Icelandair Group hf.

Consolidated Financial Statements for the year 2007

ISK

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

Contents

Endorsement and Statement by the Board of Directors and the CEO

Operations in the year 2007

The financial statements comprise the consolidated financial statements of Icelandair Group hf. (the "Company") and its subsidiaries together referred to as the "Group".

On 18 September 2007 the Company signed a purchase agreement for the acquisition of the Czech airline Travel Service, the largest private airline in the Czech Republic. Travel Service operates charter flights to and from Prague and Budapest and also owns and operates the low cost airline Smart Wings. According to the agreement Icelandair Group hf. will purchase the shares in two stages, 50% of the shares in 2007 and 30-50% during 2008.

According to the income statement net profit for the year 2007 amounted to ISK 257 million. According to the balance sheet, equity at the end of the year amounted to ISK 25,033 million, including share capital in the amount of ISK 981 million. Reference is made to the notes to the consolidated financial statements regarding information on changes in equity.

The Board of Directors proposes that no dividend will be paid to shareholders in the year 2008.

Share capital and Articles of Association

The share capital amounted to ISK 1,000 million at the end of the year, from which the Company held own shares in the amount of ISK 19 million. The share capital is divided into shares of ISK 1, each with equal rights within a single class of shares listed on the Icelandic Stock Exchange (OMX Iceland). The Board of Directors has the right to increase the share capital until 12 September 2012 up to ISK 60 million in the purpose to satisfy share option agreements. The Company issued 5 year convertible notes in October 2006. The nominal amount, ISK 2,000 million, will be paid in a single amount in 2011. The notes are convertible at the option of the holder into ordinary shares over the 5 year period at the price ISK 29.7 per share, 20% each year. The Board of Directors has the right to issue new shares in relation to the convertible notes. The Company has the right to purchase up to 10% of the nominal value of the shares of the Company according to the Company's Act.

Share option agreements have been made with employees of the Group, which enables them to purchase shares in the Company at the exercise price of ISK 27.5 per share after a vesting period of 12 to 36 months. Further information on the share option agreements is disclosed in note 35.

The Company's Board of Directors comprises five members and three alternative members elected on the annual general meeting for a term of one year. Those persons willing to stand for election must give formal notice thereof to the Board of Directors at least five days before the annual general meeting. The Company's Articles of Association may only be amended at a legitimate shareholders' meeting, provided that amendments and their main aspects are clearly stated in the invitation to the meeting. A resolution will only be valid if it is approved by at least 2/3 of votes cast and is approved by shareholders controlling at least 2/3 of the share capital represented at the shareholders' meeting.

Shareholders at the end of the year 2007 were 1,271 but were 1,507 at the beginning of the year, a decrease of 236 during the year. Three shareholders held more than 10% of outstanding shares each at year end 2007. They are Langflug ehf. with 23.8% share, Fjárfestingarfélagið Máttur ehf. with 23.1% share and Naust ehf. with 14.8% share.

Further information on matters related to share capital is disclosed in note 28.

Statement by the Board of Directors and the CEO
The annual consolidated financial statements for the year ended 31 December 2007 have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional Icelandic disclosure requirements for consolidated financial statements of listed companies.

According to our best knowledge it is our opinion that the annual consolidated financial statements give a true and fair view of the consolidated financial performance of the Company for the financial year 2007, its assets, liabilities and consolidated financial position as at 31 December 2007 and its consolidated cash flows for the financial year 2007.

Further, in our opinion the consolidated financial statements and the endorsement of the Board of Directors and the CEO give a fair view of the development and performance of the Group's operations and its position and describes the principal risks and uncertainties faced by the Group.

The Board of Directors and the CEO have today discussed the annual consolidated financial statements of Icelandair Group hf. for the year 2007 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the consolidated financial statements will be approved at the annual general meeting of Icelandair Group hf.

Reykjavík, 21 February 2008

Board of Directors:

Gunnlaugur M. Sigmundsson, Chairman of the Board of Directors
Ómar Benediktsson
Ásgeir Baldurs
Einar Sveinsson
Finnur Reyr Stefánsson

CEO:

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, 2007, and the consolidated income statement, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, 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 effective at the beginning of the year 2006.

Management's Responsibility for the 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.

Auditors' 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 the auditors' 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, the auditor considers internal control relevant to the entity's preparation and fair presentation of the 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 principles 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 audit opinion.

Opinion

In our opinion, the consolidated financial statements give a true and fair view of the consolidated financial position of Icelandair Group hf. as at 31 December 2007, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by 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, 21 February 2008

KPMG hf.

Jón S. Helgason
Guðný H. Guðmundsdóttir

Consolidated Income Statement
for the year 2007

	Notes	2007	Pro forma 2006
Operating income:			
Transport revenue		35,949	34,954
Aircraft and aircrew lease		15,510	10,675
Other operating revenue		12,018	10,514
		63,477	56,143
Operating expenses:			
Salaries and other personnel expenses	7	20,008	17,761
Aircraft fuel		9,769	9,821
Aircraft and aircrew lease		7,353	4,489
Aircraft handling, landing and communication		4,367	4,038
Aircraft maintenance expenses		5,128	3,229
Other operating expenses		11,375	10,747
		58,000	50,085
Operating profit before depreciation and amortisation (EBITDA)		5,477	6,058
Depreciation and amortisation	9	(3,140)	(2,732)
Operating profit before net finance expense (EBIT)		2,337	3,326
Finance income		396	1,599
Finance expenses		(2,545)	(2,025)
Net finance expense	10	(2,149)	(426)
Share of (loss) profit of associates, net of income tax	20	(59)	160
Profit before income tax		129	3,060
Income tax	11,12	128	(445)
Profit for the year		257	2,615
Attributable to:			
Equity holders of the Company		251	2,621
Minority Interest		6	(6)
Profit for the year		257	2,615
Earnings per share:			
Basic earnings per share (ISK)	29	0.25	2.62
Diluted earnings per share (ISK)	29	0.25	2.62

The notes on pages 11 to 49 are an integral part of these consolidated financial statements.

Financial Statements of Icelandair Group hf. 2007 7 Amounts are in ISK million

Consolidated Balance Sheet
as at 31 December 2007

	Notes	2007	2006
Assets:			
Operating assets	14-17	22,832	22,935
Intangible assets	18-19	26,846	27,845
Investments in associates	20	2,335	2,058
Prepaid aircraft acquisitions	21	249	9,669
Long-term receivables and deposits	22	1,788	2,689
Total non-current assets		54,050	65,196
Inventories	23	1,301	1,131
Trade and other receivables	24	7,284	6,149
Receivables from sale of aircrafts	25	1,753	1,094
Prepayments	26	366	271
Cash and cash equivalents	27	2,006	2,776
Total current assets		12,710	11,421
Total assets		66,760	76,617
Equity:			
Share capital		981	1,000
Share premium		25,593	26,090
Reserves		(1,296)	(584)
Accumulated deficit		(293)	(544)
Total equity attributable to equity holders of the Company	28	24,985	25,962
Minority interest		48	42
Total equity		25,033	26,004
Liabilities:			
Loans and borrowings	30-33	14,040	21,607
Deferred income tax liability	34	134	360
Total non-current liabilities		14,174	21,967
Loans and borrowings	30	11,058	4,614
Loans to finance prepaid aircraft acquisition	30	0	8,545
Trade and other payables	36	12,591	12,428
Deferred income	37	3,904	3,059
Total current liabilities		27,553	28,646
Total liabilities		41,727	50,613
Total equity and liabilities		66,760	76,617

The notes on pages 11 to 49 are an integral part of these consolidated financial statements.

Amounts are in ISK million

Consolidated Statement of Changes in Equity
for the year ended 31 December 2007

	Notes	Share capital	Share premium	Share option reserve	Hedging reserve	Translation reserve	Accumulated deficit	Total	Minority Interest	Total equity
		Attributable to equity holders of the Company								
				Reserves						
1 October - 31 December 2006										
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 Q4 2006							(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	0	(159)	(425)	(544)	25,962	42	26,004
2007										
Equity 1.1.2007		1,000	26,090	0	(159)	(425)	(544)	25,962	42	26,004
Foreign currency translation differences for foreign operations						(1,019)		(1,019)		(1,019)
Net profit on hedge of net investment in foreign operation						4		4		4
Effective portion of changes in fair value of cash flow hedges, net of tax					135			135		135
Net income and expense recognised directly in equity					135	(1,015)		(880)		(880)
Profit for the year							251	251	6	257
Total recognised income (expense)					135	(1,015)	251	(629)	6	(623)
Purchase of own shares	28	(19)	(497)					(516)		(516)
Share based payments	35			168				168		168
Equity 31.12.2007		981	25,593	168	(24)	(1,440)	(293)	24,985	48	25,033

The notes on pages 11 to 49 are an integral part of these consolidated financial statements.

Amounts are in ISK million

Consolidated Statement of Cash Flows
for the year 2007

	Notes	2007	Pro forma 2006
Cash flows from operating activities:			
Profit for the year		257	2,615
Adjustments for:			
Depreciation and amortisation	9	3,140	2,732
Other operating items	45	(1,902)	(434)
Working capital from operations		1,495	4,913
Net change in operating assets and liabilities	46	2,394	1,455
Net cash from operating activities		3,889	6,368
Cash flows from investing activities:			
Acquisition of operating assets	14	(7,571)	(7,671)
Proceeds from the sale of operating assets		3,814	3,476
Acquisition of intangible assets	18	(455)	(232)
Acquisition of subsidiaries, net of cash acquired		0	(15,953)
Long-term receivables, increase		(1,249)	(660)
Net cash used in investing activities		(5,461)	(21,040)
Cash flows from financing activities:			
Repurchase of own shares	28	(516)	0
Proceeds from issue of share capital		0	13,600
Proceeds from long term borrowings		8,723	19,961
Repayment of long term borrowings		(7,611)	(18,186)
Proceeds from short term borrowings		257	1,945
Net cash from financing activities		853	17,320
(Decrease) increase in cash and cash equivalents		(719)	2,648
Effect of exchange rate fluctuations on cash held		(51)	128
Cash and cash equivalents at beginning of the year		2,776	0
Cash and cash equivalents at 31 December 2007	27	2,006	2,776

The notes on pages 11 to 49 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 year ended 31 December 2007 comprise the Company and its subsidiaries (together referred to as the "Group" and individually as "Group entities") and the Group´s interests in associates. The Group´s operations are in the airline transportation and tourism industry. The Company is listed on the Iceland Stock Exchange.

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. was 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.

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 consolidated income statement and consolidated 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 the EU.

The financial statements were approved by the Board of Directors on 21 February 2008.

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. The methods used to measure fair values are discussed further in note 4.

c. *Functional and presentation currency*

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

d. *Use of estimates and judgements*

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

2d. contd.:

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 consolidated income statement and consolidated 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 effective 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 in the amount of ISK 122 million and decrease in income tax expense amounting to ISK 22 million.

3. Significant accounting principles

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

Certain comparatives amounts have been reclassified to conform with the current year's presentation.

a. ***Basis of consolidation***

(i) *Subsidiaries*

Subsidiaries are entities controlled by the Group. Control exists when the Group 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. The accounting policies of subsidiaries have been changed when necessary to align them with the policies adopted by the Group.

(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 accounted for using the equity method and are initially recognised at cost. The Group´s investment includes goodwill identified on acquisition, net of any accumulated impairment losses. The consolidated financial statements include the Group's share of the total recognised gains and losses and equity movements 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 including any long-term investments is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has an obligations or made payments on behalf of the investee.

3a. contd.:

(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 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 currencies of Group entities at exchange rates at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. Foreign currency differences arising on retranslation are recognised in the income statement.

(ii) *Foreign operations and Icelandic subsidiaries with foreign functional currency*

The assets and liabilities of foreign operations and Icelandic subsidiaries with functional currency other than Icelandic krona, 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 exchange rates at the dates of the transactions. Foreign currency differences arising on retranslation 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 operations 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. Subsequent to initial recognition non-derivative financial instruments are measured as described below.

Cash and cash equivalents comprise cash balances and call deposits.

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

Other non-derivative financial instruments

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

3c. contd.:

(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 below.

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.

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.

3c. contd.:

(iv) *Share capital*

Ordinary shares

Ordinary shares are classified as equity. Incremental costs directly attributable to the issue of ordinary shares are recognised as a deduction from equity, net of any tax effects.

Repurchase of share capital

When share capital recognised as equity is repurchased, the amount of the consideration paid, which includes 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. When treasury shares are sold or reissued subsequently, the amount received is recognised as an increase in equity, and the resulting surplus or deficit on the transaction is transferred to / from share premium.

d. *Operating assets*

(i) *Recognition and measurement*

Items of operating assets 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. Cost also may include transfers from equity of any gain or loss on qualifying cash flow hedges of foreign currency purchases of operating assets. Purchased software that is integral to the functionality of the related equipment is capitalised as part of that equipment.

When parts of an item of operating assets have different useful lives, they are accounted for as separate items (major components) of operating assets.

Gains and losses on disposal of an item of operating assets are determined by comparing the proceeds from disposal with the carrying amount of operating assets and are recognised net within "other operating revenue" in the income statement.

(ii) *Aircrafts and flight equipment*

Aircrafts and flight equipment, e.g. aircraft engines and aircraft spare parts, are measured at cost less accumulated depreciation and accumulated 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.

(iii) *Subsequent costs*

The cost of replacing part of an item of operating assets 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. The carrying amount of the replaced part is derecognised. All other costs are recognised in the income statement as an expense as incurred.

3d. contd.:

(iv) *Depreciation*

Depreciation is recognised in profit or loss on a straight-line basis over the estimated useful lives of each item of operating assets. Leased assets are depreciated over the shorter of the lease term and their useful lives unless it is reasonably certain that the Group will obtain ownership by the end of the lease term. The estimated useful lives for the current and comparative periods 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

Depreciation methods, useful lives and residual values are reviewed 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 accumulated 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. *Leased assets*

All leases are operating leases and the leased assets are not recognised on the Group's balance sheet.

3. contd.:

h. ***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 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. Aircraft equipment is capitalised at the foreign exchange rate ruling at the date of acquisition.

i. ***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.

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.

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.

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 post-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 recognised if the carrying amount of an asset or its cash-generating unit exceeds its estimated recoverable amount. 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.

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.

3. contd.:

j. ***Employee benefits***

(i) *Share-based payment transactions*

The grant date fair value of options granted to employees is recognised as an employee expense, with a corresponding increase in equity, over the period in which the employees become unconditionally entitled to the options. The amount recognised as an expense is adjusted to reflect the actual number of share options that vest.

The fair value of employee stock options is measured using a binomial lattice model. Measurement inputs include share price on measurement date, exercise price of the instrument, expected volatility based on weighted average historic volatility adjusted for changes expected due to publicly available information, weighted average expected life of the instruments based on historical experience and general option holder behaviour, expected dividends, and the risk-free interest rate based on government bonds. Service and non-market performance conditions attached to the transactions are not taken into account in determining fair value.

In January 2007 the Company granted options for 60.3 million shares at the exercise price ISK 27.5 per share. The options vest in 12 to 36 months from the grant date.

k. ***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.

l. ***Deferred income***

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

m. ***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.

3m. 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.

n. *Lease payments*

(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.

o. *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 in profit or loss, using the effective interest method. Dividend income is recognised in profit or loss 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.

Foreign currency gains and losses are reported on a net basis.

p. *Income tax*

Income tax on the profit or loss for the year comprises only deferred tax. Income tax expense is recognised in profit or loss except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

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.

q. *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.

3. contd.:

r. ***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 business segments are determined based on the Group´s management and internal reporting structure. The major revenue-earning assets of the Group are 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.

Inter-segment pricing is determined on an arm's length basis.

Segment results, assets and liabilities include items directly attributable to a segment as well as those that can be allocated on a reasonable basis. Unallocated items comprise mainly investments and related revenue, loans and borrowings and related expenses, corporate assets and head office expenses, and income tax assets and liabilities.

s. ***New standards and interpretations effective in 2007***

IFRS 7 *Financial Instruments: Disclosures* and the Amendment to *IAS 1 Presentation of Financial Statements: Capital Disclosures* became mandatory for the Group’s 2007 financial statements. The adoption of IFRS 7 and the amendment to IAS 1 impacted the type and amount of disclosures made in these financial statements, but had no impact on the reported profits or financial position of the Group. In accordance with the transitional requirements of the standards, the Group has provided full comparative information.

IFRIC 7 – 10 became mandatory for the Group’s 2007 financial statements but their adoption had no impact on the Group’s 2007 financial statements.

t. ***New standards and interpretations not yet adopted***

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2007, and have not been applied in preparing these consolidated financial statements:

- *IFRS 8 Operating Segments* introduces the “management approach” to segment reporting. IFRS 8, which becomes mandatory for the Group’s 2009 financial statements, will require the disclosure of segment information based on the internal reports. The Group has not yet determined the potential effect of IFRS 8 on the consolidated financial statements.

- *IAS 1 Presentation of Financial Statements* (revised in 2007) replaces IAS 1 Presentation of Financial Statements (revised in 2003) as amended in 2005. IAS 1 (Revised 2007) sets the overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. The main change in revised IAS 1 is a requirement to present all non-owner changes in equity (changes in equity not resulting from transactions with owners in their capacity as owners) in one or two statements: either in a single statement of comprehensive income, or in an income statement plus in a statement of comprehensive income. Unlike under current IAS 1, it is not permitted to present components of comprehensive income in the statement of changes in equity. IAS 1 (revised in 2007), which becomes mandatory for the Group’s 2009 financial statements if endorsed by the EU, is expected to impact the presentation of the Group’s income statement and statement of changes in equity.

3t. contd.:

- Revised *IAS 23 Borrowing Costs* removes the option to expense borrowing costs and requires that an entity capitalise borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. If endorsed by the EU, the revised IAS 23 will become mandatory for the Group's 2009 financial statements and will have no effect on the Group's accounting policies.

- The amendments to *IFRS 2 Share Based Payment – Vesting Conditions and Cancellations* (January 2008) clarify the definition of vesting conditions and the accounting treatment of cancellations. If endorsed by the EU, the amendments become mandatory for the Group's 2009 financial statements, with retrospective application required. The amendments are not expected to have any effect on the consolidated financial statements of the Group.

- *IFRS 3 Business Combinations (revised in 2008) and amended IAS 27 Consolidated and Separate Financial Statements* introduce changes to the accounting for business combinations and for non-controlling (minority) interest. The most significant changes from IFRS 3 (2004) and IAS 27 (2003) are the following:
  - IFRS 3 (2008) applies also to business combinations involving only mutual entities and to business combinations achieved by contract alone;
  - The definition of a business combination has been revised to focus on control;
  - The definition of a business has been amended;
  - Transaction costs incurred by the acquirer in connection with the business combination do not form part of the business combination transaction;
  - Acquisitions of additional non-controlling equity interests after the business combination are accounted for as equity transactions;
  - Disposals of equity interests while retaining control are accounted for as equity transactions;
  - New disclosures are required.

- *IFRS 3 (revised in 2008)* and amended IAS 27 will become mandatory for the Group's 2010 Financial Statements, if endorsed by the EU. The carrying amounts of any assets and liabilities that arose under business combinations prior to the application of IFRS 3 (revised in 2008) are not adjusted while most of the amendments to IAS 27 must be applied retrospectively. The Group has not yet determined the potential effect of IFRS 3 (revised in 2008) and amended IAS 27 on the consolidated financial statements.

- *IFRIC 11 IFRS 2 – Group and Treasury Share Transactions* requires a share-based payment arrangement in which an entity receives goods or services as consideration for its own equity instruments to be accounted for as an equity-settled share-based payment transaction, regardless of how the equity instruments are obtained. IFRIC 11 will become mandatory for the Group's 2008 financial statements, with retrospective application required. IFRIC 11 is not expected to have any impact on the consolidated financial statements.

- *IFRIC 12 Service Concession Arrangements* provides guidance on certain recognition and measurement issues that arise in accounting for public to-private service concession arrangements. IFRIC 12, which becomes mandatory for the Group's 2008 financial statements if endorsed by the EU, will have no effect on the consolidated financial statements.

- *IFRIC 13 Customer Loyalty Programmes* addresses the accounting by entities that operate, or otherwise participate in, customer loyalty programmes for their customers. It relates to customer loyalty programmes under which the customer can redeem credits for awards such as free or discounted goods or services. IFRIC 13 becomes mandatory for the Group's 2009 financial statements if endorsed by the EU. The Group has not yet determined potential effect of IFRIC 13 on the consolidated financial statements.

3t. contd.:

- *IFRIC 14 IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* clarifies when refunds or reductions in future contributions in relation to defined benefit assets should be regarded as available and provides guidance on the impact of minimum funding requirements (MFR) on such assets. It also addresses when a MFR might give rise to a liability. IFRIC 14 will become mandatory for the Group's 2008 financial statements if endorsed by the EU, with retrospective application required. The Group has not yet determined the potential effect of the interpretation on the consolidated financial statements.

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. When 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 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) *Inventories*

The fair value of inventories 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 is 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.

4. contd.:

(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 airline operations

Three companies are categorised 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 and Icelandair Ground Services, which handles airlines and passenger services at Keflavik Airport. These companies work closely together and have long historical ties.

Global capacity solutions and aircraft trading

The five 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 service provider, Icelease, which handles the buying, selling and leasing of aircrafts using IG Invest as its holding company and Lerox a company holding 50% of the stake in Travel Services which was acquired in September 2007. These five companies are grouped together to emphasise Icelandair Group’s increased focus on international expansion in this field. Their role is to capitalise 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

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

5. Contd.:

Business segments

2007

	Scheduled airline operations	Global capacity and aircraft trading	Travel and tourism	Shared services	Eliminations	Consolidated
External revenue	38,579	15,646	9,144	108		63,477
Inter-segment revenue	12,940	24	152	643	(13,759)	
Total segment revenue	51,519	15,670	9,296	751	(13,759)	63,477
Segment EBITDA	2,739	2,165	1,108	(535)		5,477
Segment results	928	1,744	582	(917)		2,337
Net finance expense	(240)	(477)	(178)	(1,254)		(2,149)
Share of loss of associates	0	(59)	0	0		(59)
Income tax	(159)	(282)	(74)	643		128
Profit (loss) for the year	529	926	330	(1,528)		257
Segment assets	28,084	11,696	5,093	45,024	(25,472)	64,425
Investments in associates	3	2,253	76	3		2,335
Total assets	28,087	13,949	5,169	45,027	(25,472)	66,760
Segment liabilities	22,549	10,703	4,163	19,195	(14,883)	41,727
Capital expenditure	3,675	3,757	559	35		8,026
Depreciation	1,670	408	504	5		2,587
Amortisation of intangible assets	238	269	34	12		553

Amounts are in ISK million

5. Contd.:

Business segments
Pro forma 2006

	Scheduled airline operations	Global capacity and aircraft trading	Travel and tourism	Shared services	Eliminations	Consolidated
External revenue	36,759	10,658	8,626	100		56,143
Inter-segment revenue	14,337	46	130	514	(15,027)	0
Total segment revenue	51,096	10,704	8,756	614	(15,027)	56,143
Segment EBITDA	3,482	1,590	1,085	(99)		6,058
Segment results	1,948	1,296	636	(554)		3,326
Net finance expense	468	(205)	(319)	(370)		(426)
Share of profit of associates	0	160	0	0		160
Income tax	(410)	(158)	(56)	179		(445)
Profit (loss) for the year	2,006	1,093	261	(745)		2,615
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	2,029	4,805	1,048	21		7,903
Depreciation	1,471	268	433	5		2,177
Amortisation of intangible assets	206	317	25	7		555

Financial Statements of Icelandair Group hf. 2007 25 Amounts are in ISK million

Business combination

6. On 18 September 2007 the Company signed a purchase agreement for the acquisition of the Czech airline Travel Service, the largest private airline in the Czech Republic. Travel Service operates charter flights to and from Prague and Budapest and also owns and operates the low cost airline Smart Wings. According to the agreement Icelandair Group hf. will purchase the shares in two stages, 50% of the shares in 2007 and 50% during 2008. According to the purchase agreement the sellers have option to buy 20% of the shares at the completion date in 2008. The sellers have to give notice to the buyer on or before 31 May 2008 if they are going to buy back the 20% share.

   The 50% share in Travel Service acquired in 2007 was acquired through the holding company, Lerox CZ s.r.o. which was 100% owned by Icelandair Group hf. at year-end 2007. The 50% share of Travel Service is accounted for using the equity method within Lerox CZ s.r.o. for the two last months of the year. The acquisition date of Lerox CZ s.r.o. was determined as 1 November 2008. Travel Service is not consolidated with Lerox CZ s.r.o. in the year 2007 since control was not in place at year-end 2007. The acquisition price for Lerox CZ s.r.o. amounted to ISK 960 million including transaction cost of ISK 104 million.

   Business combination in 2006

   During 2007 the purchase price allocation for 2006 business combination was finalised. Some minor adjustments were made to the provisional purchase price allocation in 2006.

Operating expenses

7. Salaries and other personnel expenses are specified as follows:

	2007	Pro forma 2006
Salaries	13,552	11,937
Equity-settled share based payment transactions	168	0
Salary-related expenses	3,045	2,746
Other personnel expenses	3,243	3,078
Total salaries and other personnel expenses	20,008	17,761

Auditors' fees

8. Fees to the Group's auditors is specified as follows:

Audit of financial statements	30	29
Review of interim accounts	8	10
Other services	16	16
Total auditors' fees	54	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 5 million during the year 2007.

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Depreciation and amortisation

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

	2007	Pro forma 2006
Depreciation of operating assets, see note 14	2,587	2,177
Amortisation of intangible assets, see note 18	553	555
Depreciation and amortisation recognised in the income statement	3,140	2,732

Finance income and finance expenses

10. Finance income and finance expenses are specified as follows:

	2007	Pro forma 2006
Interest income on bank deposits	194	688
Other interest income	145	398
Net foreign exchange gain	57	513
Finance income total	396	1,599
Interest expense on loans and borrowings	2,413	1,014
Other interest expenses	132	1,011
Finance expenses total	2,545	2,025
Net finance expense	(2,149)	(426)

Income tax

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

	2007	Pro forma 2006
Deferred tax expense		
Origination and reversal of temporary differences	(128)	445
Total income tax in income statement	(128)	445

12. Reconciliation of effective tax rate:

		2007		Pro forma 2006
Profit before tax		129		3,060
Income tax according to current tax rate	18.0%	23	18.0%	551
Tax exempt revenues	(38.8%)	(50)	(0.3%)	(9)
Non-deductible expenses	36.4%	47	0.2%	6
Foreign currency subsidiaries	(117.1%)	(151)	(2.8%)	(87)
Other items	2.3%	3	(0.5%)	(16)
Effective tax rate	(99.1%)	(128)	14.5%	445

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13. Income tax recognised directly in equity:

	2007	2006
Derivatives	30	(35)
Convertible notes	0	20
Total income tax recognised directly in equity	30	(15)

Operating assets

14. Operating assets are specified as follows:

Gross carrying amounts	Aircrafts 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
Sales and disposals during the period	(983)	0	(237)	(1,220)
Exchange rate difference	273	0	4	277
Balance at 31 December 2006	19,311	2,426	1,621	23,358
Sales and disposals during the year	(3,583)	(8)	(38)	(3,629)
Additions during the year	6,229	590	752	7,571
Exchange rate difference	(1,600)		(28)	(1,628)
Balance at 31 December 2007	20,357	3,008	2,307	25,672
Depreciation and impairment losses				
Depreciation	438	29	106	573
Sales and disposals during the period	(106)	0	(47)	(153)
Exchange rate difference	3	0	0	3
Balance at 31 December 2006	335	29	59	423
Depreciation for the year	2,083	121	383	2,587
Sales and disposals during the year	(202)	(5)	(32)	(239)
Exchange rate difference	79	0	(10)	69
Balance at 31 December 2007	2,295	145	400	2,417
Carrying amounts				
At 1 October 2006	16,998	2,063	1,491	20,552
At 31 December 2006	18,976	2,397	1,562	22,935
At 31 December 2007	18,062	2,863	1,907	22,832

Mortgages and commitments

15. The Group's operating assets are mortgaged to secure debt. The remaining balance of the debt amounted to ISK 14,776 million at the end of the year 2007 (2006: ISK 26,034 million).

Financial Statements of Icelandair Group hf. 2007 28 Amounts are in ISK million

Insurance value of aircrafts and flight equipment

16. The insurance value and book value of aircrafts and related equipment of the Company at year-end 2007 are specified as follows:

	Insurance value	Carrying amount
Boeing - 8 aircrafts	21,040	10,922
Other aircrafts	4,333	1,459
Flight equipment	3,453	5,681
Total aircrafts and flight equipment	28,826	18,062

Insurance value of other operating assets

17. The principal buildings owned by the Group at 31 December 2007 are the following:

	Official assessment value	Insurance value	Carrying amount
Maintenance hangar, Keflavík Airport	1,514	2,175	733
Freight building, Keflavík Airport	406	577	380
Office building, Reykjavík Airport	863	883	304
Service building, Keflavík Airport	390	578	246
Hangar 4 and other buildings, Reykjavík Airport	653	765	258
Buildings in Latvia	513	420	461
Other buildings	400	803	481
Buildings total	4,739	6,201	2,863

Official valuation of the Group's leased land for buildings at 31 December 2007 amounted to ISK 663 million and is not included in the Balance Sheet.

The insurance value of the Group's other operating assets and equipment amounted to ISK 3,216 million at the end of the year 2007. The carrying amount at the same time was ISK 1,907 million.

Intangible assets

18. Intangible assets are specified as follows:

Gross carrying amounts	Goodwill	Trademarks and slots	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 at 31 December 2006	21,114	4,587	1,148	1,156	28,005
Adjustments to provisional purchase price allocation	(351)	461	0	(110)	0
Additions during the year	37	0	0	418	455
Exchange rate difference	(657)	(128)	(65)	(52)	(902)
Balance at 31 December 2007	20,143	4,920	1,083	1,412	27,558

Financial Statements of Icelandair Group hf. 2007 29 Amounts are in ISK million

18. contd.:

Amortisation and impairment losses

Amortisation	0	0	31	128	159
Exchange rate difference	0	0	1	0	1
Balance at 31 December 2006	0	0	32	128	160
Amortisation for the year	0	0	122	431	553
Exchange rate difference	0	0	(1)	0	(1)
Balance at 31 December 2007	0	0	153	559	712

Carrying amounts

At 1 October 2006	21,447	4,637	1,137	1,037	28,258
At 31 December 2006	21,114	4,587	1,116	1,028	27,845
At 31 December 2007	20,143	4,920	930	853	26,846

Impairment test

19. Goodwill and other intangible assets that have indefinite live are tested for impairment at each reporting date. These assets were recognised 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	20,143
Trademarks and slots	4,920
Total	25,063

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 13.5 -15.2%.

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	10,625
Global capacity and aircraft trading	5,723
Travel and tourism infrastructure	2,801
Shared services	994
Total goodwill	20,143

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:

Financial Statements of Icelandair Group hf. 2007 30 Amounts are in ISK million

19. Contd.:

Cash flows were projected based on actual operating results and a 4-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 3.5 - 16.0% for the years 2008 to 2011. A post-tax discount rate of 11.5 - 13.2% 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 31-57% percent at a market interest rate of 7.5 - 9.4%.

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).

Equity accounted investees

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

	Ownership 2007	Ownership 2006
Barkham Associates SA	49%	49%
China Ice No 1 ehf.	40%	40%
China Ice No 1 slf.	40%	40%
China Ice No 2 ehf.	40%	40%
China Ice No 2 slf.	40%	40%
China Ice No 3 ehf.	40%	40%
China Ice No 4 ehf.	40%	40%
China Ice No 5 ehf.	40%	40%
China Ice No 5 slf.	40%	40%
China Ice No 6 ehf.	40%	40%
China Ice No 6 slf.	40%	40%
Icesing ehf.	49%	49%
Siglo FIJ Ltd.	49%	49%
Siglo FIR Ltd.	49%	49%
Siglo FIU Ltd.	49%	49%
Travel Service CZ s.r.o.	50%	-
Assets	21,808	29,774
Liabilities	18,319	25,261
Revenues	4,970	2,259
Expenses	5,016	1,909
Net (loss) profit	(46)	350
Share of (loss) profit of associates	(59)	160

During the year the Group acquired a 50% share in the Czech airline Travel Service. Icelandair Group hf. will purchase additional 30-50% share during 2008. All other associates are structured around ownership of aircrafts.

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Prepaid aircraft acquisitions

21. Prepaid aircraft acquisitions in the balance sheet is for the purchase of four Boeing 787 Dreamliner aircrafts to be delivered in the year 2010 and 2012. The Company has capitalised borrowing cost amounting to ISK 30 million related to these prepayments based on the average interest rate which was 6.3% at year-end. The Company also has an option to purchase three additional 787 Dreamliner aircrafts with delivery after the year 2012.

Long-term receivables and deposits

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

	2007	2006
Loans, effective interest rate 7.6% / 7.6%	775	1,012
Deposits	653	757
Other long-term receivables	1,016	943
	2,444	2,712
Current maturities of long-term receivables	(656)	(23)
Long-term receivables and deposits total	1,788	2,689

Long-term receivables contractual repayments are specified as follows:

	2007	2006
Repayments in 2007	-	23
Repayments in 2008	656	23
Repayments in 2009	23	24
Repayments in 2010	21	25
Repayments in 2011	18	26
Repayments in 2012	11	27
Subsequent	46	864
Total loans, including current maturities	775	1,012

Inventories

23. Inventories are specified as follows:

	2007	2006
Spare parts	960	872
Other inventories	341	259
Inventories total	1,301	1,131

In 2007 the write-down of inventories to net realisable value amounted to ISK 35 million (2006: 34 million). The write-down is included in other operating expenses.

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Trade and other receivables

24. Trade and other receivables are specified as follows:

	2007	2006
Trade receivables	5,158	5,009
Derivatives	0	215
Current maturities of long term-receivables	656	23
Other receivables	1,470	902
Trade and other receivables total	7,284	6,149

At 31 December 2007 trade receivables are shown net of an allowance for doubtful debts of ISK 241 million (2006: ISK 262 million) arising from the likely bankruptcy of a significant customer.

Receivables denominated in currencies other than the functional currency comprise ISK 2,609 million (2006: ISK 2,616 million) of trade receivables.

Receivables from sale of aircrafts

25. At year end 2006 the Group had made prepayments on six Boeing 737-800 aircrafts to be delivered in 2007. During the first quarter of 2007 the Group sold all these aircrafts. The Group also sold three other aircrafts during the first quarter and one during fourth quarter, two of them on a sale and leaseback contracts for 5 and 6 years. Of these aircrafts two were purchased during the first quarter and one was bought during third quarter.

Total sale price amounted to ISK 11,850 million and capital gain on sale amounted to ISK 1,196 million. Receivables from sale of aircraft amount to ISK 1,753 million at 31 December 2007 and was paid in January 2008.

Prepayments

26. Prepaid expenses which relates to subsequent periods amounted to ISK 366 million (2006: ISK 271 million) at year end. The prepayments consist mainly of insurance expenses and prepaid rental expenses.

Cash and cash equivalents

27. Cash and cash equivalents are specified as follows:

	2007	2006
Bank deposits	1,989	2,757
Cash on hand	17	19
Cash and cash equivalents total	2,006	2,776

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Equity

28. 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 51 millions with the exercise price ISK 27.5 per share. The Company bought own shares at a nominal value of ISK 19 million during the year for ISK 516 million.

    Share capital and 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.

    Share option reserve

    The reserve includes the accrued part of the fair value of share options. This reserve is reversed if share options are forfeited and is transferred to share premium if share options are exercised.

    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.

Earnings per share

29. 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.

	2007	Pro forma 2006
Profit attributable to ordinary equity holders of the parent company:		
Profit for the year attributable to equity holders of the Parent	251	2,621
Weighted average number of ordinary shares *in million shares*		
Issued ordinary shares at beginning of year	1,000	1,000
Effect of bought own shares	(9)	0
Weighted average number of ordinary shares at 31 December	991	1,000

29. contd.

Weighted average number of ordinary shares (diluted) *in million shares*	2007	Pro forma 2006
Weighted average number of ordinary shares (basic)	991	1,000
Effect of share options	(1)	0
Weighted average number of ordinary shares (diluted) at 31 December	990	1,000
Earnings per share:		
Basic earnings per share (ISK)	0.25	2.62
Diluted earnings per share (ISK)	0.25	2.62

Loans and borrowings

30. This note provides information about the contractual terms of the Group´s interest-bearing loans and borrowings, which are measured at amortised cost. For more information about the Group´s exposure to interest rate, foreign currency and liquidity risk, see note 38.

	2007	2006
Non-current loans and borrowings are specified as follows:		
Secured bank loans	14,851	22,416
Convertible notes	1,889	1,860
Current maturities	(2,700)	(2,669)
Total non-current loans and borrowings	14,040	21,607
Current loans and borrowings are specified as follows:		
Current maturities of non-current liabilities	2,700	2,669
Short term notes	6,174	0
Short-term loans from credit institutions	2,184	1,945
Total current loans and borrowings	11,058	4,614
Loans to finance prepaid aircraft acquisition	0	8,545
Total loans and borrowings	25,098	34,766

31. Secured bank loans are specified as follows:

	Average interest rates	Total remaining balance 2007	Average interest rates	Total remaining balance 2006
Debt in USD	5.6%	12,230	6.1%	15,885
Debt in EUR	6.9%	1,629	6.3%	2,623
Debt in GBP	7.9%	19	8.6%	353
Debt in NOK		0	7.2%	167
Debt in JPY	2.2%	16	3.7%	124
		13,894		19,152
Debt in ISK indexed	6.5%	957	6.5%	781
Debt in ISK not indexed		0	17.5%	2,483
Total secured bank loans		14,851		22,416

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

	2007	2006
Repayments in 2007	-	15,019
Repayments in 2008	11,058	3,526
Repayments in 2009	1,202	2,025
Repayments in 2010	1,845	7,211
Repayments in 2011	1,754	3,394
Repayments in 2012	5,345	836
Subsequent repayments	3,894	2,755
Total non-current borrowings	25,098	34,766

Convertible notes

33. Convertible notes are specified as follows:

Proceeds from issue of convertible notes - nominal amount	2,000	2,000
Transaction cost	(39)	(39)
Net proceeds	1,961	1,961
Amount classified as equity	(110)	(110)
Expensed transaction cost	38	9
Carrying amount of liability	1,889	1,860

Convertible notes were issued in October 2006. The nominal amount in ISK 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 price ISK 29.7 per share, 20% each year. The effective interest was 17.5% at year-end.

Financial Statements of Icelandair Group hf. 2007 Amounts are in ISK million

Deferred income tax liability

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

	2007	2006
Deferred income tax liability 1.1.	360	0
Additions through business combination	0	604
Exchange rate difference	(128)	(22)
Income tax recognised in income statement	(128)	(207)
Income tax recognised in equity	30	(15)
Deferred income tax liability 31.12.	134	360

Deferred tax assets and liabilities is attributable to the following:

	Assets		Liabilities		Net	
	2007	2006	2007	2006	2007	2006
Operating assets	1,453	427	0	0	1,453	427
Intangible assets	91	30	0	0	91	30
Derivatives	0	0	5	35	(5)	(35)
Convertible notes	0	20	0	0	0	20
Trade receivables	34	104	0	0	34	104
	1,578	581	5	35	1,573	546
Tax loss carry-forwards	0	0	1,339	265	(1,339)	(265)
Other items	0	79	100	0	(100)	79
Deferred income tax	1,578	660	1,444	300	134	360

	1 January 2007	Recognised in income statement	Exchange rate difference	Recognised in equity	31 December 2007
Operating assets	427	1,154	(128)		1,453
Intangible assets	30	61			91
Derivatives	(35)	0		30	(5)
Convertible notes	20	(20)			0
Trade receivables	104	(70)			34
Tax loss carry-forwards	(265)	(1,074)			(1,339)
Other items	79	(179)			(100)
	360	(128)	(128)	30	134

Amounts are in ISK million

Share-based payments

35. The terms and conditions of grants are as follows:

Grant date / employees entitled	Number of instruments in thousands	Vesting conditions	Contractual life of option
Options granted 2007	60,340	12/24/36 months service	3 years
Total	60,340		

All options are to be settled by physical delivery of shares. Options vesting in 12 months can be exercised three times during the contractual life, at the end of each 12 month period. Accordingly 24 month options can be exercised two times and the 36 month options only once at the end of the 36 month period.

The number and weighted average exercise price of share options is as follows in thousands:

	Weighted average exercise price 2007	Number of options 2007
Granted during the year	27.5	60,340
Forfeited during the year	27.5	(9,070)
Outstanding at 31 December	27.5	51,270
Exercisable at 31 December		0

The fair value of services received in return for share options granted based on the fair value of share options granted, measuring using a Black-Scholes model, with the following inputs:

	Granted 2007
Fair value at grant date, average 12, 24, and 36 months options, average	5.85
Share price	27.5
Exercise price	27.5
Expected volatility (weighted average volatility)	29.0%
Option life (expected weighted average life)	2 years
Expected dividends per share	ISK 1
Risk-free interest rate (based on government bonds)	11.7%

Total recognised expenses for the year arising from share-based payment transactions amounted to ISK 168 million (2006: ISK 0 million) including forfeited options during the year and accrued social security expenses related to share-based payments.

Trade and other payables

36. Trade and other payables are specified as follows:

Trade payables	4,546	5,009
Derivatives used for hedging	143	409
Other payables	7,902	7,010
Total trade and other payables	12,591	12,428

Deferred income

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

Financial risk management

38. **Overview**

The Group has exposure to the following risks from its use of financial instruments:
- credit risk
- liquidity risk
- market risk

This note presents information about the Group's exposure to each of the above risks, the Group's objectives, policies, and processes for measuring and managing risk, and the Group's management of capital. Further quantitative disclosures are included throughout these consolidated financial statements.

The Board of Directors has overall responsibility for the establishment and oversight of the Group's risk management framework. The Board has established the Risk Management Commitee, which is responsible for developing and monitoring the Group's risk management policies. The committee reports regularly to the Board of Directors on its activities.

The Group's risk management policies are established to identify and analyse the risks faced by the Group, to set appropriate risk limits and controls, and to monitor risks and adherence to limits. Risk management policies and systems are reviewed regularly to reflect changes in market conditions and the Group's activities. The Group, through its training and management standards and procedures, aims to develop a disciplined and constructive control environment in which all employees understand their roles and obligations.

The Group Audit Committee oversees how management monitors compliance with the Group's risk management policies and procedures and reviews the adequacy of the risk management framework in relation to the risks faced by the Group. The Group Audit Committee is assisted in its oversight role by Internal Audit. Internal Audit undertakes both regular and ad hoc reviews of risk management controls and procedures, the results of which are reported to the Audit Committee.

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38. contd.

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, and arises principally from the Group's receivables from customers.

Trade and other receivables

The Group's exposure to credit risk is influenced mainly by the individual characteristics of each customer.

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 Group is committed to only trade derivatives with trusted parties. The counterparty risk that arises from trading derivatives, used in risk management, is therefore minimised.

The Group establishes an allowance for impairment that represents its estimate of incurred losses in respect of trade and other receivables and investments. The main components of this allowance are a specific loss component that relates to individually significant exposures, and a collective loss component established for groups of similar assets in respect of losses that have been incurred but not yet identified. The collective loss allowance is determined based on historical data of payment statistics for similar financial assets.

Guarantees

The Group's policy is to provide financial guarantees only to wholly-owned subsidiaries.

Exposure to credit risk

The carrying amount of financial assets represents the maximum credit exposure. The maximum exposure to credit risk at the reporting date was:

	Notes	2007	2006
Long-term receivables and deposits	22	1,788	2,689
Trade and other receivables	24	7,284	6,149
Receivables from sale of aircrafts	25	1,753	1,094
Cash and cash equivalents	27	2,006	2,776
		12,831	12,708

Impairment losses

The aging of trade receivables at the reporting date was:

	Gross 2007	Impairment 2007	Gross 2006	Impairment 2006
Not past due	4,643	0	4,333	0
Past due 0-30 days	266	0	484	0
Past due 31-120 days	40	(10)	61	(14)
More than one year	450	(231)	393	(248)
	5,399	(241)	5,271	(262)

Amounts are in ISK million

38. contd.

The movement in the allowance for impairment in respect of trade receivables during the year was as follows:

Balance at January	262	200
Impairment loss (reversed) recognised	(21)	62
Balance at 31 December	241	262

Based on historical default rates, the Group believes that no impairment allowance is necessary in respect of trade receivables not past due or past due by 30 days; a significant part of the balance relates to customers that have a good track record with the Group.

The allowance account in respect of trade receivables is used to record impairment losses unless the Group is satisfied that no recovery of the amount owing is possible; at that point the amount is considered irrecoverable and is written off against the financial asset directly.

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, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Group's reputation.

The Group policy is to divide liquid assets into two classes depending on duration and match them against the Group’s liquidity preferences laid out by the management on annual basis. Tier one includes the estimated minimum of accessible funds for operational liquidity. Tier two includes assets of longer duration for strategic liquidity, such as shorter term investments. The amounts in each class of assets are targeted once a year with reference to a number of economic indicators such as the estimated turnover, the annual amount of fixed costs and the interest rate levels. In addition to limit its risk, the Group maintains lines of credit amounting to ISK 250 million at year end.

The following are the contractual maturities of financial liabilities, including estimated interest payments and payments of off-balance sheet items.

2007	Carrying amount	Contractual cash flows	Within 12 months	1-2 years	2-5 years	After 5 years
Non-dervative financial liabilities						
Unsecured bond issue	8,358	(8,383)	(8,383)	0	0	0
Secured bank loans	14,851	(17,895)	(3,501)	(1,836)	(8,247)	(4,311)
Convertible notes	1,889	(3,411)	(304)	(336)	(2,771)	0
Trade and other payables	12,591	(12,591)	(12,591)			
Operating lease payments	0	(26,053)	(6,272)	(5,951)	(12,612)	(1,218)
Pre delivery payments	0	(12,712)	(2,943)	(3,156)	(6,613)	0
	37,689	(81,045)	(33,994)	(11,279)	(30,243)	(5,529)

Amounts are in ISK million

38. contd.:

2006	Carrying amount	Contractual cash flows	Within 12 months	1-2 years	2-5 years	After 5 years
Non-dervative financial liabilities						
Unsecured bond issue	1,945	(1,955)	(1,955)	0	0	0
Secured bank loans	30,961	(37,633)	(5,556)	(6,212)	(20,609)	(5,256)
Convertible notes	1,860	(3,435)	(350)	(294)	(2,791)	0
Trade and other payables ...	12,428	(12,428)	(12,428)			
Operating lease payments ..	0	(24,308)	(4,979)	(4,709)	(11,019)	(3,601)
Pre delivery payments	0	(14,486)	0	(3,354)	(11,132)	0
	47,194	(94,245)	(25,268)	(14,569)	(45,551)	(8,857)

Market risk

Market risk is the risk that changes in market prices, such as foreign exchange rates, interest rates and fuel price will affect the Group's operations. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimising the return.

The Group uses derivatives in order to manage market risks. All such transactions are carried out within the guidelines set by the Board of Directors. Generally the Group seeks to apply hedge accounting in order to manage volatility in profit or loss.

Currency risk

The Group is exposed to currency risk on sales, purchases and borrowings that are denominated in a currency other than the respective functional currencies of Group entities.

The Group seeks to reduce its foreign exchange exposure arising from transactions in various currencies through a policy of matching, receipts and payments in each individual currency. Then internal trades across the range of subsidiaries are arranged by the Group as far as possible. Nevertheless, the USD cash inflow falls short of USD outflow due to fuel costs, lease 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 and Scandinavian currencies. The Group follows a hedging policy of 40-80% of net exposure with a 12 month horizon and uses a portfolio of instruments, mainly forwards and collar options.

Exposure to currency risk

The Group's exposure to foreign currency risk was as follows based on notional amounts in major currencies:

2007	USD	EUR	DKK	SEK	NOK
Net balance sheet exposure	1,046	(2,404)	192	169	133
Estimated forecast revenue	16,210	6,450	1,830	1,857	1,769
Estimated forecast purchases	(23,991)	(4,296)	(1,195)	(277)	(326)
Forward FX contracts	2,969	(2,969)	0	0	0
Net currency exposure	(3,766)	(3,219)	827	1,749	1,576

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38. contd.:

2006

Net balance sheet exposure	2,876	(1,695)	211	197	(48)
Estimated forecast revenue	19,699	7,813	2,025	1,952	1,558
Estimated forecast purchases	(28,727)	(4,114)	(1,184)	(305)	(304)
Forward FX contracts	4,380	(4,380)	0	0	0
Net currency exposure	(1,772)	(2,376)	1,052	1,844	1,206

The following significant exchange rates applied during the year:

	Average rate		Reporting date spot rate	
	2007	2006	2007	2006
USD	64.21	70.02	62.62	71.36
EUR	87.85	89.00	92.20	93.79
DKK	11.76	11.76	12.36	12.57
SEK	9.47	9.48	9.74	10.37
NOK	10.94	10.90	11.57	11.38

Sensitivity analysis

A 10% strengthening of the ISK against the following currencies at 31 December would have increased (decreased) post-tax equity and profit or loss by the amounts shown below. This analysis assumes that all other variables, in particular interest rates, remain constant. This analysis is performed on the same basis for 2006.

	Equity	Profit or loss
2007		
USD	137	309
EUR	212	264
DKK	(68)	(68)
SEK	(143)	(143)
NOK	(129)	(129)
2006		
USD	(9)	145
EUR	179	195
DKK	(86)	(86)
SEK	(151)	(151)
NOK	(99)	(99)

A 10% weakening of the ISK against the above currencies would have had the equal but opposite effect on the above currencies to the amounts shown above, on the basis that all other variables remain constant.

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38. contd.:

Interest rate risk

The largest share of outstanding long term loans, carrying 3-6 months floating interest rates 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 40-80% of interest rate exposure. Swap contracts are mainly used to exchange floating rates for fixed up to 5 years ahead, which currently amounting to USD 107 million and carry on average 4% interest rates. In recent years the contracts have proved favourable as the floating rates have exceeded the fixed rates.

At the reporting date the interest rate profile of the Group´s interest bearing financial instruments was:

	Carrying amount	
	2007	2006
Fixed rate instruments		
Financial assets	1,525	1,769
Financial liabilities	(10,325)	(6,808)
	(8,800)	(5,039)
Variable rate instruments		
Financial liabilities	(14,773)	(26,013)

Fair value sensitivity analysis for fixed rate instruments

The Group does not account for any fixed rate financial assets and liabilities at fair value through profit or loss, and the Group does not designate derivatives (interest rate swaps) as hedging instruments under a fair value hedge accounting model. Therefore a change in interest rates at he reporting date would not affect profit or loss.

A change of 100 basis points in interest rates would have increased or decreased equity by 255 million (2006: 306 million).

Fair value sensitivity analysis for variable rate instruments

A change of 100 basis points in interest rates at the reporting date would have increased (decreased) equity and profit or loss by the amounts shown below. This analysis assumes that all other variables, in particular foreign currency rates, remain constant. The analysis is performed on the same basis for 2006.

	Equity	
	100 bp increase	100 bp decrease
2007		
Variable rate instruments	130	(125)
Total	130	(125)
2006		
Variable rate instruments	150	(156)
Total	150	(156)

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38. contd.:

Fuel price risk

The jet fuel price has a lot of influence on cost of operations. Price development for the past five years has been characterized by a steep upward trend, generated by excessive world demand and periodic cycles which have added to the price volatility. In 2007 the monthly average of jet fuel prices reached a record level of 920 USD/t in November, having continuously rallied from 550 USD/t in January. Since November prices have maintained their achieved levels. The Group maintains a policy of hedging fuel price exposure by a ratio of 40-80% by using swaps and options. The average hedge ratio in 2007 was roughly 55-60%. Although prices did exceed the budgeted levels considerably towards the end of the year, the realized total fuel costs were close to budget due to the seasonality of fuel consumption and hedging activities.

Capital management

The Board's policy is to maintain a strong capital base so as to sustain future development of the business.

The Board's target is that managers of the Group hold the Company's ordinary shares. The Board has entered into share option agreements with managers for that purpose. At year-end 2007 the managers of the Group hold ISK 21.5 million of the shares and have entered into share option agreements for ISK 34.6 million as disclosed in note 43.

The Board seeks to maintain a balance between the higher returns that might be possible with higher levels of borrowings and the advantages and security afforded by a sound capital position.

Financial instruments and fair values

39. The fair values of financial assets and liabilities, together with the carrying amounts shown in the balance sheet, are as follows:

	2007		2006	
	Carrying amount	Fair value	Carrying amount	Fair value
Loans and receivables	10,825	10,825	9,932	9,932
Cash and cash equivalents	2,006	2,006	2,776	2,776
Unsecured bond issue	(8,358)	(8,354)	0	0
Secured bond loans	(14,851)	(14,755)	(22,416)	(22,316)
Convertible notes	(1,889)	(1,946)	(1,860)	(1,860)
Trade and other payables	(12,591)	(12,591)	(12,428)	(12,428)
Total	(24,858)	(24,815)	(23,996)	(23,896)

The basis for determining fair values is disclosed in note 4.

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Off-balance sheet items

40. As a lessee the Company has in place operating leases for 30 aircrafts at the end of December 2007. The leases are for sixteen Boeing 757 aircrafts, four Boeing 767 aircrafts, three Boeing 737 and seven Airbus A730 aircrafts. The Company also has in place operating leases for storage facilities, accommodations, equipment and fixtures for its operations, the longest until the year 2014. At the end of the year 2007 the leases are payable as follows:

	Real estate	Aircrafts	Other	Total
In the year 2008	686	5,475	111	6,272
In the year 2009	643	5,199	109	5,951
In the year 2010	604	4,534	58	5,196
In the year 2011	589	3,712	0	4,301
In the year 2012	557	2,558	0	3,115
Subsequent	700	518	0	1,218
Total	3,779	21,996	278	26,053

Capital commitments

41. The Group has agreements with Boeing regarding the purchase of four Boeing 787 Dreamliner aircrafts two to be delivered in the year 2010 and two in 2012. The Group also has an option to purchase three additional 787 Dreamliner aircrafts with delivery after the year 2012.

42. During the first half of 2007 the Competition Authorities fined the subsidiary, Icelandair ehf., due to an alleged breach of the competition law. The penalty amounts to ISK 130 million after it was lowered by 30% after the decision was appealed. Icelandair Group hf. has decided to take this case to court and considers it more likely than not that the fine will be withdrawn in full. Nothing has been expensed in the income statement on this case.

The penalty on Icelandair Ground Services ehf. disclosed in the financial statement for 2006, amounting to ISK 60 million, will be taken to the Supreme Court this year. The Group still considers that this case will end up in favour of the Group but to be precautious the amount has been expensed in the income statement.

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Related parties

Identity of related parties

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

Transaction with associates

During the year 2007 the Group purchased services from associates amounting to ISK 375 million (2006: ISK 410 million), but the Group did not sell them any services. The Group has granted loans to its associates. The balance at year end amounted to ISK 952 million and is included in the item long-term receivables and deposits in the balance sheet. Interest income amounting to ISK 51 million is recognised in the income statement. 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 2007, share option agreements and shares in the Company are specified as follows:

	Salaries and benefits	Share options	Shares held at year-end 2007	Share held by related parties
Board of Directors:				
Gunnlaugur M. Sigmundsson, chairman of the board	3.4			392.1
Ómar Benediktsson	5.6			61.2
Ásgeir Baldurs	0.7			
Einar Sveinsson	2.8			392.1
Finnur Reyr Stefánsson	0.0			38.2
Jón Benediktsson, alternative board member	1.4		0.4	
Martha Eiríksdóttir, alternative board member	0.4		0.1	
Sigurður Atli Jónsson, alternative board member	0.0			
Finnur Ingólfsson, former board member	5.4			
Hermann S. Guðmundsson, former board member	2.7			
Helgi S. Guðmundsson, former board member	1.7			
Jóhann Magnússon, former board member	1.7			
CEO:				
Jón Karl Ólafsson, former CEO of Icelandair Group hf. ..	34.6		0.1	18.6

Post employee benefits related to former CEO amounted to ISK 60 million, is included in the income statement and will be paid in 2008.

Managing directors:				
Thirteen MD of subsidiaries and two within the Parent	290.7	35.6	2.6	18.9

Included in the above mentioned list of shares held by management and directors are shares held by companies controlled by them.

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Group entities

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

	Ownership interest 2007	2006
Scheduled airline operations:		
Icelandair ehf.	100%	100%
Icelandair Cargo ehf.	100%	100%
Icelandair Technical Services ehf. (ITS)	-	100%
Icelandair Ground Services ehf. (IGS)	100%	100%
Global capacity solutions and aircraft trading:		
Blue Cargo ehf.	-	100%
Bluebird Cargo ehf.	100%	100%
IceLease ehf.	100%	100%
IG Invest ehf.	100%	100%
Loftleiðir - Icelandic ehf.	100%	100%
Lerox CZ s.r.o.	100%	-
Travel and tourism:		
Air Iceland ehf.	100%	100%
Iceland Travel ehf.	100%	100%
Icelandair Hotels ehf.	100%	100%
Shared services:		
IceCap Ltd., Guernsey	100%	100%
Icelandair Shared Services ehf.	100%	100%

The subsidiaries own 18 subsidiaries that are also included in the consolidated financial statements.

In the beginning of the year, Icelandair Technical Services ehf. was merged with Icelandair ehf. and Blue Cargo ehf. was merged with Bluebird Cargo ehf.

Statement of cash flows

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

	2007	Pro forma 2006
Gain on the sale of operating assets	(1,793)	(995)
Exchange rate difference and indexation of liabilities and assets	(40)	276
Share of loss (profit) of associates	59	(160)
Income tax	(128)	445
Total other operating items in the statement of cash flows	(1,902)	(434)

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

Inventories, increase	(170)	(267)
Trade and other receivables, decrease (increase)	1,076	(900)
Trade and other payables, increase	643	2,126
Prepaid income, increase	845	496
Net change in operating assets and liabilities in the statement of cash flows	2,394	1,455

47. Additional cash flow information:

Interests paid	2,365	1,421
Interests received	352	1,011
Income tax paid	17	0

Ratios

48. The Group's primary ratios at year end 2007 are specified as follows:

Working capital ratio	0.46	0.40
Equity ratio	0.37	0.34
Intrinsic value of share capital	25.52	26.00

Amounts are in ISK million