# Icelandair Group Annual Report 2008

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TRAVEL
Service

Canaria
BOEING 737-800
OK-TVA

Gunnlaugur M. Sigmundsson, Chairman of the Board

The year 2008 was a difficult one for air carrier operations across the world; fuel prices soared, there was a significant reduction in tourism, and the year ended in financial collapse in many places around the world. A number of airlines went out of business, and others drastically reduced the scope of their operations. Icelandair Group was not immune to these difficult external conditions, and the year was closed with substantial losses. In discussing these losses, however, it should be borne in mind that a substantial part of them resulted from extensive impairment of intangible assets, in addition to an extraordinary expense which can be attributed directly to external conditions. Apart from these extraordinary losses, the operation itself may be said to have surpassed expectations in light of the circumstances.

The year saw a significant increase in the company's scope of activities and volume, as the Group's total turnover reached ISK 112.7 billion, increasing by 49.2 billion between years. EBITDAR also showed a substantial increase, at ISK 17.2 billion, as compared to ISK 11.1 billion in the preceding year. This is clear evidence of the success of the operations in the face of the difficult conditions. The success in the operations themselves can be attributed to the early awareness among the Company's management of the direction that the economy was taking.

Significant changes were undertaken during the year in the operation and organisation of the company designed to increase revenues while at the same time improving efficiency and trimming costs in all areas. The route network and flight frequency to Icelandair's destinations were reviewed in order to strengthen the foundations of the operation. New and elegant seats, interiors and entertainment systems were installed in Icelandair's aircraft on scheduled routes. A new "economy comfort" class was introduced, with the company now offering three different fare classes in its route network.

Icelandair Group is engaged in dynamic business operations outside Iceland, with Loftleidir offering charter and leasing services across the world. Travel Service is a strong company owned in majority by the Group, with headquarters in Prague in the Czech Republic. In the course of the year the name of our company in Riga, Latvia, was changed to SmartLynx; the company specialises in charter and ACMI operations for other airlines. Icelandair Cargo's business plan was subjected to comprehensive review, with extensive aircraft purchases cancelled and the operations reorganised from the ground up. Bluebird's operations were successful in the year, and the same can be said of Air Iceland, which, as before, provides sound and reliable air transport within Iceland and to and from Greenland.

Unfortunately, there are signs that it will take some time for the international economy to recover, but the companies within Icelandair Group are prepared for whatever may be in store. The measures that have already been taken to strengthen the operation of the Company have put it in better shape to take on increasing competition. The staff and management of the Company face the future with optimism.

During the first nine months of 2008, Icelandair Group's operations were successful and a good operating year was expected despite very high fuel prices and a projected fourth-quarter loss. The international financial crisis which had an enormous effect on Iceland in the beginning of October drastically altered the business environment and for that reason we regard the operating results of the year as relatively strong. EBITDA for the year amounted to ISK 4.8 billion but the loss over the year was ISK 7.5 billion. Of this figure, impairment of intangible assets amounted to just over ISK 6.4 billion, based on the prospect that individual companies in the Group are facing a more challenging business environment than before.

In the past few months we have worked with the Company's bank on improving the Company's debt maturity profile. The goal is to adapt the debt repayment process to the Group's long-term repayment schedule. We expect this work to be completed in the coming months.

Icelandair Group is an international group of 12 companies with operations around the world. The Company's income is generated from various service factors in numerous regions and currencies, although the greatest part of the turnover is in Euros, US dollars and the Icelandic and Czech krona. This diversity in income generation is a source of great strength in the current turbulence.

That does not change the fact that the foundations of the Company lie in the business idea of its pioneers, the idea to turn the geographical location of Iceland between Europe and North America into an opportunity. The Icelandair route network, which creates revenue from the home market, from the tourism market to Iceland and on the large international Trans-Atlantic market, is at the heart of the Group. We have used this local base to grow into an international aviation services and tourism group which operates in all corners of the world. In 2008 our revenue growth was 78% and we have also grown rapidly in the preceding years. The growth is organic in part but this year it is mostly due to the acquisition of Travel Service and its inclusion into the Group.

It is clear that 2009 will be a challenging operating year for Icelandair Group. A large drop in private consumption in Iceland is projected, in addition to a significant reduction in passenger transport and air freight on a global basis. The streamlining measures that have already been taken will benefit the Group, and efforts to find ways of cutting costs will continue. In our opinion, the present situation offers various opportunities for all of the companies within the Group, and our history and tradition shows that versatility and flexibility are key components of this company.

We are therefore convinced that our diversified operations, and in particular our outstanding workforce, will enable the Company to achieve satisfactory operating results in 2009.

Björgólfur Jóhannsson, President and CEO

ICELANDAIR

ICELANDAIR
TF-FIO
BOEING 757-200

# Year in Review

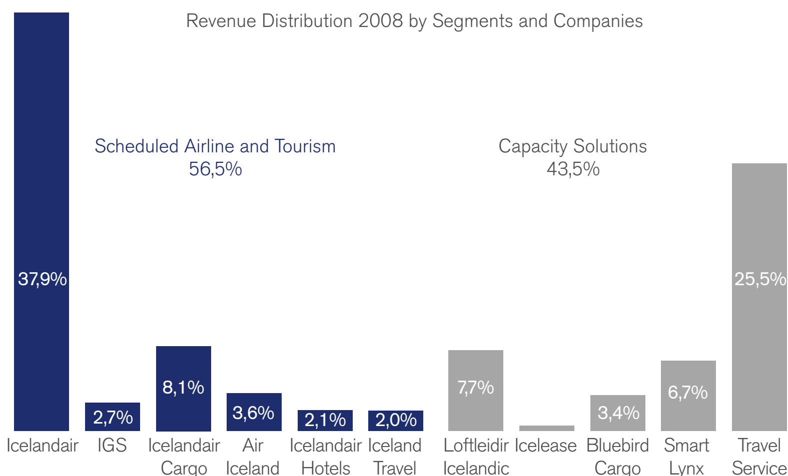
**Icelandair Group is a holding company with 12 subsidiaries focused on the airline and tourism sectors. The Group has two main business areas. The Scheduled Airline and Tourism, with the international airline Icelandair, Icelandair Ground Services (IGS), Icelandair Cargo, Iceland Travel, Air Iceland and Icelandair Hotels. Capacity Solutions offer broad worldwide aviation services with Loftleidir Icelandic, Travel Service, SmartLynx, Bluebird Cargo, and Icelease. The Group's financial services are handled by Fjarvakur.**

The year 2008 was an eventful year for Icelandair Group marked by the transformed world business environment.

In January, Björgólfur Jóhannsson, a former CEO of the seafood company Icelandic Group, took over as CEO of Icelandair and Icelandair Group. At the Annual General Meeting of Icelandair Group in March the Board of Directors of the Company was re-elected.

In April, Icelandair Group's subsidiaries Icelandair Cargo and Icelease decided not to go ahead with the lease and purchase of four Airbus A330-200 cargo aircraft. This decision was made because of a more volatile business environment.

In April, the Group raised its shareholding in Travel Service from 50 to 80%, the Czech company substantially increasing the Group's turnover.




In April, Icelandair also decided to strengthen the company's involvement in the holiday market. Subsequently, Helgi Eysteinsson was appointed as Managing Director of Iceland Travel, and Hörður Gunnarsson was appointed Chairman of the Board of Iceland Travel .

In May, Sigthor Einarsson was appointed deputy CEO of Icelandair Group and extensive changes were made in the organisation of Icelandair. Birkir Hólm Gudnason was appointed CEO of this largest company within the Group; Birkir has been with Icelandair since 2000. At the same time, Björgólfur Jóhannsson stepped down as CEO of Icelandair, to focus on his role as CEO of the Group.

At the same time Gunnar Már Sigurfinnsson, formerly SVP at Icelandair, was appointed Managing Director of Icelandair Cargo, replacing Pétur J. Eiríksson.

In June, Icelandair and its affiliated companies launched extensive streamlining measures in light of the rising fuel prices and general economic uncertainty. The 08/09 winter flight schedule was cut by almost 20%, and the staff was reduced by 230. The company's organisational chart was altered and management was trimmed.

Other companies within the Group also went through drastic cost cutting measures and staff reductions during the year, especially IGS and Icelandair Cargo.

In September, Bogi Nils Bogason was appointed Chief Financial Officer at Icelandair Group. Bogi had been CFO at the seafood company Icelandic Group in 2004-2006, and CFO at Askar Capital from the start of 2007.

In November, four new Loftleidir Icelandic aircraft leasing contracts were announced, amounting to a total of USD 125 million. The largest was with Yakutia Air Company in the Republic of Sakha in Siberia, Russia, a long standing customer.

In December, Icelandair Group entered into an agreement with its co-shareholders in Travel Service reducing Icelandair Group's share from 80% to 66%. This measure served to secure the financing of Travel Service and strengthen links with other shareholders.

**Icelandair Adapting to Changes**

Icelandair aims to be the preferred airline to and from Iceland and an attractive choice for North Atlantic travel, committed to providing safe and reliable air travel and unique services. Icelandair has built up an international route network with Iceland as a hub. Instead of viewing the country's isolation as an obstacle, the company has transformed its geographical location into a business opportunity.

Icelandair divides its marketing activities into three main categories: travel FROM Iceland, travel TO Iceland and travel VIA Iceland – that is to say flights between Europe and North America with a stopover in Iceland. By linking these three markets using the same aircraft and the same route network the company has succeeded in sustaining and strengthening this business over a long period of time.

What Icelandair's international expansion has accomplished for Icelanders, apart from an increase in the number of tourists and the business activities that have developed around the tourist industry throughout the country, is a system of outstanding flight services between Iceland and other countries. By linking the Icelandic "micromarket" with the international airline route network, Icelandair has been able to offer greater frequency, more destinations and better efficiency and services than would otherwise be possible.

The year 2008 was an eventful one, and extensive changes were made within the company to respond to the changes in the operating environment.

After several years of sharing a CEO with Icelandair Group, a new CEO was appointed for Icelandair, with Birkir Hólm Guðnason taking over the position in May. At the same time, changes were made in Icelandair's top management, and the new executive board is now composed of Helgi Már Björgvinsson, Andri Áss Grétarsson and Hlynur Elísson. Also, cuts were made in management and Icelandair's organisation was simplified.

Icelandair embarked on an extensive programme of measures designed to improve its operation in the year, both by reducing cost and increasing income, taking the necessary steps ahead of its competitors, who have subsequently undertaken similar measures. Among the largest tasks undertaken by the company, involving marketing, airline operations and technical services, was the renovation of the Boeing 757 fleet with new seats and entertainment system. This work was in progress throughout the year and transformed the appearance of the fleet. Concurrently, the company's image and services to passengers were renewed through the launch of a new Economy Comfort class and various other changes.

Extremely difficult measures were needed this summer as a result of the dire economic conditions and operating environment, particularly the high fuel costs. The great rises in jet fuel prices during the first half of the year put enormous strain on the operation. In July, extensive cutbacks were announced in the company's operation, with the flight schedule cut by 20% from the preceding year and various other measures taken in response to the fall in demand. The cutbacks meant that the number of jobs at Icelandair in 2008 had to be reduced by a total of 340 in one of the most extensive layoffs in the company's history.

The collapse of the banks and the Icelandic currency, the krona, in October was followed by a sudden and severe fall in demand in the Icelandic market. Icelandair's sales and marketing staff showed quick reflexes in rapidly changing the company's points of focus and increasing sales in markets outside Iceland, which to some extent offset the contraction in the domestic market. In all, the company flew 1.5 million passengers in 2008.

Icelandair's route network will be cut further in 2009 from its size in 2008, and the summer schedule will utilise 10 Boeing 757 aircraft, as compared to 11 in the preceding year. This reflects the fact that Icelandair is a participant in the international airline industry, where significant falls in demand are forecast in the next year and possibly in the years ahead.

### Challenging Business Environment

Other companies within the Group with close ties to Icelandair's network also faced a challenging business environment.

**Icelandair Cargo** offers freight services to all of Icelandair's destinations and also serviced eight additional destinations in 2008. Icelandair Cargo's operations are carried out either under their own flight numbers or through wet-lease contracts with other operators. The company had five B757 freight aircraft in operation in 2008, placing it at the forefront of the Icelandic market. As before, seafood accounted for the bulk of Icelandair Cargo's exports. In March, there were signs that imports were falling. A significant decrease was seen in the summer from the preceding year, with still further reductions as of October.

In April, it was announced that Icelandair Cargo and Icelease had abandoned plans for the purchase and lease of four A330-200 freight carriers. A letter of intent concerning the contract had been signed with Avion Aircraft Trading in May 2007. The goal of the Icelandair Group management was to reduce risk in the face of the prevailing economic uncertainty. Toward the autumn, steps were taken to significantly alter the flight schedule and reduce the number of flights in light of the conditions in Iceland and abroad. Extensive cost-cutting measures have been undertaken, with a third of the company's jobs cut over the year.

**Icelandair Ground Services** is an airline service company offering services for airlines and passengers passing through Keflavik International Airport. IGS offers aircraft handling, passenger check-in and baggage management at the airport as well as producing meals for airlines, and businesses and organisations in the vicinity of the airport. IGS also operates four different restaurants in the Leifur Eiríksson Air Terminal. Icelandair is IGS's largest customer by far and the reductions in the Icelandair network operations in 2008 has meant downsizing at IGS, resulting in lay-offs of over 100 employees. Other customers include Icelandair Cargo, SAS and LTU.

**Iceland Travel** specialises in services to incoming tourists, both groups and individuals. The company offers specialised tours, trips around Iceland and services to cruise liners. Iceland Travel is also a leading player in organising conferences, meetings incentive trips and special events. In June, Helgi Eysteinsson took over as Managing Director at Iceland Travel. Helgi had formerly worked at the Úrval Útsýn travel agency when that agency was owned by Icelandair's predecessor, Flugleidir.

This summer, Iceland Travel launched the VITA brand to sell a wide variety of leisure tours for Icelanders travelling abroad. VITA takes advantage of opportunities that arise through the company's partnership with Icelandair, thereby offering a secure and attractive option for Icelanders seeking services and assistance in their organised group and individual tours such as vacation tours, golf and ski trips and city breaks.

**Icelandair Hotels** owns and operates two chains of hotels in Iceland. Icelandair Hotels, which includes Hótel Loftleidir and the Hilton Reykjavik Nordica hotel in Reykjavík as well as six hotels in rural areas operated under a franchise agreement. Over the summer, the company operates the Edda hotel chain with over 1,500 rooms on offer at 13 locations around the country. In co-operation with Hilton, work has been in progress in 2008 on strengthening services to customers on business trips or attending meetings and conferences at the Hilton Hotel.

**Air Iceland** provides scheduled flights and charter flights in Iceland and in the North Atlantic. The company operates six Fokker 50 aircraft and two Dash-8 aircraft. In 2008, Air Iceland carried 422,000 passengers, including 22,000 passengers on international flights. There were four domestic destinations from Reykjavík, Akureyri, Egilsstaðir, Ísafjörð and the Vestmann Islands. The company's international destinations are in Greenland, Kulusuk, Constable Point, Narsassuaq and Nuuk. Flights were also offered to the Faeroe Islands.

During the course of the year, the operation of two Air Iceland Twin Otter aircraft was sold to Nordurflug in Akureyri. Air Iceland has leased out Fokker-50 aircraft temporarily for assignments with Air Baltic in Latvia and Skyways in Sweden, and will continue to seek leasing projects in response to the foreseeable domestic market slump in 2009. In 2009, Air Iceland will for the first time offer scheduled flights to Ilulissat on the west coast of Greenland in order to strengthen Iceland still further as a connection point for passengers en route between Greenland and Denmark.

### Offering Capacity Solutions

**Icelandair Group** offers a wide variety of aviation related solutions through several of its companies. With its array of products and services Icelandair Group has a global reach and is currently involved in different activities on all continents, through a network of individually managed small to medium sized aviation companies with a coordinated commercial strategy and financial control. These companies are Loftleidir Icelandic, Smartlynx (formerly Latcharter Airlines) Travel Service, Bluebird Cargo and Icelease. Great emphasis is put on utilizing the specific expertise within each company by giving the management of each subsidiary full control of day to day business in order to reap maximum benefits from local and industry knowledge.

In a year when the aircraft charter and leasing market felt the problems in the banking sector and an economic downturn, most of the Icelandair Group charter companies enjoyed relative success.

**Travel Service** is the largest private airline company in the Czech Republic and, at the same time, one of the most dynamically expanding charter carriers in Central Europe. Travel Service entered Icelandair Group in April 2008 and is 66% owned by Icelandair Group. The business model of Travel Service is designed to adapt to the changes in local demand by combining the Central European summer leisure market and countercyclical markets around the world.

During the summer months the primary focus of Travel Service is to provide charter flights in Central Europe, along with scheduled low cost flights under the Smart Wings brand. This operation is based in Prague, Warsaw, Katowice and Budapest. Because of the cyclical nature of the European holiday market, Travel Service re-deploys a part of the aircraft fleet for seasonal ACMI leases during the winter months. In 2008 aircraft were placed in Canada, Vietnam, Ukraine, Greece, Italy and Tajikistan.

The Travel Service fleet in 2008 comprised twelve modern Boeing 737 aircraft (10 x Boeing 737 – 800, 2x Boeing 737 – 500) and a new modern business jet Cessna 680 Citation Sovereign. In addition Travel Service leased in one Airbus A320 from SmartLynx and one B767-300ER from Loftleidir Icelandic. Travel Service Airline flies to more than 230 airports worldwide throughout the year. Travel Service is the official air carrier of the Czech national football team.

**Loftleidir Icelandic** charter business had nine aircraft in operation in 2008: two B767-300ER and seven B757-200. The key to Loftleidir Icelandic's strong performance has been the company's ability to respond promptly to market signals. Increased emphasis on developing and marketing Aircraft & Maintenance (AM) has paid off for Loftleidir Icelandic. Since the establishment of Loftleidir Icelandic, wet leasing has been among the main pillars of the operation; over the course of last year, however, AM projects overtook wet

leasing in scope. At year-end 2008, there were two aircraft on an AM contract with Yakutia Air Company in the Republic of Sakha in Russia, and a third aircraft undergoing a registration process. On the execution of the contract on the third aircraft, the contracts of the other two were extended to 2012 and 2014.

In April, Air Niugini in Papua New Guinea, leased one B767-300ER on AM lease for three years. Concurrently, there was one B757-200 under contract with the company, manned by Icelandic pilots. By year-end, the B757-200 had been transferred to an AM lease contract.

One B757-200 has been on AM lease to Gadair in Spain. This autumn, Santa Barbara Airlines (SBA) in Venezuela terminated its lease of one B767-300ER. This aircraft was then shifted to another project for Travel Service in the Czech Republic. One B757-200 remains with SBA. Loftleidir Icelandic's co-operation with SBA has now been ongoing for three successive years. Co-operation will continue with Abercrombie & Kent in the United States involving luxury trips on a VIP configured B757-200 aircraft. Loftleidir Icelandic had partners on most continents in 2008.

**Smartlynx** is a charter company based in Riga, Latvia. In 2008, Smartlynx had ten aircraft in operation: two B767-300ER and eight A320-200. Smartlynx offers three forms of service. The company operated air charter services for tour operators in the domestic market in Latvia, wet-lease projects in Europe and Africa and dry-lease projects, including maintenance, in Israel, Greece and France. The two Boeing aircraft were on wet lease at Virgin Nigeria, flying between London Gatwick in the UK and Lagos in Nigeria. The Airbus aircraft were engaged in services for Air Malta, Israir, Hellas Jet, Travel Service and XL in France as well as in Latvia. The economic downturn and less demand from clients caused Smartlynx difficulties during the year. A new name and appearance were unveiled in September when Latcharter became Smartlynx. One A320-200 was added to the company fleet and engaged by Travel Service in the Czech Republic. There was a change of the watch at the turn of the year when Gardar Forberg left his post as Managing Director, with Ómar Benediktsson appointed CEO of Smartlynx to replace him.

**Bluebird Cargo** is a cargo airline based in Iceland. The company's fleet consists of seven cargo aircraft, three B737-400F and two B737-300F. The third B737-400F cargo aircraft will be added to the fleet in February '09. Bluebird Cargo has focused primarily on wet leasing, with about 80% of the company's revenue generated through ACMI projects undertaken for the express delivery companies UPS and DHL. Other income derives from general freight operations to and from Iceland. A long term contract for two B737-400 aircraft was signed with China Postal and the first aircraft was delivered in November with the second one scheduled for delivery in February 2009.

**Icelease** is an arrangement company which ties together and utilizes the vast knowledge, experience and business contacts within Icelandair Group in the business of buying, selling and leasing of aircraft.

Market conditions in late 2007 and early 2008 were ideal for selling off assets as values had reached their peak. As a result most of the company's activities in 2008 were focused on the sale and long term lease of assets. These transactions included the future lease of the first B787 Dreamliner to Air Niugini as well as brokering a long term lease of two B737-400 freigher aircraft to China Postal, on behalf of Bluebird Cargo.

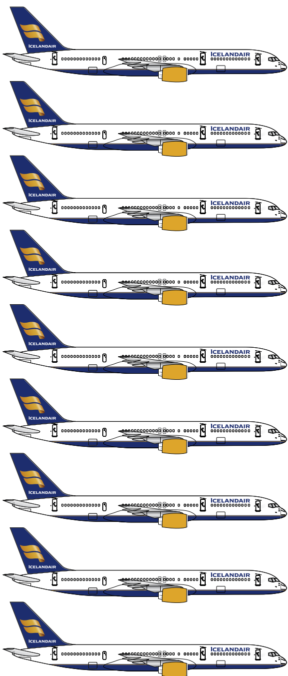
## Financial Services

**Fjarvakur,** Icelandair Shared Services is handling various financial services for Icelandair Group companies. Fjarvakur is also offering services to companies outside the Group. The company was established on the foundations of the finance division of Icelandair Group and its subsidiaries. Customers can choose between outsourcing their entire financial processes or specific components. Fjarvakur's services are divided into financial services, personnel services and ticketing services. Fjarvakur's subsidiary is Airline Services Estonia (ASE). ASE is based in Tallin, Estonia, and handles revenue accounting for Fjarvakur's airline customers.

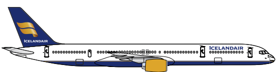
SMARTLYNX
36 F 18

# Icelandair Group Fleet

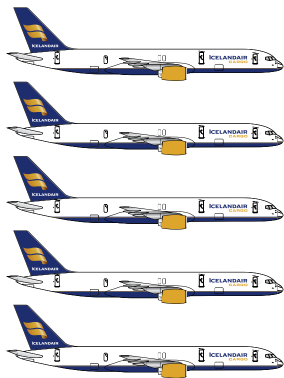
9 Boeing 757-200



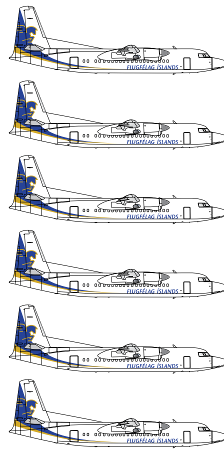
1 Boeing 757-300



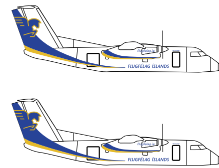
5 Boeing 757-200



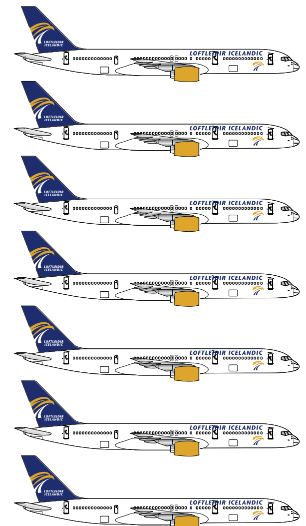
6 Fokker Friendship



2 Dash 8



7 Boeing 757-200



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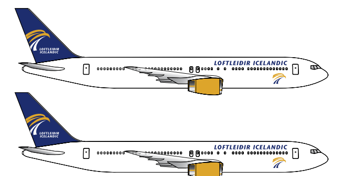
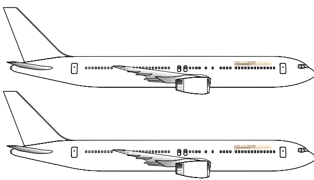
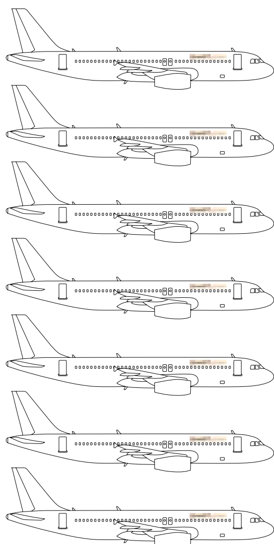


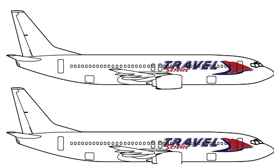
2 Boeing 767-300



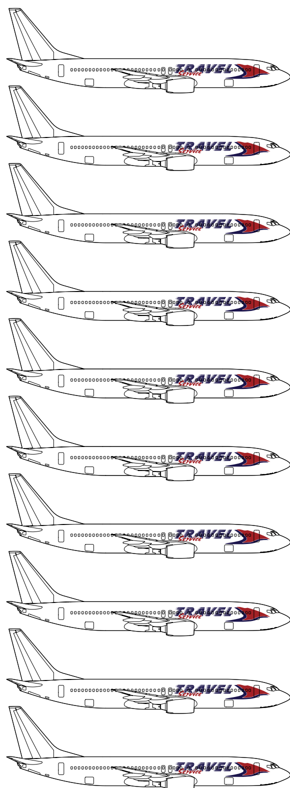
7 Airbus A320-200



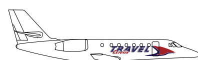
2 Boeing 737-500



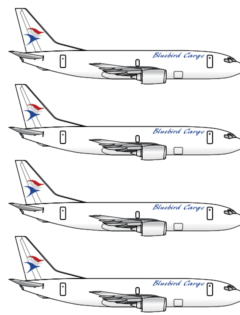
10 Boeing 737-800



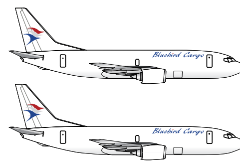
1 Sovereign



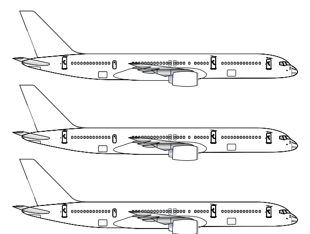
4 Boeing 737-300



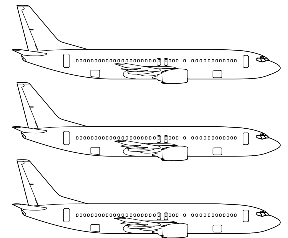
2 Boeing 737-400



3 Boeing 757-200



3 Boeing 737-500



# Financials

- *Net loss ISK 7.5 billion*
- *EBITDA ISK 4.8 billion*
- *Revenue growth 78%*
- *Total assets ISK 98.8 billion*
- *Equity ratio 20.3%*
- *Net operating cash ISK 2.9 billion*

**Income Statement**

Our net loss of ISK 7.5 billion does not reflect the performance of the core operations as the impairment of intangible assets totaling ISK 6.4 billion dominated the result. The EBITDA for the year, which amounted to ISK 4.8 billion, gives a better indication of how the core business performed and highlights the fact that it coped well. The EBITDA result in Q3 2008 was ISK 6.2 billion, the best in the company's history. The worldwide economic meltdown provided a significant operational challenge which was met with cost cutting and capacity reducing measures. This caused a significant deviation in the EBITDA result in Q4 which was forecast to be positive at the start of the year but was ISK -2.3 billion. The EBITDA for 2008 amounted to ISK 4.8 billion compared to ISK 5.5 billion in 2007. Profits from the sales of aircraft amounted to ISK 0.2 billion 2008 as compared to ISK 1.8 billion in 2007. Net loss result in 2008 was ISK 7.5 billion compared to a profit of ISK 0.3 billion in 2007.

INCOME

Total revenue for 2008 was ISK 112.7 billion, representing an increase of 78%. A large part of this increase in revenues, about 52%, can be attributed to the consolidation of Travel Service as of 1 April 2008.

Transport revenue in 2008 was ISK 45.9 billion, up 28% from last year. Charter and AC lease amounted to ISK 53.1 billion compared to ISK 15.5 billion the previous year, of which 28.3 billion can be attributed to Travel Service. Other operating revenue totaled ISK 13.8 billion, increasing 15% from last year.

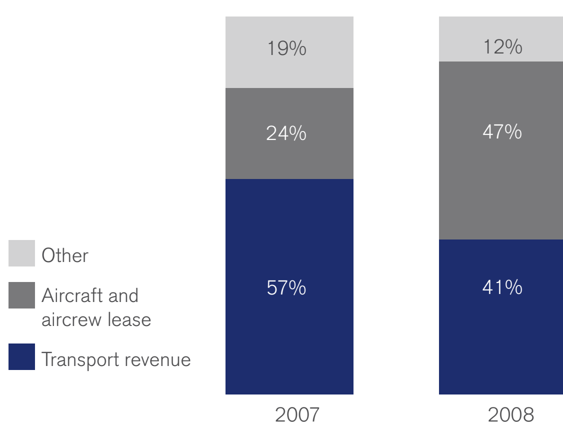
OPERATING EXPENSES

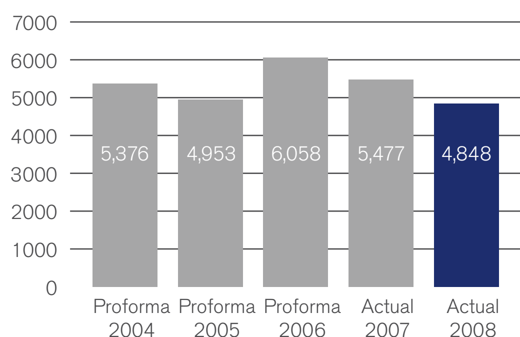
Operating expenses in 2008 totaled ISK 107.9 billion compared to ISK 58 billion in 2006. Salaries and related expenses rose 20% or ISK 4 billion from 2007. Aircraft fuel cost rose by ISK 16.1 billion, which corresponds to a 165% increase. The impact of the inclusion of Travel Service accounts for approximately ISK 9 billion of this figure. The average price of fuel in 2008 was USD 1,008 per ton, as compared to USD 711 in 2007. Aircraft servicing, handling and navigation increased by ISK 11.1 billion between years, of which ISK 9.6 billion can be attributed to Travel Service.

DEPRECIATION AND AMORTISATION

Impairment of intangible assets amounted to ISK 6.4 billion in 2008, all accrued in the fourth quarter. The Group's intangible assets have been allocated to individual subsidiaries. Impairment tests are conducted in compliance with IFRS. A number of factors are taken into account when conducting the tests, including future operating and investment plans, and required cost of capital. Capital costs, and in particular risk premiums, have increased of late, as has the required return on equity. These factors have adversely affected the test results. Changes in the operating

Revenue Distribution



environment of two companies, SmartLynx and Icelandair Cargo, since the original allocation of their goodwill has resulted in substantial write-downs. Intangible assets relating to SmartLynx appreciated in value by ISK 0.8 during the year through equity as a result of the weakening of the Icelandic krona. The amount, which previously was entered through equity, is subsequently expensed in the profit and loss account. A substantial impairment has also been entered on account of Air Iceland, even though the company returned good operating results in 2008. The primary reason for this is that the company's aircraft fleet is capitalised in foreign currency and its book value has increased during the course of the year as a result of the weakening of the Icelandic krona. This increase was entered through equity. The book value of all assets, both tangible and intangible,must be supported by future cash flow.

FINANCIAL INCOME AND EXPENSES

Net interest expenses increased between 2007 and 2008 due to rising domestic interest rates, higher margins and a bigger balance sheet after the acquisition of Travel Service. Tighter liquidity arising from a very challenging international economic environment in the fourth quarter added to this effect. However currency effects due to a weaker ISK in addition to gains from derivative positions had positive counter effects causing the net total finance cost to decrease somewhat from last year.

## Balance Sheet

ASSETS

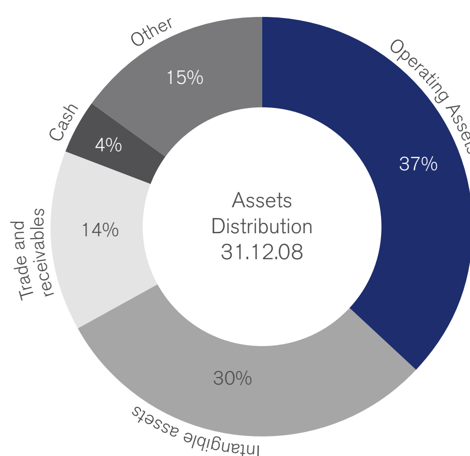
Icelandair Group's total assets as of 31 December 2008 totaled ISK 99 billion. Total assets increased by 48% from ISK 67 billion between years despite an ISK 6.4 billion impairment of intangible assets. This increase in total assets can be mostly attributed to the weak ISK and the consolidation of Travel Service. Operating assets totaled ISK 36.8 billion and consist mainly of aircraft. Intangible assets amounted to ISK 29.3 billion, an increase of ISK 2.5 billion which can be explained by the consolidation of Travel Service and the weak ISK. Investment in associates was ISK 1 billion at year-end 2008, down from ISK 2.3 billion in 2007 which is because of the sale of four associates related to Boeing 737-800 aircraft. Prepaid aircraft acquisitions increased by ISK 4 billion to ISK 4.2 at year end 2008. This is for the purchase of two Boeing 737-800 to be delivered in 2010 and five Boeing 787 Dreamliners to be delivered in 2013 and 2015.

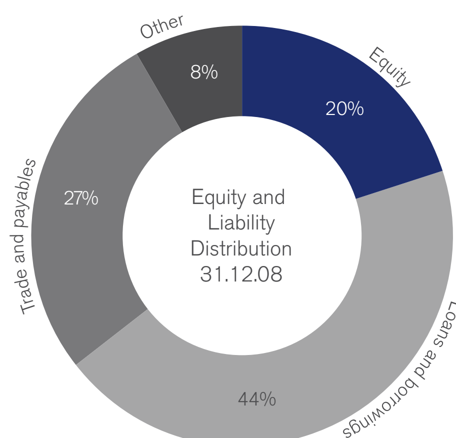
LIABILITIES

Icelandair Group's total loans and borrowings as of 31 December 2008 totaled ISK 43.6 billion compared to ISK 25 billion at year-end 2007. ISK 20.7 billion of these loans and borrowings are due within one year. Total prepaid aircraft acquisitions amounted to ISK 2 billion at year end 2008. Deferred income, which represents sold unused tickets and other prepayments, increased by ISK 2.2 billion to ISK 6.1 billion during the course of the year.

EQUITY

The Group's total equity amounted to ISK 20 billion at year end 2008, resulting in an equity ratio of 20,3%. The number of shareholders at the end of 2008 were 851 but were 1,271 at the beginning of the year. Three shareholders owned over 10% of the share capital: Langflug ehf. with 23.8%, Fjárfestingafélagið Máttur ehf. with 23.1% and Naust ehf. with 14.8%.



# Risk Management

## Risk Management

Various sources of financial risk inevitably play part in the Group's operations. The Board of Directors is responsible for defining treasury policy measures to reduce the Group's exposure to risk. The approved treasury policy outlines the parameters and framework to which the Group is subject when dealing with financial risk arising from price volatility, liquidity fluctuations, asset management and corporate financing. An internal Risk Management Team, chaired by the CEO, actively controls the risk exposure within the limits set by the Board's policy. The main policy objectives outline the methods to be used to reduce costs and inconvenience arising from price volatility and uncertainty. To that end, the financial budget is used as a benchmark when evaluating market conditions and hedging strategies.

## Currency risk

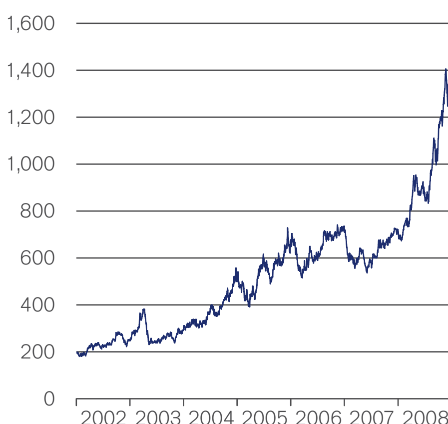
The Group seeks to reduce its foreign exchange exposure arising from transactions in various currencies through a policy of matching, as far as possible, all receipts and payments in each individual currency. Any mismatch is dealt with using currency trades within the Group before turning to outside parties. The biggest currency mismatch is found in Icelandair, where US dollar cash inflow falls short of dollar outflow due to fuel costs and capital-related payments, which are to a large extent denominated in US dollars. This shortage is financed by a surplus of European currencies, most importantly the Euro and Scandinavian currencies. The Group follows a hedging policy of a 40-80% hedging ratio, 12 months in advance, and uses a portfolio of instruments, mainly risk reversals and forwards. Since October, the international bank crisis has affected and limited hedging opportunities with the consequence that hedge positions have temporarily been reduced below preferred ratios and policy limits.

## Fuel price risk

Jet fuel prices proved to be extremely volatile in 2008. At the beginning of the year, prices continued to rise from their unprecedented levels to new heights which showed no hints of a turnaround. The oil prices were mainly demand-driven, and in general the market was under the impression that the new price territory was sustainable.

Market specialists argued that increased future demand for oil in the Far East supported the price rally, and that the concept of oil as alternative asset class for investors and speculators underpinned this development. Market sentiment took sides with this concept until July, when the oil price collapsed and became within four months a mere fraction of what it had been.

Of all the subsidiaries within Icelandair Group, Icelandair has by far the biggest risk exposure, as the other companies are in a better position to price in the risk or transfer it to the counterparty. Icelandair has maintained the ratio level between 50-60%, but this year has been an exception due to the abnormal prices. In June, July and August, the ratio was kept at the minimum policy level due to the inflated prices and doubts of sustainability. When prices started falling by the end of August with increased momentum the risk committee decided to recommend to the Board of Directors that the hedge ratios should be permitted to cross the policy's lower hedge limits. In addition to giving their consent, the Board of Directors approved the purchase of put options to lower the exposure of the open swap and collar positions. These actions have reduced the negative impact of the oil price collapse on the estimated value of the outstanding hedge positions. Of those subsidiaries



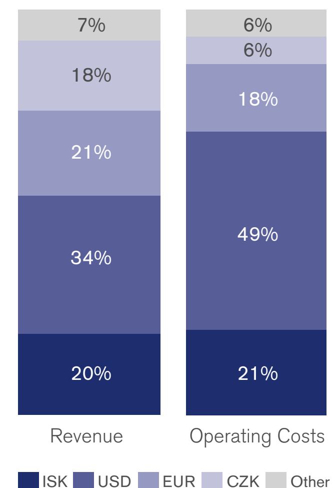
which hedge fuel risk in collaboration with customer contracts, Travel Service is by far the largest. Hedge positions from last summer intended to match customer contracts are currently valued as a liability according to their end of year market value on top of Icelandair´s position.

### Interest rate risk

The largest share of outstanding loans is directly related to aircraft financing and denominated in US dollars. The Group follows a policy of hedging 40-80% of the interest rate exposure of long-term financing, 2-5 years in advance. Currently, foreign loans are hedged against interest rate fluctuations with swap contracts, where the floating rate is exchanged for fixed interest rates. End-of-year open contracts amount to USD 85 million and have been quite favorable in recent years, as the floating rate has been increasing. In 2008, USD interest rates have fallen sharply. The average fixed interest rate is 4%, which can be considered a modest level in historical terms. All of the swap contracts expire in 2009 and 2010, apart from one 10 million USD contract which expires in 2011, so the recent developments should bring opportunities for improved hedge positions beyond 2009.

### Liquidity risk

The Group's policy extends to two tiers of liquidity preferences. Tier one relates to the necessary minimum benchmark to maintain adequate operational liquidity and tier two relates to preferred minimum for strategic liquidity. In both cases, certain asset classes are identified to qualify for each tier based on duration and value sensitivity. The amounts are re-valued annually with respect to the estimated turnover, annual fixed costs, cost of capital and uncertainty.



LOFTLEIÐIR ICELANDIC

# Corporate Governance

Icelandair Group holds the view that effective Corporate Governance principles are essential to assure shareholders and other stakeholders that the Company is doing its best to ensure sound and effective control of the Company's affairs and a high level of business ethics. Exercising good Corporate Governance will, in the long run, build a solid Company returning shareholders satisfactory profits on their investment. Corporate Governance serves to ensure an open and transparent relationship between the Company's management, its Board of Directors, its shareholders and other stakeholders.

The guidelines on Corporate Governance issued by the Iceland Chamber of Commerce, the Iceland Stock Exchange and the Confederations of Icelandic Employers, along with the Company's Articles of Association, and rules for Issuers of Securities listed on the OMX Nordic exchanges, make up the framework for Icelandair Group Corporate Governance practices.

It is the opinion of the Board of Directors that Icelandair Group is in full compliance with the Icelandic guidelines for Corporate Governance.

### Shareholders' Meetings

Shareholders exercise their powers at shareholders' meetings, which represent the supreme authority in all the affairs of Icelandair Group within the limits provided for by the Company's Articles of Association and statutory law. All shareholders are permitted to attend shareholders' meetings, express their views and exercise their voting rights. Shareholders may be represented by proxies, and they may be accompanied by advisors. The auditors of the Company and the CEO also have full rights to speak and submit motions at shareholders' meetings, whether they are shareholders or not.

Notices of shareholders' meetings must specify the business to be addressed at the meeting. If the agenda includes motions to amend the Articles of Association of the Company, the substance of the motion must be included in the notice of the meeting. Seven days before a shareholders' meeting, at the latest, an agenda, final submissions and, in the case of annual general meetings, the annual accounts, report of the Board of Directors and the auditor's report must be laid open for inspection by shareholders at the Company office.

Each shareholder is entitled to have a specific item of business included on the agenda of a shareholders' meeting, provided that such shareholder submits a written request to this effect to the Board of Directors of the Company with sufficient advance notice for the item to be included on the agenda in accordance with the Company's Articles of Association.

Items of business which are not included on the agenda may not be accepted for final decision at a shareholders' meeting except with the consent of all the shareholders in the Company, but a resolution may be passed to provide guidance to the Board of Directors of the Company. Lawfully submitted motions for amendments may be put to a vote at the meeting itself, even if they have not been laid open for inspection by shareholders. An Annual General Meeting is always permitted to conclude matters which it is required to address pursuant to statutory law or the Company's Articles of Association.

### Rights, Preferences and Restrictions on Shares

All voting shares carry equal rights, and no privileges are attached to any shares in the Company. All the shares are freely transferable except as otherwise provided by law.

### Actions Necessary To Change Shareholders' Rights.

The Articles of Association may be amended only at a lawful annual general meeting or extraordinary shareholders' meeting, provided that the notice of the meeting clearly indicates that such an amendment is proposed and outlines the main substance of the amendment. A decision to amend the Articles is valid only if it has the support of at least 2/3 of the cast votes and the support of shareholders controlling at least 2/3 of the share capital represented at the meeting, provided always that no other force of vote is required by the Articles or statutory law, as further provided in Article 93 of the Companies Act.

The annual general meeting shall be held before the end of May each year.

### Auditing and Accounts

An auditing firm is elected at the Annual General Meeting each year. The auditor examines the Company's annual accounts, in accordance with generally accepted accounting stardards, and has access to all the books and documents needed for this work. The accounting firm working for Icelandair Group is KPMG hf, and acting on their behalf are Jón S. Helgason, and Guðný H. Guðmundsdóttir.

### Insider Information

The Board of Directors appoints a Compliance Officer and his or her substitute. The Compliance Officer's responsibilities are to ensure that all rules set by the Company regarding insider trading and insider information are observed at all times.

### Board Practices

The company's Board of Directors consists of five members and three alternate members, elected at the Annual General Meeting for a term of one year. Those who intend to stand for election to the Board of Directors must inform the Board in writing of their intention at least five days before the Annual General Meeting, or extraordinary shareholders' meeting at which elections are scheduled. Only those who have informed the Board of their candidacy are eligible.

The members of the Board of Directors of Icelandair Group elected at the Annual General Meeting of 2008 are:

Gunnlaugur M. Sigmundsson, Chairman
Ómar Benediktsson, Vice-chairman
Ásgeir Baldurs
Finnur Reyr Stefánsson
Einar Sveinsson

Alternate Board Members

Jón Benediktsson
Martha Eiríksdóttir
Sigurður Atli Jónsson

In January 2009, Ómar Benediktsson resigned from the Board of Director following his appointment as the managing director of Smartlynx, an Icelandair Group subsidiary.

## Shares in Icelandair Group

### Share Capital

The share capital of Icelandair Group as of 31 December 2008 is ISK 1,000,000,000 in nominal value, divided into an equal number of shares, each with a nominal value of ISK 1.0. Each issued share carries one vote. Icelandair Group holds 25.460.00 shares in itself or 2,55% of the total shares
Icelandair Group has been listed on the OMX Nordic Exchange Iceland since December 2006. Therefore 2008 being the second whole year of the Company's listing. The ticker symbol for Icelandair Group is ICEAIR .

### Share Performance

At the end of 2008, the market capitalisation of Icelandair Group was ISK 13.25 billion. The share price of Icelandair Group in 2008 changed dramatically. The share price started out at 27.4 and the year closed at 13.25, after the collapse of the Icelandic banks in September. This is an annual decrease of 51%. During the year 2008, the high and low share prices were. 27.95 and 12.9 respectively. Total turnover in 2008 amounted to ISK 5.9 billion, Average monthly trading volume was ISK 0.5 billion in 2008.

### Dividend Policy

The Board of Directors of Icelandair Group will propose to the Annual General Meeting that no dividends should be paid with respect to the financial year 2008.

### Shareholders

At the end of 2008 Icelandair Group shares were held by a total of 851 shareholders. 1,2% of the totals shares in Icelandair Group were held by foreign investors. Ownership in Icelandair Group is tight, three shareholders hold 61.76% of the total shares.

### 20 Largest Shareholders as of 31 December 2008

| *Shareholder* | *Holdings* | *Shares in %* |
|---|---:|---:|
| Langflug ehf | 238,350,000 | 23.84 |
| Fjárfestingafélagið Máttur ehf | 231,101,393 | 23.11 |
| Naust ehf | 148,148,148 | 14.81 |
| Sparisjóðabanki Íslands hf | 93,572,562 | 9.36 |
| Nýi Glitnir banki hf | 49,982,102 | 5.0 |
| Alnus ehf | 32,992,831 | 3.3 |
| Icelandair Group hf | 25,460,000 | 2.55 |
| Saga Capital Fjárfestingarb hf | 21,992,272 | 2.2 |
| Glitnir banki hf | 20,925,000 | 2.09 |
| Sigla ehf | 20,000,000 | 2.0 |
| Flugval ehf | 18,518,519 | 1.85 |
| Arkur ehf | 17,500,000 | 1.75 |
| N1 hf | 12,844,611 | 1.28 |
| Stafir lífeyrissjóður | 9,539,260 | 0.95 |
| Almenni lífeyrissjóðurinn | 6,571,047 | 0.66 |
| Fluglind ehf | 5,555,556 | 0.56 |
| Fjárfestingafélag Tannanes ehf | 3,703,704 | 0.37 |
| Kaupfélag Suðurnesja | 3,375,000 | 0.34 |
| Landsbanki Luxembourg S.A. | 2,870,961 | 0.29 |
| Flugfar ehf | 2,222,223 | 0.22 |
| | **965,225,189** | **96.53** |

# Endorsement and Statement by the Board of Directors and the CEO

## Operations in the year 2008

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. should purchase the shares in two stages, 50% of the shares in 2007 and 30-50% during 2008. At year end 2008 the ownership in Travel Service was 66%. Travel Service is consolidated as of 1 April 2008 which was the acquisition date.

According to the income statement net loss for the year 2008 amounted to ISK 7,468 million. According to the balance sheet, equity at the end of the year amounted to ISK 20,080 million, including share capital in the amount of ISK 975 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 2009.

## 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 25 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 by 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 36.

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 2008 were 850 but were 1,271 at the beginning of the year, a decrease of 421 during the year. Three shareholders held more than 10% of outstanding shares each at year end 2008. 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 2008 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 2008, its assets, liabilities and consolidated financial position as at 31 December 2008 and its consolidated cash flows for the financial year 2008.

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 2008 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, 20 February 2009

Board of Directors:
Gunnlaugur M. Sigmundsson
Ómar Benediktsson
Ásgeir Baldurs
Einar Sveinsson
Finnur Reyr Stefánsson
Jón Benediktsson
Martha Eiríksdóttir
Sigurður Atli Jónsson

CEO
Björgólfur Jóhannsson

# 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 report by the Board of Directors, the balance sheet as at December 31, 2008, and the consolidated income statement, consolidated statement of changes in equity and consolidated cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

**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.

**Auditor's Responsibility**
Our responsibility is to express an opinion on these consolidated financial statements based on our audit. 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 auditor's 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 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 as at December 31, 2008, 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.

Reykjavík,
20 February 2009

**KPMG hf.**
Jón S. Helgason
Guðný H. Guðmundsdóttir

# Consolidated Income Statement

for the year 2008

| | Notes | 2008 | 2007 |
|---|---|---|---|
| **Operating income:** | | | |
| Transport revenue | 7 | 45,913 | 35,949 |
| Aircraft and aircrew lease | | 53,055 | 15,510 |
| Other operating revenue | | 13,771 | 12,018 |
| | | 112,739 | 63,477 |
| **Operating expenses:** | | | |
| Salaries and other personnel expenses | 8 | 24,105 | 20,008 |
| Aircraft fuel | | 25,887 | 9,769 |
| Aircraft and aircrew lease | | 15,345 | 7,353 |
| Aircraft handling, landing and communication | | 15,515 | 4,367 |
| Aircraft maintenance expenses | | 11,314 | 5,128 |
| Other operating expenses | | 15,725 | 11,375 |
| | | 107,891 | 58,000 |
| **Operating profit before depreciation and amortisation (EBITDA)** | | 4,848 | 5,477 |
| Depreciation and amortisation | 10 | ( 10,537) | ( 3,140) |
| **Operating (loss) profit before net finance expense (EBIT)** | | ( 5,689) | 2,337 |
| Finance income | | 2,383 | 396 |
| Finance expenses | | ( 3,697) | ( 2,545) |
| **Net finance expense** | 11 | ( 1,314) | ( 2,149) |
| Share of profit (loss) of associates, net of income tax | 21 | 178 | ( 59) |
| **(Loss) profit before income tax** | | ( 6,825) | 129 |
| Income tax | 12,13 | ( 643) | 128 |
| **(Loss) profit for the year** | | ( 7,468) | 257 |
| **Attributable to:** | | | |
| Equity holders of the Company | | ( 7,998) | 251 |
| Minority Interest | | 530 | 6 |
| **(Loss) profit for the year** | | ( 7,468) | 257 |
| **(Loss) earnings per share:** | | | |
| Basic (loss) earnings per share (ISK) | 29 | ( 8.10) | 0.25 |
| Diluted (loss) earnings per share (ISK) | 29 | ( 8.10) | 0.25 |

The notes on pages 10 to 49 are an integral part of these consolidated financial statements.

# Consolidated Balance Sheet

as at 31 December 2008

| | Notes | 2008 | 2007 |
|---|---|---|---|
| **Assets:** | | | |
| Operating assets | 15-18 | 36,798 | 22,832 |
| Intangible assets | 19-20 | 29,306 | 26,846 |
| Investments in associates | 21 | 1,008 | 2,335 |
| Prepaid aircraft acquisitions | 22 | 4,226 | 249 |
| Long-term receivables and deposits | 23 | 6,054 | 1,788 |
| Total non-current assets | | 77,392 | 54,050 |
| Inventories | 24 | 2,309 | 1,301 |
| Trade and other receivables | 25 | 13,836 | 7,284 |
| Receivables from sale of aircrafts | | 0 | 1,753 |
| Prepayments | 26 | 1,228 | 366 |
| Cash and cash equivalents | 27 | 4,065 | 2,006 |
| Total current assets | | 21,438 | 12,710 |
| **Total assets** | | 98,830 | 66,760 |
| **Equity:** | | | |
| Share capital | | 975 | 981 |
| Share premium | | 25,450 | 25,593 |
| Reserves | | 1,856 | ( 1,296) |
| Accumulated deficit | | ( 8,216) | ( 293) |
| Total equity attributable to equity holders of the Company | 29 | 20,065 | 24,985 |
| Minority interest | | 15 | 48 |
| Total equity | | 20,080 | 25,033 |
| **Liabilities:** | | | |
| Loans and borrowings | 30-33 | 22,900 | 14,040 |
| Prepayments | 34 | 2,189 | 0 |
| Deferred income tax liability | 35 | 23 | 134 |
| Total non-current liabilities | | 25,112 | 14,174 |
| Loans and borrowings | 30 | 20,735 | 11,058 |
| Trade and other payables | 37 | 26,773 | 12,591 |
| Deferred income | 38 | 6,130 | 3,904 |
| Total current liabilities | | 53,638 | 27,553 |
| Total liabilities | | 78,750 | 41,727 |
| **Total equity and liabilities** | | 98,830 | 66,760 |

The notes on pages 10 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 2008

| | | Attributable to equity holders of the Company | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Reserves | | | | | | |
| | Notes | Share capital | Share premium | Share option reserve | Hedging reserve | Translation reserve | Accumulated deficit | Total | Minority Interest | Total equity |
| **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 | | (19) | (497) | | | | | (516) | | (516) |
| Share based payments | 36 | | | 168 | | | | 168 | | 168 |
| Equity 31.12.2007 | | 981 | 25,593 | 168 | (24) | (1,440) | (293) | 24,985 | 48 | 25,033 |
| **2008** | | | | | | | | | | |
| Equity 1.1.2008 | | 981 | 25,593 | 168 | ( 24) | ( 1,440) | ( 293) | 24,985 | 48 | 25,033 |
| Foreign currency translation differences for foreign operations | | | | | | 7,344 | | 7,344 | ( 41) | 7,303 |
| Effective portion of changes in fair value of cash flow hedges, net of tax | | | | | ( 4,183) | | | ( 4,183) | ( 516) | ( 4,699) |
| Net income and expense recognised directly in equity | | | | | ( 4,183) | 7,344 | | 3,161 | ( 557) | 2,604 |
| Loss for the year | | | | | | | ( 7,998) | ( 7,998) | 530 | ( 7,468) |
| Total recognised income (expense) | | | | | ( 4,183) | 7,344 | ( 7,998) | ( 4,837) | ( 27) | ( 4,864) |
| Purchase of own shares | | ( 6 ) | ( 143) | | | | | ( 149) | | ( 149) |
| Share based payments | 36 | | | ( 15) | | | 75 | 60 | | 60 |
| Minority, change | | | | | | 6 | | 6 | ( 6) | |
| Equity 31.12.2008 | | 975 | 25,450 | 153 | ( 4,207) | 5,910 | ( 8,216) | 20,065 | 15 | 20,080 |

The notes on pages 10 to 49 are an integral part of these consolidated financial statements.

# Consolidated Statement of Cash Flows

for the year 2008

| | Notes | 2008 | 2007 |
|---|---|---|---|
| **Cash flows from operating activities:** | | | |
| (Loss) profit for the year | | ( 7,469) | 257 |
| Adjustments for: | | | |
| Depreciation and amortisation | 10 | 10,537 | 3,140 |
| Other operating items | 47 | ( 157) | ( 1,902) |
| Working capital from operations | | 2,911 | 1,495 |
| Net change in operating assets and liabilities | 48 | 27 | 2,394 |
| Net cash from operating activities | | 2,938 | 3,889 |
| **Cash flows from investing activities:** | | | |
| Acquisition of operating assets | 15 | ( 3,820) | ( 7,571) |
| Proceeds from the sale of operating assets | | 447 | 3,814 |
| Acquisition of intangible assets | 19 | ( 165) | ( 455) |
| Prepaid aircraft acquisitions, increase | | ( 2,215) | 0 |
| Acquisition of subsidiaries, net of cash acquired | 6 | ( 750) | 0 |
| Long-term receivables, increase | | 923 | ( 1,249) |
| Net cash used in investing activities | | ( 5,580) | ( 5 ,461) |
| **Cash flows from financing activities:** | | | |
| Repurchase of own shares | 28 | ( 149) | ( 516) |
| Proceeds from long term borrowings | | 6,499 | 8,723 |
| Repayment of long term borrowings | | ( 9,381) | ( 7,611) |
| Proceeds from short term borrowings | | 5,923 | 257 |
| Net cash from financing activities | | 2,892 | 853 |
| **Increase (decrease) in cash and cash equivalents** | | 250 | ( 719) |
| **Effect of exchange rate fluctuations on cash held** | | 1,809 | ( 51) |
| **Cash and cash equivalents at beginning of the year** | | 2,006 | 2,776 |
| **Cash and cash equivalents at 31 December 2008** | 27 | 4,065 | 2,006 |

The notes on pages 10 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 2008 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.

## 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 and authorised for issue by the Board of Directors on 20 February 2009.

### 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.

Significant areas of estimation uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amount recognised in the consolidated 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.

## 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.

# Notes, contd.:

3a. contd.:

*(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.

*(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 equit.

*(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 long-term receivables and deposits, 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 at amortised cost using the effective interest method, less any impairment losses.

Cash and cash equivalents comprise cash balances and call deposits.

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

# Notes, contd.:

3c. *(i)* contd.:

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

*(ii)* *Derivative financial instruments*

The Group holds derivative financial instruments to hedge its foreign currency, fuel price and interest rate risk exposures. Derivatives are recognised initially at fair value; attributable transaction costs are recognised in profit or loss when incurred. Subsequent to initial recognition, derivatives are measured at fair value, and changes therein are accounted for as described below. The Group holds no trading derivatives.

*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.

*Other non-trading derivatives*

When a derivative financial instrument is not held for trading, and is not designated in a qualifying hedge relationship, all changes in its fair value are recognised immediately in profit or loss.

*(iii)* *Compound financial instruments*

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

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

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

*(iv)* *Share capital*

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.

# Notes, contd.:

3c. contd.:

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 assets 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 cycles. 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.

*(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 yearss |
| Engines | Cycles. |
| Buildings | 15-50 years |
| Other property and equipment | 3-8 years |

Depreciation methods, useful lives and residual values are reviewed at each reporting date.

# Notes, contd.:

3. contd.:

***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 is stated at cost less any accumulated impairment losses. Goodwill is allocated to cash-generating units and is tested annually for impairment.

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.

***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.

# Notes, contd.:

3i. contd.:

*(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.

***j. Employee benefits***

*(i) Defined contribution plans*

Obligations for contributions to pension plans are recognised as an expense in the Income Statement when they are due.

*(ii) 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 for which the related service and non-market vesting conditions are met.

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.

Share-based payment arrangements in which the Group receives services as consideration for its own equity instruments are accounted for as equity-settled share-based payment transactions, regardless of how the equity instruments are obtained by the Group.

***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.

# Notes, contd.:

3k. contd.:

*(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.

Provisions are entered into the Balance Sheet among trade and other payables.

***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 twelve 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.

*(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 recognised using the balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. 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.

# Notes, contd.:

3p. contd.:

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

***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.

***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.

Segment capital expenditure is the total cost incurred during the period to acquire property, plant and equipment, and intangible assets other than goodwill.

***s. 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 2008, 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 consolidated financial statements, will require a change in the presentation and disclosure of segment information based on the internal reports regularly reviewed by the Group's Chief Operating Decision Maker in order to assess each segment's performance and to allocate resources to them. Currently the Group presents segment information in respect of its business segments (see note 6). Under the management approach, the Group will present segment information in respect of Scheduled airline & tourism operations, Global capacity and aircraft trading and Shared services.
- 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. The revised IAS 23 will become mandatory for the Group's 2009 consolidated financial statements and will not constitute a change in accounting policy for the Group. Therefore there will be no impact on prior periods in the Group's 2009 consolidated financial statements.
- *IFRIC 13 Customer Loyalty Programmes* addresses the accounting by entities that operate, or otherwise participate in, customer loyalty programmes under which the customer can redeem credits for awards such as free or discounted goods or services. IFRIC 13, which becomes mandatory for the Group's 2009 consolidated financial statements, is expected to have immaterial impact on the consolidated financial statements.

# Notes, contd.:

3s. contd.:

- Revised *IAS 1 Presentation of Financial Statements* (2007) introduces the term total comprehensive income, which represents changes in equity during a period other than those changes resulting from transactions with owners in their capacity as owners. Total comprehensive income may be presented in either a single statement of comprehensive income (effectively combining both the income statement and all non-owner changes in equity in a single statement), or in an income statement and a separate statement of comprehensive income. Revised IAS 1, which becomes mandatory for the Group's 2009 consolidated financial statements, is expected to have a impact on the presentation of the consolidated financial statements. The Group plans to provide total comprehensive income in a single statement of comprehensive income for its 2009 consolidated financial statements.
- Amendments to *IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements – Puttable Financial Instruments and Obligations Arising on Liquidation* requires putable instruments, and instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation, to be classified as equity if certain conditions are met. The amendments, which become mandatory for the Group's 2009 consolidated financial statements, with retrospective application required, are not expected to have any impact on the consolidated financial statements.
- *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 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.

# Notes, contd.:

## 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) Receivables*

The fair value of 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.

*(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.

# Notes, contd.:

## 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 three segments, scheduled airline and tourism operations, global capacity and aircraft trading and shared services. In the beginning of the year the Group changed it structure and merged two segments, scheduled airline operations and travel and tourism. Comparable amounts have been changed accordingly.

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

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

   *Scheduled airline and tourism operations*
   Six companies are categorised as being part of the Scheduled Airline and Tourism 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. 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.

   *Global capacity solutions and aircraft trading*
   The six companies forming this part of Icelandair Group hf. are Loftleiðir-Icelandic and Smartlynx (previously LatCharter), a capacity providers 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 Travel Services which is consolidated as of 1 April 2008. These six 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.

   *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.

# Notes, contd.:

5. contd.:

***Business segments***

| **2008** | Scheduled airline and tourism operations | Global capacity and aircraft trading | Shared services | Eliminations | Consolidated |
|---|---|---|---|---|---|
| External revenue | 57,036 | 55,487 | 216 | | 112,739 |
| Inter-segment revenue | 16,556 | 1,161 | 644 | (18,361) | |
| Total segment revenue | 73,592 | 56,648 | 860 | (18,361) | 112,739 |
| Segment EBITDAR | 7,193 | 10,976 | (1,003) | | 17,166 |
| Segment EBITDA | 1,936 | 3,915 | (1,003) | | 4,848 |
| Segment results | (5,197) | 1,146 | (1,638) | | (5,689) |
| Net finance expense | (751) | 855 | (1,418) | | (1,314) |
| Share of profit of associates | 1 | 177 | | | 178 |
| Income tax | 318 | (1,152) | 191 | | (643) |
| (Loss) profit for the year | (5,629) | 1,026 | (2,865) | | (7,468) |
| Segment assets | 52,083 | 32,549 | 56,178 | (42,988) | 97,822 |
| Investments in associates | 116 | 835 | 57 | | 1,008 |
| Total assets | 52,199 | 33,384 | 56,235 | (42,988) | 98,830 |
| Segment liabilities | 50,742 | 28,301 | 35,100 | (35,393) | 78,750 |
| Total liabilities | 50,742 | 28,301 | 35,100 | (35,393) | 78,750 |
| Capital expenditure | 3,802 | 2,376 | 22 | | 6,200 |
| Depreciation | 2,832 | 599 | 14 | | 3,445 |
| Amortisation of intangible assets | 204 | 458 | 15 | | 677 |
| Impairment loss | 4,097 | 1,712 | 606 | | 6,415 |

# Notes, contd.:

5. contd.:

***Business segments***

| **2007** | Scheduled airline and tourism operations | Global capacity and aircraft trading | Shared services | Eliminations | Consolidated |
|---|---|---|---|---|---|
| External revenue | 47,723 | 15,646 | 108 | | 63,477 |
| Inter-segment revenue | 13,092 | 24 | 643 | (13,759) | |
| Total segment revenue | 60,815 | 15,670 | 751 | (13,759) | 63,477 |
| Segment EBITDAR | 7,628 | 3,963 | (535) | | 11,056 |
| Segment EBITDA | 3,847 | 2,165 | (535) | | 5,477 |
| Segment results | 1,510 | 1,744 | (917) | | 2,337 |
| Net finance expense | (418) | (477) | (1,254) | | (2,149) |
| Share of profit of associates | | (59) | 0 | | (59) |
| Income tax | (233) | (28) | 643 | | 128 |
| Profit (loss) for the year | 859 | 926 | (1,528) | | 257 |
| Segment assets | 33,177 | 11,696 | 45,024 | (25,472) | 64,425 |
| Investments in associates | 79 | 2,253 | 3 | | 2,335 |
| Total assets | 33,256 | 13,949 | 45,027 | (25,472) | 66,760 |
| Segment liabilities | 26,712 | 10,703 | 19,195 | (14,883) | 41,727 |
| Total liabilities | 26,712 | 10,703 | 19,195 | (14,883) | 41,727 |
| Capital expenditure | 4,234 | 3,757 | 35 | | 8,026 |
| Depreciation | 2,174 | 408 | 5 | | 2,587 |
| Amortisation of intangible assets | 272 | 269 | 12 | | 553 |

**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. purchases the shares in two stages, 50% of the shares in 2007 and 50% during 2008. The 50% share in Travel Service acquired in 2007 was acquired through the holding company, Lerox CZ s.r.o. which is 100% owned by Icelandair Group hf. The 50% share of Travel Service was accounted for using the equity method within Lerox CZ s.r.o. from the acquisition date of Lerox CZ s.r.o. as of 1 November 2007 until 1 April 2008, the acquisition date, when Icelandair Group hf. obtained control of Travel Service due to resolution of constraints in the share purchase agreement..

# Notes, contd.:

6. contd.:

During the 2nd Quarter, Icelandair Group hf. acquired the second 50% part of the shares in Travel Service directly and at the same time transferred the ownership of the 50% from Lerox to Icelandair Group hf. According to the purchase agreement the sellers had option to buy back 20% of the shares at the completion date in 2008. The sellers exercised this option so Icelandair Group hf. owned 80% of Travel Service until December when the minority owners acquired additional 14%. Icelandair Groups hf. therefore owns 66% on 31 December 2008.

The acquisition had the following effect on the Group´s assets and liabilities on acquisition date:

| | Pre-acquisition carrying amount | Fair value adjustments | Recognised values on acquistion |
|---|---|---|---|
| Intangible assets | 105 | 1.433 | 1,538 |
| Operating assets | 494 | (59) | 435 |
| Prepaid aircraft acquistions | 573 | | 573 |
| Long-term receivabels and deposits | 574 | 48 | 622 |
| Inventories | 328 | | 328 |
| Receivables | 1,331 | (220) | 1,111 |
| Prepayments | 408 | (183 ) | 225 |
| Loans and borrowings | (1,818) | 11 | (1,807) |
| Trade and other payables | (1,658) | (511) | (2,169) |
| Net assets | | | 856 |
| Goodwill on acquisition | | | 1,257 |
| Total purchase price, satisfied in cash | | | 2,113 |
| Paid in 2007 | | | (960) |
| Cash and cash equivalents acquired | | | (403) |
| Net cash outflow | | | 750 |

The purchase price includes ISK 104 million direct cost related to the transaction.

Pre-acquisition carrying amounts were determined based on applicable IFRSs immediately before the acquisition. The values of assets, liabilities, and contingent liabilities recognised on acquisition are their estimated fair values (see note 4 for the methods used in determining fair values). In determining the fair value of tradename acquired, the Group applied a discount rate of 14% to the estimated royalty payments avoided. Favorable leases and customer relationships were discounted using 11% and 14%, respectively.

The goodwill recognised on the acquisition is attributable mainly to the skills and technical talent of the acquired business's work force, and the synergies expected to be achieved from integrating the company into the Group's existing airline operations.

Consolidated revenues increased by 33,276 million ISK and profit increased by 2,752 million ISK by consolidating Travel Service from 1 April 2008. If the acquistion had occurred on 1 January 2008 the Group´s revenue would have been ISK 115,676 million and the consolidated loss for the year would have been ISK 7,574 million.

# Notes, contd.:

### Operating income

7. Transport revenue is specified as follows:

| | 2008 | 2007 |
|---|---|---|
| Passengers | 40,168 | 31,011 |
| Cargo and mail | 5,745 | 4,938 |
| Total transport revenue | 45,913 | 35,949 |

### Operating expenses

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

| | | |
|---|---|---|
| Salaries | 16,324 | 13,552 |
| Equity-settled share based payment transactions | 60 | 168 |
| Contribution to pension funds | 1,966 | 1,520 |
| Other salary-related expenses | 1,905 | 1,525 |
| Other personnel expenses | 3,850 | 3,243 |
| Total salaries and other personnel expenses | 24,105 | 20,008 |

### Auditors' fees

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

| | | |
|---|---|---|
| Audit of financial statements | 33 | 30 |
| Review of interim accounts | 19 | 8 |
| Other services | 18 | 16 |
| Total auditors' fees | 70 | 54 |

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 17 million during the year 2008 (2007: ISK 5 million).

### Depreciation and amortisation

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

| | | |
|---|---|---|
| Depreciation of operating assets, see note 15 | 3,445 | 2,587 |
| Amortisation of intangible assets, see note 19 | 677 | 553 |
| Impairment, see note 19 | 6,415 | 0 |
| Depreciation and amortisation recognised in the income statement | 10,537 | 3,140 |

# Notes, contd.:

### Finance income and finance expenses

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

| | 2008 | 2007 |
|---|---|---|
| Interest income on bank deposits | 142 | 194 |
| Other interest income | 41 | 145 |
| Net foreign exchange gain | 1,724 | 57 |
| Trading derivatives | 476 | 0 |
| Finance income total | 2,383 | 396 |
| Interest expense on loans and borrowings | 3,502 | 2,413 |
| Other interest expenses | 195 | 132 |
| Finance expenses total | 3,697 | 2,545 |
| Net finance expense | (1,314) | (2,149) |

### Income tax

12. In May 2008 the Icelandic Parliament approved a decrease in the income tax rate from 18% to 15% as of 1 January 2008 and the change will become effective in the tax assessment of the year 2009. Due to this the deferred tax liability at year-end 2007 decreased by ISK 22,4 million. The decrease is recognised as a part of income tax in the income statement.

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

| | 2008 | 2007 |
|---|---|---|
| *Deferred tax expense* | | |
| Origination and reversal of temporary differences | 643 | (128) |
| Total income tax in income statement | 2,651 | 1,879 |

13. Reconciliation of effective tax rate:

| | | 2008 | | 2007 |
|---|---|---|---|---|
| (Loss) profit before tax | | (6,825) | | 129 |
| Income tax according to current tax rate | 15.0% | (1,024) | 18.0% | 23 |
| Change in tax rate from 18% to 15% | (0.3%) | 22 | | |
| Tax exempt revenues | 0.6% | (42) | (38.8%) | (50) |
| Non-deductible expenses | (21.6%) | 1,477 | 36.4% | 47 |
| Foreign currency subsidiaries | (3.0%) | 207 | (117.1%) | (151) |
| Other items | (0.0%) | 3 | 2.3% | 3 |
| Effective tax rate | (9.4%) | 643 | (99.1%) | (128) |

# Notes, contd.:

14. Income tax recognised directly in equity:

| | 2008 | 2007 |
|---|---|---|
| Derivatives | 1,065 | 30 |
| Total income tax recognised directly in equity | 1,065 | 30 |

## Operating assets

15. Operating assets are specified as follows:

| **Gross carrying amounts** | Aircrafts and flight equipment | Buildings | Other property and equipment | Total |
|---|---|---|---|---|
| Balance at 1 January 2007 | 19,311 | 2,426 | 1,621 | 23,358 |
| Additions during the year | 6,229 | 590 | 752 | 7,571 |
| Sales and disposals during the year | (3,583) | (8) | (38) | (3,629) |
| Exchange rate difference | (1,600) | 0 | (28) | (1,628) |
| Balance at 31 December 2007 | 20,357 | 3,008 | 2,307 | 25,672 |
| Additions through business combinations | 381 | 5 | 49 | 435 |
| Additions during the year | 3,344 | 86 | 390 | 3,820 |
| Sales and disposals during the year | (692) | (29) | (33) | (754) |
| Exchange rate difference | 15,440 | 373 | 85 | 15,898 |
| Balance at 31 December 2008 | 38,830 | 3,443 | 2,798 | 45,071 |
| **Depreciation and impairment losses** | | | | |
| Balance at 1 January 2007 | 335 | 29 | 59 | 423 |
| Depreciation | 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 | 2,840 |
| Depreciation for the year | 2,850 | 153 | 442 | 3,445 |
| Sales and disposals during the year | (388) | (4) | (25) | (417) |
| Exchange rate difference | 2,286 | 62 | 57 | 2,405 |
| Balance at 31 December 2008 | 7,043 | 356 | 874 | 8,273 |
| **Carrying amounts** | | | | |
| At 1 January 2007 | 18,976 | 2,397 | 1,562 | 22,935 |
| At 31 December 2007 | 18,062 | 2,863 | 1,907 | 22,832 |
| At 31 December 2008 | 31,787 | 3,087 | 1,924 | 36,798 |
| Depreciation ratios | 7-10% | 2-6% | 13-33% | |

# Notes, contd.:

### Mortgages and commitments

16. The Group's operating assets are mortgaged to secure debt. The remaining balance of the debt amounted to ISK 34,186 million at the end of the year 2008 (2007: ISK 14,776 million).

### Insurance value of aircrafts and flight equipment

17. The insurance value and book value of aircrafts and related equipment of the Company at year-end 2008 are specified as follows:

| | Insurance value | Carrying amount |
|---|---|---|
| Boeing - 8 aircrafts | 41,591 | 22,426 |
| Other aircrafts | 8,148 | 1,550 |
| Flight equipment | 6,496 | 7,811 |
| Total aircrafts and flight equipment | 56,235 | 31,787 |

### *Insurance value of other operating assets*

18. The principal buildings owned by the Group at 31 December 2008 are the following:

| | Official assessment | Insurance value | Carrying amount |
|---|---|---|---|
| Maintenance hangar, Keflavík Airport | 1,543 | 2,701 | 708 |
| Freight building, Keflavík Airport | 409 | 733 | 364 |
| Office building, Reykjavík Airport | 863 | 1,120 | 290 |
| Service building, Keflavík Airport | 424 | 731 | 230 |
| Hangar 4 and other buildings, Reykjavík Airport | 653 | 490 | 304 |
| Buildings in Latvia | 785 | 726 | 743 |
| Other buildings | 417 | 982 | 448 |
| Buildings total | 5,094 | 7,483 | 3,087 |

Official valuation of the Group's leased land for buildings at 31 December 2008 amounted to ISK 645 million and is not included in the Balance Sheet.

The insurance value of the Group's other operating assets and equipment amounted to ISK 4,247 million at the end of the year 2008. The carrying amount at the same time was ISK 1,933 million

# Notes, contd.:

## Intangible assets

19. Intangible assets are specified as follows:

| Gross carrying amounts | Goodwill | Trademarks and slots | Customer relations | Other intangibles | Total |
|---|---|---|---|---|---|
| Balance at 1 January 2007 | 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 |
| Additions through business combinations | 1,257 | 833 | 263 | 442 | 2,795 |
| Additions during the year | 0 | 0 | 0 | 165 | 165 |
| Sales and disposals during the year | (580) | 0 | 0 | (18) | (598) |
| Exchange rate difference | 5,181 | 1,295 | 486 | 277 | 7,239 |
| Balance at 31 December 2008 | 26,001 | 7,048 | 1,832 | 2,278 | 37,159 |
| **Amortisation and impairment losses** | | | | | |
| Balance at 1 January 2007 | 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 |
| Amortisation for the year | 0 | 0 | 204 | 473 | 677 |
| Impairment loss | 5,182 | 884 | 340 | 9 | 6,415 |
| Sales and disposals during the year | 0 | 0 | 0 | (16) | (16) |
| Exchange rate difference | 0 | 0 | 24 | 41 | 65 |
| Balance at 31 December 2008 | 5,182 | 884 | 721 | 1,066 | 7,853 |
| **Carrying amounts** | | | | | |
| At 1 January 2007 | 21,114 | 4,587 | 1,116 | 1,028 | 27,845 |
| At 31 December 2007 | 20,143 | 4,920 | 930 | 853 | 26,846 |
| At 31 December 2008 | 20,819 | 6,164 | 1,111 | 1,212 | 29,306 |

### *Impairment test*

20. Goodwill and other intangible assets that have indefinite live are tested for impairment at each reporting date. These assets were recognised at fair value on acquistion dates. Goodwill and other intangible assets with indefinite live are specified as follows:

| | 2008 | 2007 |
|---|---|---|
| Goodwill | 20,819 | 20,143 |
| Trademarks and slots | 6,164 | 4,920 |
| Total | 26,983 | 25,063 |

# Notes, contd.:

20. contd.:

For the purpose of impairment testing on goodwill, goodwill is allocated to the subsidiaries which represent 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 segment (group of units) are as follows:

| | 2008 | 2007 | 2008 | 2007 |
|---|---|---|---|---|
| | Goodwill | | Trademarks and slots | |
| Scheduled airline and tourism operations | 9,826 | 13,426 | 3,294 | 3,727 |
| Global capacity and aircraft trading | 10,352 | 5,723 | 2,870 | 1,193 |
| Shared services | 641 | 994 | 0 | 0 |
| Total goodwill | 20,819 | 20,143 | 6,164 | 4,920 |

The recoverable amounts of cash-generating units was based on their value in use. Value in use was determined by discounting the future cash flows generated from the continuing use of the units. Cash flows were projected based on actual operating results and a 5-year business plan. Cash flows were extrapolated for determining the residual value using a constant growth rate which was consistent with the long-term average growth rate for the industry. Management believes that this forecast period was justified due to the long-term nature of the business.

"The 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). Value in use was based on the following key assumptions:

| | Scheduled airline and tourism operations | Global capacity and aircraft trading | Shared services |
|---|---|---|---|
| Long term growth rate | 4% | 4% | 4% |
| Revenue growth: | | | |
| Weighted average 2009 | 5.3% | 8.3% | 7.0% |
| 010 - 2013 | 0-5% | 4-5% | 4-7% |
| WACC | 11.0 - 13.2% | 8.5 - 10.9% | 14.7% |
| Interest rate | 6.0 - 10.2% | 4.9 - 6.1% | 11.0% |

Changes in key assumptions would have the following impact on the carrying amount of goodwill:

| | | | |
|---|---|---|---|
| WACC +1% | (2,095) | 0 | (50) |
| EBITDA - 5% | (1,179) | 0 | (34) |

# Notes, contd.:

## Equity accounted investees

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

| | Ownership | |
|---|---|---|
| | 2008 | 2007 |
| Barkham Associates SA | 49% | 49% |
| China Ice No 1 ehf. | 40% | 40% |
| China Ice No 1 slf. - dissolved in 2008 | 0% | 40% |
| China Ice No 2 ehf. | 40% | 40% |
| China Ice No 2 slf. - dissolved in 2008 | 0% | 40% |
| China Ice No 3 ehf. | 40% | 40% |
| China Ice No 3 slf. - dissolved in 2008 | 0% | 40% |
| China Ice No 4 ehf. | 40% | 40% |
| China Ice No 5 ehf. | 40% | 40% |
| China Ice No 6 ehf. | 40% | 40% |
| China Ice No 6 slf. - dissolved in 2008 | 0% | 40% |
| Travel Service CZ s.r.o. 2007 and Jan - March 2008 | 50% | 50% |
| Icesing ehf. | 49% | 49% |
| Siglo FIJ Ltd. | 49% | 49% |
| Siglo FIR Ltd. | 49% | 49% |
| Siglo FIU Ltd. | 49% | 49% |
| Assets | 7,373 | 21,808 |
| Liabilities | 6,356 | 18,319 |
| Revenues | 1,763 | 4,970 |
| Expenses | 1,034 | 5,016 |
| Net profit (loss) | 729 | (46) |
| Share of (loss) profit of associates | 178 | (59) |

## Prepaid aircraft acquisitions

22. Prepaid aircraft acquisitions in the balance sheet is for the purchase of two, Boeing 737 - 800 aircrafts to be delivered in 2010 and five Boeing 787 Dreamliner aircrafts to be delivered in the year 2013 and 2015. The Company has capitalised borrowing cost amounting to ISK 147 million related to these prepayments based on the average USD interest rate which was 4,9% at year-end. The Company also has an option to purchase four additional 787 Dreamliner aircrafts

# Notes, contd.:

## Long-term receivables and deposit

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

| | 2008 | 2007 |
|---|---|---|
| Loans, effective interest rate 7.6% / 7.6% | 336 | 775 |
| Deposits | 3,070 | 653 |
| Other long-term receivables | 2,693 | 1,016 |
| | 6,099 | 2,444 |
| Current maturities of long-term receivables | (45) | (656) |
| Long-term receivables and deposits total | 6,054 | 1,788 |
| Long-term receivables contractual repayments are specified as follows: | | |
| Repayments in 2008 | - | 656 |
| Repayments in 2009 | 45 | 23 |
| Repayments in 2010 | 44 | 21 |
| Repayments in 2011 | 43 | 18 |
| Repayments in 2012 | 183 | 11 |
| Repayments in 2013 | 4 | 0 |
| Subsequent | 17 | 46 |
| Total loans, including current maturities | 336 | 775 |

Long-term receivables and deposits denominated in currencies other than the functional currency comprise ISK 5.841 million (2007: ISK 1.720 million).

## Inventories

24. Inventories are specified as follows:

| | 2008 | 2007 |
|---|---|---|
| Spare parts | 1,879 | 960 |
| Other inventories | 430 | 341 |
| Inventories total | 2,309 | 1,301 |

In 2008 the write-down of inventories to net realisable value amounted to ISK 46 million (2007: 35 million). The write-down is included in other operating expenses.

## Trade and other receivables

25. Trade and other receivables are specified as follows:

| | 2008 | 2007 |
|---|---|---|
| Trade receivables | 8,789 | 5,158 |
| Current maturities of long term-receivables | 100 | 656 |
| Restricted cash | 409 | 0 |
| Other receivables | 4,538 | 1,470 |
| Trade and other receivables total | 13,836 | 7,284 |

# Notes, contd.:

25. contd.:

At 31 December 2008 trade receivables are shown net of an allowance for doubtful debts of ISK 825 million (2007: ISK 241 million) arising from the likely bankruptcy of a significant customer.

Receivables denominated in currencies other than the functional currency comprise ISK 4,780 million (2007: ISK 2,609 million) of trade receivables.

### Prepayments

26. Prepaid expenses which relates to subsequent periods amounted to ISK 1.228 million (2007: ISK 366 million) at year end. The prepayments consist mainly of insurance expenses and prepaid rental expenses.

### Cash and cash equivalents

| | 2008 | 2007 |
|---|---|---|
| 27. Cash and cash equivalents are specified as follows: | | |
| Bank deposits | 3,743 | 1,989 |
| Marketable securities | 90 | 0 |
| Cash on hand | 232 | 17 |
| Cash and cash equivalents total | 4,065 | 2,006 |

### 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 11 March 2008 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. Granted outstanding options to key employees amounted to ISK 28 millions at year-end with the average exercise price ISK 27.5 per share. The Company bought own shares at a nominal value of ISK 6 million during the year for ISK 149 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.

# Notes, contd.:

## 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.

| **Basic earnings per share:** | 2008 | 2007 |
|---|---|---|
| **Profit attributable to ordinary equity holders of the parent company:** | | |
| Profit for the year attributable to equity holders of the Parent | (7,998) | 251 |
| **Weighted average number of ordinary shares** | | |
| *in million shares* | | |
| Issued ordinary shares at beginning of year | 991 | 1,000 |
| Effect of bought own shares | (3) | (9) |
| Weighted average number of ordinary shares at 31 December | 988 | 991 |
| **Weighted average number of ordinary shares (diluted)** | | |
| *in million shares* | | |
| Weighted average number of ordinary shares (basic) | 988 | 991 |
| Effect of share options | 0 | (1) |
| Weighted average number of ordinary shares (diluted) at 31 December | 988 | 990 |
| **(Loss) earnings per share:** | | |
| Basic (loss) earnings per share (ISK) | (8.10) | 0.25 |
| Diluted (loss) earnings per share (ISK) | (8.10) | 0.25 |

## 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 39.

Non-current loans and borrowings are specified as follows:

| | 2008 | 2007 |
|---|---|---|
| Secured bank loans | 25,542 | 14,851 |
| Convertible notes | 1,918 | 1,889 |
| Current maturities | (4,560) | (2,700) |
| Total non-current loans and borrowings | 22,900 | 14,040 |

Current loans and borrowings are specified as follows:

| | 2008 | 2007 |
|---|---|---|
| Current maturities of non-current liabilities | 4,560 | 2,700 |
| Short term notes | 3,681 | 6,174 |
| Short-term loans from credit institutions | 12,494 | 2,184 |
| Total current loans and borrowings | 20,735 | 11,058 |
| Total loans and borrowings | 43,635 | 25,098 |

# Notes, contd.:

30. contd.:

At the end of December 2008 loans and borrowings due within one year amounted to ISK 20,735 million. Thereof 4,560 million are current maturities of long term loans and 16,175 million are revolvers and other short term loan facilities. At the same time the current ratio was 0.4 which is below the Company's target. The Company is working with its commercial bank, New Glitnir, on improving its debt maturity profile.

31. Secured bank loans are specified as follows:

| | Average interest rates | Total remaining balance 2008 | Average interest rates | Total remaining balance 2007 |
|---|---|---|---|---|
| Debt in USD | 5.3% | 20,776 | 5.6% | 12,230 |
| Debt in EUR | 4.3% | 1,995 | 6.9% | 1,629 |
| Debt in GBP | | 0 | 7.9% | 19 |
| Debt in JPY | | 0 | 2.2% | 16 |
| | | 22,771 | | 13,894 |
| Debt in ISK indexed | 8.7% | 2,387 | 6.5% | 957 |
| Debt in ISK not indexed | 18.0% | 384 | | 0 |
| Total secured bank loans | | 25,542 | | 14,851 |

32. Contractual repayments of loans and borrowings are specified as follows:

| | 2008 | 2007 |
|---|---|---|
| Repayments in 2008 | - | 11,058 |
| Repayments in 2009 | 20,735 | 1,202 |
| Repayments in 2010 | 3,609 | 1,845 |
| Repayments in 2011 | 8,308 | 1,754 |
| Repayments in 2012 | 1,922 | 5,345 |
| Repayments in 2013 | 2,642 | 938 |
| Subsequent repayments | 6,419 | 2,956 |
| Total loans and borrowings | 43,635 | 25,098 |

# Notes, contd.:

## Convertible notes

33. Convertible notes are specified as follows::

| | 2008 | 2007 |
|---|---|---|
| Proceeds from issue of convertible notes - nominal amount | 2,000 | 2,000 |
| Transaction cost | (29) | (39) |
| Net proceeds | 1,971 | 1,961 |
| Amount classified as equity | (82) | (110) |
| Expensed transaction cost | 29 | 38 |
| Carrying amount of liability | 1,918 | 1,889 |

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.

## Prepayments

34. Prepayments at the end of the year consist of deposits from 3rd party in relation to future aircraft transactions.

## Deferred income tax liability

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

| | | |
|---|---|---|
| Deferred income tax liability 1.1. | 134 | 360 |
| Additions through business combination | (218) | 0 |
| Exchange rate difference | 529 | (128) |
| Income tax recognised in income statement | 643 | (128) |
| Income tax recognised in equity | (1,065) | 30 |
| Deferred income tax liability 31.12. | 23 | 134 |

Deferred tax assets and liabilities is attributable to the following:

| | Assets | | Liabilities | | Net | |
|---|---|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 | 2008 | 2007 |
| Operating assets | (319) | 0 | 2,107 | 1,453 | 1,788 | 1,453 |
| Intangible assets | (24) | 0 | 62 | 91 | 38 | 91 |
| Derivatives | (420) | (5) | 0 | 0 | (420) | (5) |
| Trade receivables | (38) | 0 | 21 | 34 | (17) | 34 |
| | (801) | (5) | 2,190 | 1,578 | 1,389 | 1,573 |
| Tax loss carry-forwards | (1,200) | (1,339) | 0 | 0 | (1,200) | (1,339) |
| Other items | (193) | (100) | 27 | 0 | (166) | (100) |
| Deferred income tax | (2,194) | (1,444) | 2,217 | 1,578 | 23 | 134 |

# Notes, contd.:

35. contd.:

| | 1 January 2008 | Recognised in income statement | Exchange rate difference | Additions through business combination | Recognised in equity | 31 December 2008 |
|---|---|---|---|---|---|---|
| Operating assets | 1,453 | 489 | (212) | 58 | 0 | 1,788 |
| Intangible assets | 91 | 9 | (19) | (43) | 0 | 38 |
| Derivatives | (5) | 648 | 2 | 0 | (1,065) | (420) |
| Trade receivables | 34 | (24) | (7) | (20) | 0 | (17) |
| Tax loss carry-forwards | (1,339) | (521) | 835 | (175) | 0 | (1,200) |
| Other items | (100) | 42 | (70) | (38) | 0 | (166) |
| | 134 | 643 | 529 | (218) | (1,065) | 23 |

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

**Share-based payments**

36. 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.

# Notes, contd.:

36. contd.:

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

| | Weighted average exercise price 2008 | Number of options 2008 | Weighted average exercise price 2007 | Number of options 2007 |
|---|---|---|---|---|
| Outstanding at 1 January | 27,5 | 51,270 | | 0 |
| Exercised during the year | | 0 | | 0 |
| Granted during the year | | 0 | 27,5 | 60,340 |
| Forfeited during the year | 27,5 | (23,017) | 27,5 | (9,070) |
| Outstanding at 31 December | 27,5 | 28,253 | 27,5 | 51,270 |
| Exercisable at 31 December | | 0 | | 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 60 million (2007: ISK 168 million) including forfeited options during the year and accrued social security expenses related to share-based payments.

**Trade and other payables**

37. Trade and other payables are specified as follows:

| | 2008 | 2007 |
|---|---|---|
| Trade payables | 7,898 | 4,546 |
| Derivatives used for hedging | 5,534 | 143 |
| Other payables | 13,341 | 7,902 |
| Total trade and other payables | 26,773 | 12,591 |

# Notes, contd.:

37. contd.:

On 6 October 2008 Althingi, the Parliament of Iceland, passed Law no. 125/2008, authorizing a disbursement of funds from the Treasury due to the unusual situation facing the financial market, which includes a change to the Act on Financial Undertakings no. 161/2002 and other laws. This law authorized the Financial Supervisory Authority of Iceland, FME, inter alia, to take special measures, due to unusal circumstances, in order to minimize harm or danger of harm to the financial market. On 7 October 2008, FME took control over the Company's commercial bank Glitnir Bank hf. On 14 October 2008, FME took decision on the disposal of assets and liabilities of Glitnir Bank hf. to New Glitnir Bank hf. which is now the commercial bank for the Company in Iceland on 7 October 2008 Icelandair Group hf. had several open derivatives with Glitnir Bank hf. These derivatives are considered, by the Company, in default on 7 October 2008 and therefore that is considered to be the settlement date

All derivative with Glitnir Bank hf. have been calculated based on 7 October 2008. Due to fluctuations on the ISK these calculations could change to some extent if the settlement date would be considered else. If the settlement date is considered 31 December 2008 the other payables would increase by approx ISK 600 million.

### Deferred income

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

### Financial risk management

39. 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.

### 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.

# Notes, contd.:

39. contd.:

*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 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 | 2008 | 2007 |
|---|---|---|---|
| Long-term receivables and deposits | 23 | 6,054 | 1,788 |
| Trade and other receivables | 25 | 13,836 | 7,284 |
| Receivables from sale of aircrafts | | 0 | 1,753 |
| Cash and cash equivalents | 27 | 4,065 | 2,006 |
| | | 23,955 | 12,831 |

**Impairment losses**

The aging of trade receivables at the reporting date was: :

| | Gross 2008 | Impairment 2008 | Gross 2007 | Impairment 2007 |
|---|---|---|---|---|
| Not past due | 5,637 | 0 | 4,643 | 0 |
| Past due 0-30 days | 1,278 | 0 | 266 | 0 |
| Past due 31-120 days | 1,477 | (160) | 40 | (10) |
| Past due 121-365 days | 653 | (266) | 0 | 0 |
| More than one year | 569 | (399) | 450 | (231) |
| | 9,614 | (825) | 5,399 | (241) |

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

| | 2008 | 2007 |
|---|---|---|
| Bal ance at January | 241 | 262 |
| Impairment loss recognised (reversed) | 584 | (21) |
| Balance at 31 December | 825 | 241 |

Amounts are in ISK million

# Notes, contd.:

39. contd.:

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.

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

| 2008 | Carrying amount | Contractual cash flows | Within 12 months | 1-2 years | 2-5 years | After 5 years |
|---|---|---|---|---|---|---|
| **Financial liabilities** | | | | | | |
| Unsecured bond issue | 16,175 | (16,175) | (16,175) | 0 | 0 | 0 |
| Secured bank loans | 25,542 | (31,396) | (5,852) | (4,674) | (14,379) | (6,491) |
| Convertible notes | 1,918 | (2,189) | 0 | 0 | (2,189) | 0 |
| Trade and other payables | 26,773 | (26,773) | (26,773) | 0 | 0 | 0 |
| | 70,408 | (76,533) | (48,800) | (4,674) | (16,568) | (6,491) |
| **Off balance sheet liabilities** | | | | | | |
| Operating lease payments | 0 | (66,556) | (17,345) | (14,672) | (28,302) | (6,237) |
| Pre delivery payments | 0 | (23,287) | (876) | (815) | (14,907) | (6,689) |
| | 0 | (89,843) | (18,221) | (15,487) | (43,209) | (12,926) |
| **Exposure to liquidity risk** | 70,408 | (166,376) | (67,021) | (20,161) | (59,777) | (19,417) |

Unused loan commitments at year end 2008 amounted to ISK 1,643 million.

# Notes, contd.:

39. contd.:

| 2007 | Carrying amount | Contractual cash flows | Within 12 months | 1-2 years | 2-5 years | After 5 years |
|---|---|---|---|---|---|---|
| **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 & other payables | 12,591 | (12,591) | (12,591) | 0 | 0 | 0 |
| | 37,689 | (42,280) | (24,779) | (2,172) | (11,018) | (4,311) |
| **Off balance sheet liabilities** | | | | | | |
| 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 |
| | 0 | (38,765) | (9,215) | (9,107) | (19,225) | (1,218) |
| **Exposure to liquidity risk** | 37,689 | (81,045) | (33,994) | (11,279) | (30,243) | (5,529) |

**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. 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 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, CZK 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 options. Due exceptional domestic and international economic circumstances on the financial markets, hedge ratios have temporarily fallen below the lower policy boundaries of 40%.

# Notes, contd.:

39. contd.:

*Exposure to currency risk*

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

| **2008** | USD | EUR | DKK | SEK | NOK | CZK |
|---|---|---|---|---|---|---|
| Net bal. sheet exposure | 5,563 | ( 1,271) | 132 | 120 | 53 | ( 2,142) |
| Estim, forecast revenue | 45,820 | 30,031 | 2,064 | 1,943 | 1,412 | 27,296 |
| Estim, forecast purchases | ( 70,405) | ( 23,421) | ( 655) | ( 469) | ( 467) | ( 9,364) |
| Forward FX contracts | 3,997 | ( 3,997) | 0 | 0 | 0 | 0 |
| Net currency exposure | (15,025) | 1,342 | 1,541 | 1,594 | 998 | 15,790 |

| **2007** | USD | EUR | DKK | SEK | NOK |
|---|---|---|---|---|---|
| Net bal. sheet exposure | 1,046 | ( 2,404) | 192 | 169 | 133 |
| Estim, forecast revenue | 16,210 | 6,450 | 1,830 | 1,857 | 1,769 |
| Estim, 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 |

The following significant exchange rates applied during the year

| | Average rate | | Reporting date spot rate | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| USD | 88.16 | 64.21 | 121.61 | 62.62 |
| EUR | 127.69 | 87.85 | 170.09 | 92.20 |
| CZK | 5.48 | - | 6.38 | - |
| DKK | 17.15 | 11.76 | 22.84 | 12.36 |
| SEK | 13.23 | 9.47 | 15.64 | 9.74 |
| NOK | 15.46 | 10.94 | 17.42 | 11.57 |

*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 2007.

# Notes, contd.:

39. contd.:

| 2008 | Equity | Profit or loss |
|---|---|---|
| USD | 1,277 | 1,517 |
| EUR | ( 114) | 78 |
| DKK | ( 131) | ( 131) |
| SEK | ( 135) | ( 135) |
| NOK | ( 85) | ( 85) |
| CZK | ( 1,342) | 0 |
| **2007** | | |
| USD | 137 | 309 |
| EUR | 212 | 264 |
| DKK | ( 68) | ( 68) |
| SEK | ( 143) | ( 143) |
| NOK | ( 129) | ( 129) |

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.

**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 amounts 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, however this year there has been a turnaround with rates falling sharply below 2%.

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

| | Carrying amount | |
|---|---|---|
| | 2008 | 2007 |
| Fixed rate instruments | | |
| Financial assets | 3,406 | 1,525 |
| Financial liabilities | ( 5,914) | ( 10,325) |
| | (2,508) | (8,800) |
| Variable rate instruments | | |
| Financial liabilities | ( 37,721) | ( 14,773) |

*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.

# Notes, contd.:

39. contd.:

A change of 100 basis points in interest rates would have increased or decreased equity by 247 million (2007: 255 million).

*Cash flow 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 2007.

| | Equity | |
|---|---|---|
| | 100 bp increase | 100 bp decrease |
| **2008** | | |
| Variable rate instruments | 122 | (125) |
| Total | 122 | (125) |
| **2007** | | |
| Variable rate instruments | 130 | (125) |
| Total | 130 | (125) |

**Other market riskt**

*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 2008 the monthly average of jet fuel prices reached a record level of 1,356 USD/t in July, having continuously rallied from 550 USD/t in January 2007. Since July prices have fallen sharply. 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 2008 was roughly 40-50%. Due market conditions the management decided in early September to scale down the hedge exposure below the lower policy limits and purchase put options. As these options fail effectiveness tests, their positive value due falling oil prices spill some influence on the profit and loss accounts in 2008 as can be see below in the sensitivity analysis. Furthermore, the newly included subsidiary Travel Service adds to the effects on equity in 2008 compared to 2007.

*Sensitivity analysis*

The following table demonstrates the sensitivity of financial instruments to a reasonably possible change in fuel prices, with all other variables held constant, on profit before tax and equtiy:

| | 2008 | 2007 | 2008 | 2007 |
|---|---|---|---|---|
| | Effect on equity | | Effect on profit before tax | |
| Increase in fuel prices by 10 % | 412 | 174 | ( 60) | 0 |
| Decrease in fuel prices by 10 % | ( 414) | ( 59) | 67 | 0 |

**Capital management**

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

# Notes, contd.:

39. contd.:

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 2008 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 41.

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

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

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | Carrying amount | Fair value | Carrying amount | Fair value |
| Loans and receivables | 19,890 | 19,890 | 10,825 | 10,825 |
| Cash and cash equivalents | 4,065 | 4,065 | 2,006 | 2,006 |
| Unsecured bond issue | 0 | 0 | (8,358) | (8,354) |
| Secured bond loans | (25,542) | (25,542) | (14,851) | (14,755) |
| Convertible notes | (1,918) | (1,918) | (1,889) | (1,946) |
| Trade and other payables | (26,773) | (26,773) | (12,591) | (12,591) |
| Total | (30,278) | (30,278) | (24,858) | (24,815) |

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

### Off-balance sheet items

41. As a lessee the Company has in place operating leases for 44 aircrafts at the end of December 2008. The leases are for sixteen Boeing 757 aircrafts, four Boeing 767 aircrafts, fifteen Boeing 737, eight Airbus A730 aircrafts an one Cessna. The Company also has in place operating leases for storage facilities, accommodations, equipment and fixtures for its operations, the longest until the year 2016. At the end of the year 2008 the leases are payable as follows:

| | Real estate | Aircrafts | Other | Total 2008 | Total 2007 |
|---|---|---|---|---|---|
| In the year 2008 | | | | - | 6,272 |
| In the year 2009 | 1,270 | 15,884 | 191 | 17,345 | 5,951 |
| In the year 2010 | 1,187 | 13,313 | 172 | 14,672 | 5,196 |
| In the year 2011 | 1,115 | 11,489 | 106 | 12,710 | 4,301 |
| In the year 2012 | 1,073 | 8,781 | 16 | 9,870 | 3,115 |
| In the year 2013 | 960 | 4,758 | 4 | 5,722 | 1,065 |
| Subsequent | 2,508 | 3,729 | 0 | 6,237 | 153 |
| Total | 8,113 | 57,954 | 489 | 66,556 | 26,053 |

42. As a lessor the Company leases aircrafts on wet, dry and other various leases, both on short and long term leases. Lease income for the year 2008 amounted to ISK 53,055 million (2007; ISK 15,510 million)

### Capital commitments

43. The Group has agreements with Boeing regarding the purchase of two Boeing 737-800 aircraft to be delivered in 2010 and five Boeing 787 Dreamliner aircrafts to be delivered in the year 2012 and in 2015. The Group also has an option to purchase two additional 787 Dreamliner aircrafts.

### Litigations and claims

44. 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 2007, amounting to ISK 60 million was lowered to ISK 40 million by the decision of the Supreme Court this year. As the full amount had been expensed in prior year ISK 20 million was posted as revenue as a final conclusion to this case.

### Related parties

*Identity of related parties*

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

*Transaction with associates*

During the year 2008 the Group purchased services from associates amounting to ISK 516 million (2007: ISK 375 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 370 million and is included in the item long-term receivables and deposits in the balance sheet. Interest income amounting to ISK 34 million is recognised in the income statement. Transactions with associates are priced on an arm's length basis.

*Transactions with management and key personnel*

During the year 2008 the Group granted to the Managing Directors guarantees in relation to purchase of shares in the Company. These guarantees amounted to ISK 136 million and are expensed in the income statement.

Salaries and benefits of management paid for their work for Group companies during the year 2008, share option agreements and shares in the Company are specified as follows:

| | Salaries and benefits | Share options | Shares held at year-end 2008 | Share held by related parties |
|---|---|---|---|---|
| **Board of Directors:** | | | | |
| Gunnlaugur M. Sigmundsson, chairman of the board | 9.6 | | | 392.1 |
| Ómar Benediktsson | 6.3 | | | |
| Ásgeir Baldurs | 3.4 | | | |
| Einar Sveinsson | 3.6 | | | 392.1 |
| Finnur Reyr Stefánsson | | | | 38.2 |
| | | | | |
| Jón Benediktsson, alternative board member | 3.3 | | 0.4 | 12.8 |
| Martha Eiríksdóttir, alternative board member | 4.7 | | 0.1 | |
| Sigurður Atli Jónsson, alternative board member | 2.2 | | | |

Amounts are in ISK million

45. contd.:

| | Salaries and benefits | Share options | Shares held at year-end 2008 | Share held by related parties |
|---|---|---|---|---|
| **CEO:** | | | | |
| Björgólfur Jóhannsson CEO of Icelandair Group hf. | 37.4 | | | |
| **Managing directors:** | | | | |
| Sigþór Einarsson, COO and Deputy CEO of the Group | 28.7 | 1.9 | 0.1 | 3.7 |
| Bogi Nils Bogason, CFO of the Group | 4.1 | | | |
| Hlynur Elísson, former CFO of the Group | 21.8 | 1.9 | 0.1 | 2.2 |
| Twelve MD of subsidiaries | 225.3 | 12.6 | 2.4 | 10.7 |

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

## Group entities

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

| | Ownership interest 2008 | 2007 |
|---|---|---|
| Scheduled airline & tourism operations:: | | |
| Air Iceland ehf. | 100% | 100% |
| Iceland Travel ehf. | 100% | 100% |
| Icelandair ehf. | 100% | 100% |
| Icelandair Cargo ehf. | 100% | 100% |
| Icelandair Ground Services ehf. (IGS) | 100% | 100% |
| Icelandair Hotels ehf. | 100% | 100% |
| Global capacity solutions and aircraft trading: | | |
| Bluebird Cargo ehf. | 100% | 100% |
| IceLease ehf. | 100% | 100% |
| IG Invest ehf. | 100% | 100% |
| Loftleiðir - Icelandic ehf. | 100% | 100% |
| Smart Lynx, Latvia | 100% | 100% |
| Lerox CZ s.r.o., Czech Republic, dormant | 100% | 100% |
| Travel Service, Czech Republic | 66% | 50% |
| Shared services: | | |
| IceCap Ltd., Guernsey | 100% | 100% |
| Icelandair Shared Services ehf. | 100% | 100% |

The subsidiaries own 15 subsidiaries that are also included in the consolidated financial statements.

## Statement of cash flows

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

| | 2008 | 2007 |
|---|---|---|
| Gain on the sale of operating assets | (161) | (1,793) |
| Exchange rate difference and indexation of liabilities and assets | 580 | (248) |
| Share of loss (profit) of associates | (178) | 59 |
| Income tax | (450) | (128) |
| Other items | 52 | 208 |
| Total other operating items in the statement of cash flows | (157) | (1,902) |

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

| | 2008 | 2007 |
|---|---|---|
| Inventories, increase | (460) | (170) |
| Trade and other receivables, decrease | 286 | 1,076 |
| Trade and other payables, (decrease) increase | (207) | 643 |
| Prepaid income, increase | 408 | 845 |
| Net change in operating assets and liabilities in the statement of cash flows | 27 | 2,394 |

49. Additional cash flow information:

| | 2008 | 2007 |
|---|---|---|
| Interests paid | 3,186 | 2,365 |
| Interests received | 200 | 352 |
| Income tax paid | 0 | 17 |

## Ratios

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

| | 2008 | 2007 |
|---|---|---|
| Working capital ratio | 0.40 | 0.46 |
| Equity ratio | 0.20 | 0.37 |
| Intrinsic value of share capital | 20.59 | 25.52 |

| | |
|---|---|
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