Icelandair Group hf.

Consolidated Financial Statements
for the year 2008

ISK

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

Contents

Endorsement and Statement by the Board of Directors and the CEO

Operations in the year 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:

Ómar Benediktsson
Ásgeir Baldurs
Einar Sveinsson
Jón Benediktsson
Marta 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.

Amounts are in ISK million

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.

Consolidated Financial Statements of Icelandair Group hf. 2008 7 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.

Amounts are in ISK million

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.

Consolidated Financial Statements of Icelandair Group hf. 2008 9 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.

(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 equity.

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

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

c. ***Financial instruments***

(i) *Non-derivative financial instruments*

Non-derivative financial instruments comprise 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).

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

3c. contd.:

(ii) *Derivative financial instruments*

The Group holds derivative financial instruments to hedge its foreign currency, fuel price and interest rate risk exposures. Derivatives are recognised initially at fair value; attributable transaction costs are recognised in profit or loss when incurred. Subsequent to initial recognition, derivatives are measured at fair value, and changes therein are accounted for as described below. 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.

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.

3d. contd.:

(iv) *Depreciation*

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

	Useful life
Aircrafts and flight equipment	10-14 years
Engines	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.

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.

3. contd.:

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.

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.

3. contd.:

k. ***Provisions***

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

(i) *Frequent flyer program*

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

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

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

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.

3. contd.:

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.

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.

3. contd.:

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.

- 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.

3s. contd.:

- 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.

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.

4. contd.:

(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.

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.

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

Consolidated Financial Statements of Icelandair Group hf. 2008 24 Amounts are in ISK million

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)	(282)	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

Consolidated Financial Statements of Icelandair Group hf. 2008 25 Amounts are in ISK million

Business combination

6. On 18 September 2007 the Company signed a purchase agreement for the acquisition of the Czech airline Travel Service, the largest private airline in the Czech Republic. Travel Service operates charter flights to and from Prague and Budapest and also owns and operates the low cost airline Smart Wings. According to the agreement Icelandair Group hf. 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.

   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.

Consolidated Financial Statements of Icelandair Group hf. 2008 26 Amounts are in ISK million

6. contd.:

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.

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

Consolidated Financial Statements of Icelandair Group hf. 2008 Amounts are in ISK million

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:

Deferred tax expense	2008	2007
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)

14. Income tax recognised directly in equity:

	2008	2007
Derivatives	1.065	30
Total income tax recognised directly in equity	1.065	30

Consolidated Financial Statements of Icelandair Group hf. 2008 Amounts are in ISK million

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%	

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

Consolidated Financial Statements of Icelandair Group hf. 2008 29 Amounts are in ISK million

Insurance value of other operating assets

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

	Official assessment value	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.

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	Goodwill	Trademarks and slots	Customer relations	Other intangibles	Total
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

Consolidated Financial Statements of Icelandair Group hf. 2008 Amounts are in ISK million

19. contd.:

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

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%
2010 - 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%

Consolidated Financial Statements of Icelandair Group hf. 2008 Amounts are in ISK million

Notes, contd.:

20. contd.:

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

	Scheduled airline and tourism operations	Global capacity and aircraft trading	Shared services
WACC +1%	(2.095)	0	(50)
EBITDA - 5%	(1.179)	0	(34)

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.

Consolidated Financial Statements of Icelandair Group hf. 2008 Amounts are in ISK million

Long-term receivables and deposits

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:

	2008	2007
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

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.

Consolidated Financial Statements of Icelandair Group hf. 2008 Amounts are in ISK million

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

27. Cash and cash equivalents are specified as follows:

	2008	2007
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.

Consolidated Financial Statements of Icelandair Group hf. 2008 34 Amounts are in ISK million

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.

	2008	2007
Non-current loans and borrowings are specified as follows:		
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:		
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

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

Convertible notes

33. Convertible notes are specified as follows:

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.

Consolidated Financial Statements of Icelandair Group hf. 2008 36 Amounts are in ISK million

Deferred income tax liability

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

	2008	2007
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

	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

Consolidated Financial Statements of Icelandair Group hf. 2008 Amounts are in ISK million

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.

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

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 th 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.

Consolidated Financial Statements of Icelandair Group hf. 2008 39 Amounts are in ISK million

39. contd.

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.

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)

Consolidated Financial Statements of Icelandair Group hf. 2008 Amounts are in ISK million

39. contd.

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

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

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.

Consolidated Financial Statements of Icelandair Group hf. 2008 Amounts are in ISK 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%.

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

Consolidated Financial Statements of Icelandair Group hf. 2008 Amounts are in ISK million

39. contd.:

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.

	Equity	Profit or loss
2008		
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.

Consolidated Financial Statements of Icelandair Group hf. 2008 Amounts are in ISK million

39. contd.:

Interest rate risk

The largest share of outstanding long term loans, carrying 3-6 months floating interest rates are directly related to aircraft financing and denominated in USD. That is a consequence of the fact that the most liquid market for commercial aircraft denominates prices in USD. The Group follows a policy of hedging 40-80% of interest rate exposure. Swap contracts are mainly used to exchange floating rates for fixed up to 5 years ahead, which currently 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.

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)

Consolidated Financial Statements of Icelandair Group hf. 2008 44 Amounts are in ISK million

39. contd.:

Other market risk

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.

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.

Consolidated Financial Statements of Icelandair Group hf. 2008 Amounts are in ISK million

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.

Consolidated Financial Statements of Icelandair Group hf. 2008 46 Amounts are in ISK million

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			
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.

Consolidated Financial Statements of Icelandair Group hf. 2008 47 Amounts are in ISK million

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

Consolidated Financial Statements of Icelandair Group hf. 2008 48 Amounts are in ISK million

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:

Working capital ratio	0,40	0,46
Equity ratio	0,20	0,37
Intrinsic value of share capital	20,59	25,52

Consolidated Financial Statements of Icelandair Group hf. 2008 49 Amounts are in ISK million