associates	(69)
Income tax expense	(207)
Total other operating items in the statement of cash flows	(384)

47. Net change in operating assets and liabilities in the statement of cash flows is specified as follows:

Inventories, decrease	26
Trade and other receivables, decrease	147
Trade and other payables, increase	954
Prepaid income, decrease	(950)
Net change in operating assets and liabilities in the statement of cash flows	177

48. Additional cash flow information:

Interests paid	599
Interests received	465
Income tax paid	0

Amounts are in ISK million

Ratios

49. The Group's primary ratios at year end 2006 are specified as follows:

Working capital ratio	0.40
Equity ratio	0.34
Intrinsic value of share capital	26.00