

FL GROUP hf.

Consolidated Financial Statements Year Ended 31 December 2005

FL GROUP hf.
Suðurlandsbraut 12
108 Reykjavík
Reg. no. 601273-0129

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Endorsement and Signatures of the Board of Directors and the CEO

FL GROUP hf.'s financial statements are for the first time prepared according to International Financial Reporting Standards. The Company's financial statements for the previous years have been prepared in accordance with the Financial Statements Act and accounting principles in Iceland. The total effect of IFRS adoption on the Company's financial statements is that equity at the beginning of the year 2005 decreases by ISK 195 million, from ISK 14,935 million to ISK 14,740 million. The effect of IFRS adoption is further explained in the notes to the financial statements.

During the year fundamental changes were made on the Group's organisational structure, the Company's main operations are now considered to be investment activities. The Company's investments will fall under two key areas which are on one hand strategic investments, and on the other hand asset management and investments. The presentation of the financial statements and comparative amounts have been altered according to this new strategy.

In the beginning of the year 2006 the Company announced its intention to float Icelandair Group ehf. on the Icelandic Stock Exchange. A total of 11 subsidiaries of FL GROUP hf. at the end of the year 2005, form Icelandair Group hf.

According to the income statement net profit for the year amounted to ISK 17,251 million. According to the balance sheet, equity at the end of the period amounted to ISK 74,443 million, including share capital in the amount of ISK 5,802 million.

In August 2005 the acquisition of the subsidiaries Bláfugl hf. and Flugflutningar ehf. was finalised. Both subsidiaries are consolidated from that time.

In November 2005 the Company issued new shares at a nominal value of ISK 3,235 million at ISK 13.6 per share. The shares were, for the most part, paid with shares listed on the Icelandic Stock Exchange. At a shareholders meeting in November 2005, the Board of Directors was granted permission to issue new shares at a nominal value of ISK 330 million at the price of ISK 13.6 per share, with the intention to acquire Sterling Airlines A/S and related companies. The Board of Directors used a large portion of this permission at the beginning of the year 2006. The Company has taken over the operations of Sterling Airlines A/S as of January 6, 2006, financial statements of Sterling will be a part of the consolidated financial statements of FL GROUP hf. from that date.

The Company's share capital amounted to ISK 5,845 million at the end of the year, the Company holds own shares in the amount of ISK 43 million. Shareholders at the end of the year 2005 were 5,024, but were 4,133 at the beginning of the year, an increase of 891 during the year. Two shareholders held more than 10% of outstanding shares, they are Landsbanki Íslands hf. with a 30.1% share, thereof a 28.3% share has been sold forward, and Eignarhaldsfélagið Oddaflug ehf. with an 20.0% share. When forward agreements are taken into account, Baugur Group hf. has a 19.4% share and the share of Icon ehf. and Materia Invest ehf., which are mostly owned by the same shareholders, was 14.7%.

The Board of Directors proposes a dividend payment of 104% of the nominal value of share capital, in 2006 arising from operations in 2005 in the amount of ISK 6,034 million. The dividend payment therefore is 35% of profits for the year, reference is made to the notes to the financial statements regarding information on other changes in equity.

The Board of Directors and the CEO of FL GROUP hf. hereby confirm the Company's financial statements by means of their signatures:

Reykjavík, March 10, 2006

The Board of Directors:

Skarphéðinn Berg Steinarsson, stjórnarformaður
Magnús Ármann Smári S. Sigurðsson
Þorsteinn M. Jónsson Þórður Bogason

CEO:

Hannes Smárason

Auditors' Report

Board of Directors and Shareholders of FL GROUP hf.

We have audited the accompanying consolidated balance sheet of FL GROUP hf. (the "Company") as of December 31, 2005 and the related consolidated statement of income and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements give a true and fair view of the financial position of the Company as of December 31, 2005 and of the results of its operations and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU.

Reykjavík, March 10, 2006

Jón S. Helgason

Sæmundur Valdimarsson

KPMG Endurskoðun hf.

Income Statement for the year 2005

	Note	2005	2004
Investment income:			
Profits from investments and derivatives	4	21.199	2.319
Interest income		1.270	545
Interest expenses	(2.258)	(928)
Net foreign exchange (loss) gain	(621)	218
		19.590	2.154
Operating income:			
Income from aviation services	5	35.470	31.234
Other income		12.174	11.352
		47.644	42.586
Operating expenses:			
Aviation services expenses	6	33.271	29.522
Other operating expenses		13.420	10.900
		46.691	40.422
Profit before income tax		20.543	4.318
Income tax expense	10,11	(3.292)	(713)
Profit for the year		17.251	3.605
Attributable to:			
Equity holders of the parent		17.249	3.602
Minority interest		2	3
Profit for the year		17.251	3.605
Earnings per share:			
Basic earnings per share (ISK)	12	5,90	1,63
Diluted earnings per share (ISK)	12	5,84	1,61

Balance Sheet December 31, 2005

	Note	2005	2004
Assets:			
Cash and cash equivalents		10.350	2.819
Securities	13	68.658	12.912
Derivatives	14	6.341	462
Investments in companies	15	480	384
Inventories	16	876	832
Trade and other receivables	17-18	7.222	5.267
Operating assets	19-24	35.221	20.522
Intangible assets	25-27	3.470	284
Total assets		132.618	43.482
 Equity:			
Share capital	28	5.802	2.525
Share premium		43.169	3.609
Other reserves		434	(636)
Retained earnings		25.027	9.242
Total equity attributable to equity holders of the parent		74.432	14.740
Minority interest		11	21
Total equity	29	74.443	14.761
 Liabilities:			
Interest-bearing loans and borrowings	30-32	39.668	17.355
Derivatives		277	285
Deferred income tax liability	33	4.694	1.451
Pension liability		345	191
Trade and other payables	34	10.550	7.290
Prepaid income	35	2.641	2.149
Total liabilities		58.175	28.721
Total equity and liabilities		132.618	43.482

Statement of Cash Flows for the year 2005

	Note	2005	2004
Cash flows from operating activities:			
Profit for the year		17.251	3.605
Adjustments for:			
Depreciation	8	2.408	2.440
Other operating items	39	(16.093)	(1.183)
Working capital from operations		3.566	4.862
Net change in operating assets and liabilities	40	1.855	(266)
Net cash provided by operating activities		5.421	4.596
Cash flows from investing activities:			
Securities, change		(22.000)	(14.599)
Investments in companies and receivables		(2.607)	(300)
Acquisition of subsidiary, net of cash acquired	3	(2.626)	0
Acquisition of operating assets		(18.159)	(2.921)
Acquisition of intangible assets		(111)	(296)
Proceeds from the sale of assets		5.269	83
Net cash used in investing activities		(40.234)	(18.033)
Cash flows from financing activities:			
Proceeds from the issue of share capital		24.399	2.025
Own shares, change		(1.471)	1.445
Dividend paid		(1.466)	(640)
Proceeds from borrowing		24.190	6.819
Repayment of borrowings		(3.916)	(1.660)
Net cash provided by financing activities		41.736	7.989
Increase (decrease) in cash and cash equivalents		6.923	(5.448)
Effect of exchange rate fluctuations on cash held		608	525
Cash and cash equivalents at 1 January		2.819	7.742
Cash and cash equivalents at 31 December		10.350	2.819
Investment and financing with out cash flow effect:			
Securities		(19.513)	0
Issued share capital		19.513	0
Other information:			
Interest income received		1.105	581
Interest expenses paid		1.956	820

Notes

Significant accounting policies

FL GROUP hf.'s legal residence is at Suðurlandsbraut 12, Reykjavík, Iceland. The consolidated financial statements of the Company for the year ended 31 December 2005 comprise the Company and its subsidiaries, together referred to as the "Group". The financial statements were authorised for issue by the directors on 10 March 2006.

a. *Statement of compliance*

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs) and its interpretations adopted by the International Accounting Standards Board (IASB), as confirmed by the EU. These are the Group's first consolidated financial statements prepared according to IFRS and IFRS 1, First-time Adoption of IFRS, has been applied.

An explanation of how the transition to IFRSs has affected the reported financial position and financial performance of the Group is provided in note 44. In the note, the changes in equity's comparative figures and the Group's results as they were disclosed according to Icelandic GAAP for the year 2004 and as they are according to IFRS, are explained.

b. *Basis of preparation*

The consolidated financial statements are presented in Icelandic kronas, rounded to the nearest million. They are prepared on the historical cost basis except that securities and derivative financial instruments are stated at their fair value.

The preparation of financial statements in conformity with IFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The consolidated financial statements have been prepared in accordance with valid International Financial Reporting Standards (IFRSs) or those who are allowed for preparation of first consolidated financial statements according to IFRS.

The preparation of financial statements in conformity with IFRS has led to changes in accounting policies from the previous year, the financial statements were prepared according to Icelandic GAAP for the year 2004. The accounting policies set out below have been applied consistently to all periods presented in these consolidated financial statements and in preparing an opening IFRS balance sheet at 1 January 2004 for the purposes of the transition to IFRSs.

The accounting policies have been applied consistently by Group entities.

Notes, contd.:

c. **Basis of consolidation**

(i) *Subsidiaries*

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

(ii) *Associates*

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

(iii) *Transactions eliminated on consolidation*

Intragroup balances and any unrealised gains and losses or income and expenses arising from intragroup transactions, are eliminated in preparing the consolidated financial statements. Unrealised gains arising from transactions with associates are eliminated to the extent of the Group's interest in the entity and are deducted from the carrying value of associates. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

d. **Foreign currency**

(i) *Foreign currency transactions*

Transactions in foreign currencies are translated at the foreign exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated to Icelandic kronas at the foreign exchange rate ruling at that date. Foreign exchange differences arising on translation are recognised in the income statement. Operating expenses and sales in foreign currencies are translated at the foreign exchange rate ruling at the date of the transaction.

(ii) *Financial statements in foreign currencies and of foreign operations*

The Parent Company and two domestic subsidiaries record their accounts in US dollars and prepare their financial statements in the same currency. Also there are a few foreign subsidiaries a part of the consolidated financial statements. The assets and liabilities of these foreign operations are translated to Icelandic kronas at foreign exchange rates ruling at the balance sheet date. The revenues and expenses of foreign operations are translated to Icelandic kronas at the average exchange rate for the period. Foreign exchange differences arising on retranslation are recognised directly in a separate component of equity.

e. **Derivative financial instruments**

The Company uses derivative financial instruments to hedge its exposure to interest rate risk, foreign exchange rate risk and fuel price risk arising from operational and financing activities. Derivative financial instruments are stated at fair value and the underlying assets are not recognised in the balance sheet.

Where derivatives qualify for hedge accounting of cash flow hedges, any gain or loss is recognised as a separate component of equity. The gain or loss on other derivative financial instruments is recognised in the income statement.

Notes, contd.:

e. Contd.:

(i) *Hedge of monetary assets and liabilities*

Where a derivative financial instrument is designated as a hedge of the variability in cash flows of a recognised asset or liability, or a highly probable forecasted transaction, the effective part of any gain or loss on the derivative financial instrument is recognised directly in equity. When the forecasted transaction affects profits or loss the associated cumulative gain or loss is removed from equity and recognised in the income statement. The ineffective part of any gain or loss is recognised immediately in the income statement.

(ii) *Hedging of fuel price risk*

Forward contracts and options entered into with the purpose of limiting exposure to fluctuation of jet fuel prices are recognised in the financial statements when the related fuel is used.

f. ***Cash and cash equivalents***

Cash and cash equivalents consist of cash balances and liquid bank deposits.

g. ***Securities and other financial instruments***

Securities comprise of shares and various other short-term securities, on which the Company intends to make a profit. Listed securities are stated at their latest quoted price and a change in their fair value is recognised in the income statement.

(i) *Classification*

The Company's investments comprise of investments in debt and equity securities. The investments are classified as current assets and stated at fair value through profit and loss and any resultant gain or loss recognised in the income statement. The investments include listed debt and equity securities, unit shares in mutual funds, unlisted debt and equity securities, derivative financial instruments and other short-term securities. Financial liabilities recognised at fair value are derivative financial instruments.

Debt and equity securities whose fair value cannot be reliably measured are stated at cost less impairment losses.

Financial assets, other than those stated at fair value through profit and loss, are shares in related companies as well as trade receivables and other receivables.

Financial liabilities, other than those stated at fair value through profit and loss, include interest-bearing loans and borrowings and trade payables.

(ii) *Initial recognition*

Financial assets and liabilities are recognised when the Company becomes a party to the contractual provisions of the instrument.

A conventional purchase of financial assets is recognised using trade date accounting. From this date any gains and losses arising from changes in fair value of the financial assets or financial liabilities are recorded.

Financial liabilities are not recognised unless a contractor has fulfilled his part of the agreement or if it is a derivative financial instrument not exempt from the scope of IAS 39.

Notes, contd.:

g. Contd.:

(iii) *Measurement*

Financial instruments are initially recognised at fair value (acquisition price). In case of a financial asset or financial liability not stated at fair value through profit and loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. Transaction costs on financial assets and financial liabilities at fair value are expensed immediately, while the cost is amortised for other financial instruments.

Subsequent to initial recognition, all instruments classified at fair value through profit or loss, are measured at fair value with changes recognised in the income statement.

Financial assets classified as loans and receivables are carried at amortised cost using the effective interest rate method, less impairment losses.

Financial liabilities, other than those at fair value through profit and loss, are measured at amortised cost using the effective interest rate.

(iv) *Fair value measurement principles*

The fair value of financial instruments is based on their quoted market prices or dealer price quotations for financial instruments traded in active markets at the balance sheet date without any deduction for estimated future selling costs.

If a quoted market price is not available on a recognised stock exchange or from broker for non-exchange-traded financial instruments, the fair value of the instrument is estimated using approved valuation techniques. The valuation techniques can include the use of recent arm's length market transactions, current fair value of another instrument that is substantially the same, discounted cash flow techniques, option pricing models or any other valuation technique that provides a reliable estimate of prices obtained in actual market transactions.

Where discounted cash flow techniques are used, estimated future cash flows are based on management's best estimates and the discount rate used is a market rate at the balance sheet date applicable for an instrument with similar terms and conditions. Where other pricing models are used, inputs are based on market data at the balance sheet date. Fair values for unquoted equity investments are estimated, if possible, using applicable price / earnings ratios for similar listed companies adjusted to reflect the specific circumstances of the issuer.

The fair value of derivatives that are not exchange-traded is estimated at the amount that the Group would receive or pay to terminate the contract at the balance sheet date taking into account current market conditions (volatility, appropriate yield curve) and the current creditworthiness of the counterparties. Specifically, the fair value of a forward contract is determined as a net present value of estimated future cash flows, discounted at appropriate market rates on the valuation date and the fair value of an option contract is determined by applying the Black-Scholes option valuation model.

(v) *Impairment*

The carrying amounts of the Group's assets are reviewed at each balance sheet date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated. An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognised in the income statement. The recoverable amount is calculated as the present value of estimated future cash flows, discounted at the original effective interest rate.

If an impairment loss, in respect of goodwill or non-current assets, is reversed the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

Notes, contd.:

(vi) *Derecognition*

The Group derecognises a financial asset when the contractual rights to the cash flows from the financial asset expire or it transfers the financial asset and the transfer qualifies for derecognition in accordance with IAS.

The Group uses the first in first out method to determine realised gains and losses on derecognition.

A financial liability is derecognised when the obligation specified in the contract is discharged, cancelled or expired.

h. *Investments in companies*

Investments in companies comprise investments in associates and other companies that are not a part of the investment operation of the Group. Shares in associates are stated according to the equity method. Investments in other securities are classified as held for sale and stated at cost since their fair value is not evident. Financial assets are recognised by the Group from the day the Group has committed to buy the financial assets and are derecognised when the Group commits to sell them.

i. *Inventories*

Goods for resale and supplies are stated at the lower of cost and net realisable value. Net realisable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses. Aircraft parts are capitalised at the foreign exchange rate ruling at the date of acquisition.

j. *Trade and other receivables*

Trade and other receivables are stated at their cost less impairment losses.

Long-term receivables consist of pre-payments, insurance deposits, deposits and debt securities classified as held to maturity. Long-term receivables are stated according to the effective interest rate.

k. *Operating assets*

(i) *Aircrafts and flight equipment*

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

Prepayments for undelivered aircrafts are recognised among aircrafts and related assets. The Company capitalises the financing costs arising from these prepayments according to the Company's average cost of debt.

(ii) *Buildings and other property and equipment*

Buildings and other property and equipment are stated at cost less accumulated depreciation and impairment losses.

Notes, contd.:

k. Contd.:

(iii) *Subsequent costs*

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

(iv) *Depreciation*

Depreciation is charged to the income statement on a straight-line basis over the estimated useful lives and is specified as follows:

	Useful life
Aircrafts and flight equipment	10-25 years
Engine hours	Flying hrs.
Buildings	20-50 years
Other property and equipment	3-8 years

The residual value is estimated annually, if not immaterial.

1. *Intangible assets*

(i) *Goodwill*

All business combinations are accounted for by applying the purchase method. Goodwill represents amounts arising on acquisition of subsidiaries and associates. In respect of business acquisitions that have occurred since 1 January 2004, 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. Every year an impairment test is performed.

Negative goodwill arising on an acquisition is recognised directly in profit or loss.

(ii) *Other intangible assets*

Other intangible assets that are acquired by the Group are stated at cost less accumulated amortisation and impairment losses. Amortisation is charged to the income statement on a straight line basis over the estimated useful life of the relevant asset. Estimated useful life is specified as follows:

	Useful life
Software	3 years
Other intangible assets	5 years

(iii) *Subsequent expenditure*

Subsequent expenditure on capitalised intangible assets 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.

Notes, contd.:

m. *Impairment*

The carrying amounts of the Group's assets, other than inventories and securities are reviewed at each balance sheet date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated. An impairment test is performed at least every year for intangible assets believed to have indefinite useful life.

An impairment loss is recognised whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. Impairment losses are recognised in the income statement.

An impairment test was performed on goodwill at the beginning of the year 2006. An impairment test was not performed on 1 January 2004, the day that the International Financial Reporting Standards were adopted, since the subsidiaries to which the goodwill belongs were acquired in the year 2005.

(i) *Calculation of recoverable amount*

The recoverable amount of the Group's long-term receivables is calculated as the present value of estimated future cash flows, discounted at the original effective interest rate. Receivables with a short duration are not discounted.

The recoverable amount of other assets is the greater of their net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

(ii) *Reversals of impairment*

An impairment loss in respect of receivables is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

Goodwill impairment is not reversed.

In respect of other assets, 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.

n. *Share capital*

(i) *Repurchase of share capital*

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

(ii) *Dividends*

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

Notes, contd.:

o. ***Interest-bearing loans and borrowings***

Interest-bearing loans and borrowings are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, interest-bearing loans and borrowings are stated on an effective interest basis.

p. ***Employee benefits***

(i) ***Retirement benefit obligation***

The company has entered into pension plan agreements with some of its former employees. The obligation is recognised in the balance sheet. The increase or decrease of the obligation is recognised in the income statement. The obligation is estimated according to average life expectancy and its present value calculated using 2% interest rates. Obligations arising from retirement agreements with former management personnel are recognised among trade and other payables in the balance sheet.

(ii) ***Share-based payment transactions***

The share option agreements entered into during the year 2005, allow Company employees to acquire shares of the Company. The fair value of options granted is recognised as an employee expense with a corresponding increase in equity. The fair value is measured at grant date and spread over the period during which the employees become unconditionally entitled to the options. The fair value of the options granted is measured using the Black Scholes model, taking into account the terms and conditions upon which the options were granted.

q. ***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. If the effect is material, 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, where appropriate, the risks specific to the liability.

r. ***Trade and other payables***

Trade and other payables are stated at cost.

s. ***Prepaid income***

Sold unused flight documents and other prepayments are presented as prepaid income in the balance sheet.

t. ***Investment income***

(i) ***Profits from investments and derivatives***

Profits from investments and derivatives comprise gain on the sale of shares, changes in the market value of securities, including dividend income, changes in the fair value of share based derivatives and gains and losses from associates.

(ii) ***Interest income***

Interest income is recognised in the income statement as it accrues, using the effective interest method.

Notes, contd.:

(iii) *Interest expenses*

Interest expenses comprise interest expenses of loans calculated using the effective interest rate method and other financing expenses.

(iv) *Net foreign exchange (loss) gain*

Net foreign exchange gain (loss) comprises foreign exchange changes arising from assets and liabilities denominated in foreign currencies and gains and losses arising from derivatives in relation to foreign currencies.

u. ***Operating income***

(i) *Income from aviation services*

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

(ii) *Other operating income*

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

v. ***Operating expenses***

(i) *Aviation services expenses*

Aviation services expenses comprise aircraft leases, fuel costs, service charges, landing and handling fees, aircraft maintenance, salaries and salary-related expenses, depreciation and other aviation services related costs.

(ii) *Other operating expenses*

Payments made according operating lease agreements are recognised on a straight-line basis of the duration of the lease agreement.

x. ***Income tax expenses***

Income tax on the profit or loss for the period comprise current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

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

Deferred tax is provided using the balance sheet liability 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 income tax effect arising from subsidiaries sold in the year 2006 have been recognised and entered in the financial statements. 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 balance sheet date.

Notes, contd.:

Segment reporting

- The segment information is presented in respect of the Group's business segments. The business segments are based on the Group's management and internal reporting structure. Results, assets and liabilities, and cash-flows are divided between investment activities, and aviation and tourism activities. This format is consistent with the Company's new direction, making investment activities its primary focus. In the interim financial statements published during the year 2005 the segment report has been presented differently, where in addition to the investment segment, there were also segment information regarding international flights and tourism services. The two latter segments are now included in one segment, aviation services and tourism. Included in the aviation and tourism services segment are all international flights, domestic flights, hotel operations, car rentals and other tourism services.

Segment results, assets and liabilities include items directly attributable to a segment as well as those that can be allocated on a reasonable basis. Aircrafts and real estate owned by the Parent Company and their operations are included in the aviation and tourist services segment.

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

Geographical segment information is not presented.

The Group's operations during the year 2005 by business segment is specified as follows:

	Investment activities		Aviation and tourism services		Eliminations		Consolidated	
	2005	2004	2005	2004	2005	2004	2005	2004
Income statement:								
Investment income	19.794	2.560	(204)	(406)			19.590	2.154
Operating income	232	0	47.412	42.586			47.644	42.586
Operating expenses								
before depreciation	(1.652)	(150)	(42.631)	(37.832)			(44.283)	(37.982)
Depreciation	0	0	(2.408)	(2.440)			(2.408)	(2.440)
Profit before tax	18.374	2.410	2.169	1.908	0	0	20.543	4.318
Income tax expense	(2.969)	(530)	(323)	(183)			(3.292)	(713)
Profit for the year	15.405	1.880	1.846	1.725	0	0	17.251	3.605
EBITDA	(1.420)	(150)	4.781	4.754	0	0	3.361	4.604
EBIT	(1.420)	(150)	2.373	2.314			953	2.164
Balance sheet:								
Segment assets	106.524	21.014	37.837	33.212	(11.743)	(10.744)	132.618	43.482
Segment liabilities	(32.093)	(6.079)	(30.835)	(27.905)	4.753	5.263	(58.175)	(28.721)
Cash flow statement:								
Net cash provided								
by operating activities	(278)	329	5.699	4.267			5.421	4.596
Investing activities	(37.708)	(9.186)	(2.526)	(8.847)			(40.234)	(18.033)
Financing activities	41.892	7.843	(156)	146			41.736	7.989

Notes, contd.:

Quarterly Statements

2. Summary of the Group's operating results by quarters:

The year 2005	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Total
Investment income	1.594	1.421	2.635	13.940	19.590
Operating income	7.816	12.248	16.774	10.806	47.644
Total income	9.410	13.669	19.409	24.746	67.234
Operating expenses without aircraft leases and depreciation	8.544	10.407	12.531	10.991	42.473
Aircraft leases	296	328	558	628	1.810
Depreciation	542	626	626	614	2.408
	9.382	11.361	13.715	12.233	46.691
Profit before income tax	28	2.308	5.694	12.513	20.543
Income tax expenses	(3)	(400)	(1.052)	(1.837)	(3.292)
Profit	25	1.908	4.642	10.676	17.251
Attributable to:					
Equity holders of the parent	26	1.907	4.638	10.678	17.249
Minority interest	(1)	1	4	(2)	2
Profit	25	1.908	4.642	10.676	17.251
Operating profit without depreciation and aircraft leases (EBITDAR)	(728)	1.841	4.243	(185)	5.171
Operating pr. before depr. (EBITDA)	(1.024)	1.513	3.685	(813)	3.361
Operating profit (EBIT)	(1.566)	887	3.059	(1.427)	953
The year 2004					
Investment income	158	193	(42)	1.845	2.154
Operating income	7.280	11.576	15.160	8.570	42.586
Total income	7.438	11.769	15.118	10.415	44.740
Operating expenses without aircraft leases and depreciation	7.532	9.541	10.811	8.653	36.537
Aircraft leases	381	407	369	288	1.445
Depreciation	570	628	646	596	2.440
	8.483	10.576	11.826	9.537	40.422
Profit before income tax	(1.045)	1.193	3.292	878	4.318
Income tax expenses	190	(221)	(575)	(107)	(713)
Profit	(855)	972	2.717	771	3.605
Attributable to:					
Equity holders of the parent	(856)	973	2.716	769	3.602
Minority interest	1	(1)	1	2	3
Profit (loss)	(855)	972	2.717	771	3.605
Operating profit without depreciation and aircraft leases (EBITDAR)	(252)	2.035	4.349	(83)	6.049
Operating pr. before depr. (EBITDA)	(633)	1.628	3.980	(371)	4.604
Operating profit (EBIT)	(1.203)	1.000	3.334	(967)	2.164

Notes, contd.:

Investments in subsidiaries

3. In February 2005 the Company acquired all outstanding shares in Bláfugl hf. and Flugflutningar hf. On August 16, 2005 the acquisition was finalized. The companies are therefore part of FL GROUP hf.'s consolidated financial statements as of that date.

Comparative amounts in the Consolidated Financial Statements do not contain amounts from the Financial Statements of the aforementioned companies.

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

Cash and cash equivalents	153
Trade and other receivables	545
Operating assets	1.988
Deferred income tax	(71)
Interest-bearing loans and borrowings	(1.467)
Trade and other payables	(262)
Net identifiable assets and liabilities	886
Goodwill on acquisition	3.243
Consideration paid	4.129
Consideration satisfied by share issue	(1.350)
Consideration satisfied in cash	2.779
Net cash acquired	(153)
Acquisition of subsidiary, net of cash acquired according to the statement of cash flows	2.626

Included in the consideration paid are acquisition related expenses, for example expert advisors fees and other fees.

The allocation of the consideration according to IFRS 3 is in process. It is estimated that the outcome will have insubstantial effect on the Group's financial statements.

Investment income

4. Profit from investments and derivatives are specified as follows:

	2005	2004
Gain on the sale of shares	1.473	592
Share of profit of associates	49	0
Change in fair value of securities	12.940	1.727
Change in the fair value of derivatives	6.737	0
Profit from investment and derivatives	21.199	2.319

Income from aviation services

5. Income from aviation services is specified as follows:

Passengers	25.549	21.789
Cargo and mail	3.504	3.373
Charter revenue and aircraft lease	6.038	5.594
Other operating revenue	379	478
Total income from aviation services	35.470	31.234

Notes, contd.:

Aviation services expenses

6. Aviation services expenses is specified as follows:

	2005	2004
Salaries, salary-related expenses and other personnel expenses	12.117	10.536
Aircraft fuel	7.149	5.582
Aircraft lease	2.919	2.059
Aircraft servicing, handling and communication	3.434	3.923
Aircraft maintenance expenses and cost of maintenance services sold	1.746	1.280
Booking fee and commission expenses	1.282	1.361
Communication expenses	945	886
Depreciation	1.840	1.891
Other operating expenses	1.839	2.004
Total aviation services expenses	<u>33.271</u>	<u>29.522</u>

Salary and related expenses

7. Salaries and related expenses are specified as follows:

Salaries	12.407	10.173
Salary-related expenses	2.567	2.048
Total salary and salary-related expenses	<u>14.974</u>	<u>12.221</u>
Other personnel expenses	2.664	2.214
Salaries, salary-related expenses and other personnel expenses, total	<u>17.638</u>	<u>14.435</u>
Average number of employees for the year	2.574	2.465

Salaries and salary-related expenses are allocated as follows on items in the income statement:

Aviation services expenses	12.117	10.536
Other operating expenses	5.521	3.899
Salaries, salary-related expenses and other personnel expenses, total	<u>17.638</u>	<u>14.435</u>

Depreciation

8. The Group's depreciation charge in the income statement is specified as follows:

	2005	2004
Depreciation of operating assets, see note 20	2.240	2.310
Amortisation of intangible assets, see note 25	168	130
Depreciation and amortisation recognised in the income statement	<u>2.408</u>	<u>2.440</u>

Depreciation is allocated as follows on operating items:

Aviation services expenses	1.840	1.891
Operating expenses	568	549
Depreciation according to the income statement	<u>2.408</u>	<u>2.440</u>

Notes, contd.:

Auditors' fees

9. Remuneration to the Company's Auditors are specified as follows:

	2005	2004
Audit of Financial Statements	18	11
Review of Interim Financial Statements	15	13
Other services	19	2
Total auditors' fees	<u>52</u>	<u>26</u>

The abovementioned figures include fees to the auditors of all companies within the Group. Fees to other auditors than the auditors of the Parent Company amounted to ISK 11 million during the year 2005.

Income tax expense

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

	2005	2004
Change in the deferred income-tax liability	<u>3.292</u>	<u>713</u>

11. Reconciliation of effective tax rate

	2005		2004	
Profit before tax		<u>20.543</u>		<u>4.318</u>
Income tax according to current tax rate	18,0%	3.697	18,0%	777
Non-deductible expenses	0,1%	25	0,7%	30
Tax exempt revenues	(0,2%)	(48)	(2,2%)	(94)
Deferred tax asset of subsidiaries	(0,9%)	(193)	0,0%	0
Other items	(0,9%)	(189)	0,0%	0
Effective tax rate	<u>16,0%</u>	<u>3.292</u>	<u>16,5%</u>	<u>713</u>

Earnings per share

12. 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 year and shows the earnings per each share. The calculation of diluted earnings per share takes into consideration the outstanding stock options when calculating the share capital.

Notes, contd.:

12. Contd.:

	2005	2004
Basic earnings per share:		
Profit for the year attributable to equity holders of the parent	17.249	3.602
Share capital at the beginning of the year	2.525	2.132
Effect of bought and sold own shares	(9)	52
Effect of the increase of share capital in November 2004		28
Effect of the increase of share capital in November 2005	408	
Calculated average share capital	2.924	2.212
Earnings per share of ISK 1	5,90	1,63
Diluted earnings per share:		
Profit for the year attributable to equity holders of the parent	17.249	3.602
Share capital at the beginning of the year	2.525	2.132
Effect of bought and sold own shares	(9)	52
Effect of the increase of share capital in November 2004		28
Effect of the increase of share capital in November 2005	408	
Effect of share options	32	25
Calculated average share capital	2.956	2.237
Diluted earnings per share of ISK 1	5,84	1,61

Securities

13. Securities are specified as follows:

	Market value 31.12.2005	Thereof assets in forwards	Carrying amount 31.12.2005
<i>Listed on foreign stock exchanges:</i>			
easyJet Plc.	26.697	3.628	23.069
Other companies	2.636	1.999	637
Total listed on foreign stock exchanges	29.333	5.627	23.706
<i>Listed on the Icelandic Stock Exchange:</i>			
Íslandsbanki hf.	22.320	8.494	13.826
KB Banki hf.	31.250	17.639	13.611
Straumur - Burðarás fjárfestingarbanki hf.	10.380	885	9.495
Landsbanki Íslands hf.	11.375	8.857	2.518
Kögun hf.	2.134	550	1.584
Other companies	6.650	3.284	3.366
Listed bonds	552		552
Total listed on the Icelandic Stock Exchange	84.661	39.709	44.952
Total securities	113.994	45.336	68.658

Notes, contd.:

Derivatives

14. Net assets in derivatives are specified as follows:

	Market value	
	31.12.2005	31.12.2004
Assets in listed shares, see note 13	45.336	0
Liabilities in share based derivatives	(40.377)	0
Nett asset in share based derivatives	4.959	0
Net position of currency based derivatives	1.382	462
Net asset in derivatives	6.341	462

Investments in companies

15. Investment in companies is specified as follows:

	2005	2004
Investment in associated companies	225	192
Investment in other companies	255	192
Total investment in companies	480	384

Inventories

16. Inventories are specified as follows:

	2005	2004
Flight equipment expendable parts	633	587
Fuel inventories	10	6
Other inventories	233	239
Total inventories	876	832

Notes, contd.:

Trade and other receivables

17. Trade and other receivables are specified as follows:

	2005	2004
Trade receivables	4.392	3.931
Prepaid expenses	350	307
Other receivables	1.273	736
Long-term receivables, see notes 18	1.442	515
Bad debt provision	(235)	(222)
Receivables and other payables total	<u>7.222</u>	<u>5.267</u>

Bad debt provision has been calculated because of receivables that may be lost. The bad debt provision is based on the judgement of the Group's management and historical experience.

18. Among long-term receivables there are payments of insurance deposits arising from aircraft and real estate leases, and loans in relations to investment projects. Long-term receivables are specified as follows:

Loans in relations to investment projects and other loans	928	116
Aircraft lease insurance deposits	366	188
Prepaid rent	57	59
Other deposits	91	152
Total long-term receivables	<u>1.442</u>	<u>515</u>

Operating assets

19. Operating assets according to the balance sheet is specified as follows:

	2005	2004
Operating assets, see note 20	20.731	19.785
Prepaid aircraft acquisitions, see note 21	14.490	737
Total operating assets	<u>35.221</u>	<u>20.522</u>

20. Operating assets are specified as follows:

Cost	Buildings	Aircraft and flight equipment	Other property and equipment	Total
Balance at 1.1.2004	3.802	24.297	3.352	31.451
Changes due to IFRS		118		118
Balance at 1.1.2004, restated (IFRSs)	3.802	24.415	3.352	31.569
Exchange rate difference	(488)	(3.054)	(1)	(3.543)
Additions during the year	9	1.234	771	2.014
Sales and disposals during the year	0	(88)	(296)	(384)
Balance at 31.12.2004	3.323	22.507	3.826	29.656
Exchange rate difference	90	573	0	663
Additions through business combinations	0	2.794	52	2.846
Additions during the year	181	3.646	1.108	4.935
Sales and disposals during the year	(252)	(5.484)	(690)	(6.426)
Transferred to other items	0	(67)	(31)	(98)
Balance 31.12.2005	<u>3.342</u>	<u>23.969</u>	<u>4.265</u>	<u>31.576</u>

Notes, contd.:

20. Contd.:

	Buildings	Aircraft and flight equipment	Other property and equipment	Total
Depreciation and impairment losses				
Balance at 1.1.2004, restated (IFRSs)	1.696	5.376	1.685	8.757
Exchange rate difference	(235)	(670)	(905)	
Depreciation	138	1.680	492	2.310
Sales and disposals during the year		(73)	(218)	(291)
Balance 31.12.2004	1.599	6.313	1.959	9.871
Exchange rate difference	44	122		166
Additions through business combinations		802	25	827
Depreciation	116	1.605	519	2.240
Sales and disposals during the year	(87)	(1.685)	(475)	(2.247)
Transferred to other items		(12)		(12)
Balance 31.12.2005	1.672	7.145	2.028	10.845
Carrying amounts				
1.1.2004	2.106	1.891	1.667	22.694
31.12.2004	1.724	16.194	1.867	19.785
31.12.2005	1.670	16.824	2.237	20.731
Depreciation ratios	2-4%	4-10%	12-33%	

During the year the Company sold operating assets in the amount of ISK 3,584 million. The gain on the sale is entered among other operating income in the income statement, the gain on the sale amounted to ISK 263 million.

Due to indications that the fair value of aircrafts was lower than their carrying amount, an impairment test was performed on aircrafts held by the Parent Company. According to the outcome, the estimated value in use was higher than the carrying amount and therefore no impairment losses were recognised.

21. Among aircraft prepayments in the financial statements there is a contract in the amount of ISK 14,490 million, for the purchase of 10 Boeing 737-800 aircrafts which will be delivered to the Company in the year 2006. The first aircraft will be delivered in March 2006. In May 2005 the Company entered into a contract regarding the purchase of additional five Boeing 737-800 aircrafts which will be delivered in the year 2007. The intention is to lease out all the aircrafts. In February 2005 the Company entered into an agreement with Boeing regarding the purchase of two Boeing 787 Dreamliner aircrafts to be delivered in the year 2010. The intention is to use these aircrafts in on scheduled routes in Icelandair ehf.

Mortgages and commitments

22. The Group's assets are mortgaged to secure debt, the remaining balance of which amounted to ISK 28,034 million at the end of the year 2005.

Notes, contd.:

Insurance value and official assessment value

Insurance value of aircraft and flight equipment

23. The insurance value and book value of aircraft and related equipment of the parent company at year-end 2005 are specified as follows:

	Insurance value	Carrying amount
Boeing 757-200 / 300 - 5 aircrafts	14.353	11.372
Other aircrafts	2.693	2.541
Flight equipment	3.054	1.852
Total aircraft and flight equipment	20.100	15.765
Engine hours	2.277	1.059
Total aircraft, flight equipment and engine hours	22.377	16.824

The insurance value of the Group's other operating assets and equipment amounted to ISK 2,455 million at the end of the year 2005.

Real estate insurance value

24. The principal buildings owned by the Group at 31 December 2004 are the following:

	Official assessment value	Insurance value	Carrying amount
Maintenance hangar, Keflavík Airport	1.209	1.786	560
Freight building, Keflavík Airport	326	500	346
Office building, Reykjavík Airport	606	751	187
Service building, Keflavík Airport	332	484	128
Hangar 4 and other buildings, Reykjavík Airport	396	489	116
Other buildings	332	602	333
Buildings total	3.201	4.612	1.670

Official valuation of the Group's leased land for buildings at December 31, 2005 amounted to ISK 512 million, and is not included in the Balance Sheet

Intangible assets

25. The Group's intangible assets are specified as follows:

Cost:	Goodwill	Other intangible assets	Total
Balance at 1 January 2004		233	233
Additions		213	213
Balance at 31 December 2004	0	446	446
Additions	3.267	113	3.380
Sales and disposals during the year		(29)	(29)
Balance at 31 December 2005	3.267	530	3.797

Notes, contd.:

25. Contd.:

	Goodwill	Other intangible assets	Total
Amortisation and impairment losses			
Balance at 1 January 2004	0	32	32
Amortisation	0	130	130
Balance 31.12.2004	0	162	162
Amortisation	0	168	168
Sales and disposals during the year	0	(3)	(3)
Balance at 31 December 2005	0	327	327
Carrying amounts			
1.1.2004	0	201	201
31.12.2004	0	284	284
31.12.2005	3.267	203	3.470

26. Goodwill is divided down to cash generating units as follows:

Bláfugl hf. and Flugflutningar ehf.	3.243
Kynnisferðir ehf.	24
Total goodwill	3.267

27. At the end of the year an impairment test was performed on the Group's goodwill. The present value of estimated future cash flows is used to decide if impairment losses have occurred. In the present value calculations, an interest rate is used that reflects the weighted average of cost of capital, or the cost of debt and equity allowed for income tax effects. If the fair value of goodwill, which is the present value of future cash flows, is lower than the carrying amount the difference is charged to the income statement. The present value at the end of the year was higher than the carrying amount.

Equity

28. *Issued capital*

A shareholders meeting on November 1, 2005 approved an increase in share capital for the maximum of ISK 3,235 million nominal value or 44,000 million at market value according to the share offering price of ISK 13.6 per share. The increase was executed at the end of November 2005. Also approved was an increase in share capital amounting to ISK 330 million nominal value to fulfil the acquisition agreement for Sterling Airlines A/S. In the beginning of the year 2006 the Board of Directors issued new share capital at the nominal value of ISK 296 million on the basis of this permission because of the takeover of Sterling Airlines A/S. The Board of Directors was also given permission to increase share capital by ISK 73 million nominal value to fulfil employee stock option agreements. This permission was used in December 2005.

Notes, contd.:

28. Contd.:

The Company's share capital, according to its Articles of Association amounts to ISK 5,845 million. One vote is attached to each ISK one share. Share capital was increased by a nominal value of ISK 3,308 million, from ISK 2,537 million to ISK 5,845 million. The Company bought own shares at a nominal value of ISK 238 million during the year for ISK 3,609 million. The Company sold own shares in at a nominal value of ISK 206 million for ISK 2,138 million. Share capital according to the balance sheet amounted to ISK 5,802 million at the end of the year, share capital is specified as follows:

	Amounts	Ratio
Total issued shares at the end of the year	5.802	99,3%
Own shares	43	0,7%
Share capital according to the Articles of Association	<u>5.845</u>	<u>100,0%</u>

Other reserves

Fair value of share options

The item share option reserve includes the accrued part of the fair value of share options.

Hedging reserve

The hedging reserve comprise 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

Foreign exchange differences arising on translation of financial statements of subsidiaries are recognised directly in a separate component of equity.

Notes, contd.:

29. Summary of equity:

	Other reserves						Retained earnings	Shareholders of the Parent	Minority interest	Total equity
	Share capital	Share premium	Share option reserve	Hedging reserve	Translation reserve	Unrealised gain on shares				
Equity 1.1.2004	2.132	533	1				6.544	20	9.230	
IFRS adoption			6				(72)	(2)	(68)	
Equity 1.1.2004, restated	2.132	533	7	0	0	0	6.472	18	9.162	
Issued share capital	230	1.795							2.025	
Dividends to shareholders							(640)		(640)	
Own shares, change	163	1.281							1.444	
Net profit (loss) for the year			80	223	(958)		3.602	3	2.950	
Equity 31.12.2004	2.525	3.609	87	223	(958)		9.434	21	14.941	
Adoption of IAS 32 / 39				(323)	335		(192)		(180)	
Restated equity 1.1.2005	2.525	3.609	87	(100)	(623)		9.242	21	14.761	
Equity 31.12.2004	2.525	3.609	213	223	(958)	1.417	7.906	21	14.956	
IFRS adoption			(126)	(323)	335	(1.417)	1.336		(195)	
Equity 1.1.2005, restated	2.525	3.609	87	(100)	(623)	0	9.242	21	14.761	
Issued share capital	3.308	40.839							44.147	
Dividends to shareholders							(1.466)		(1.466)	
Own shares, change	(31)	(1.440)							(1.471)	
Exercised stock options		161	(161)						0	
Net profit (loss) for the year			142	287	802		17.251	2	18.484	
Minority interest, change								(12)	(12)	
Equity 31.12.2005	5.802	43.169	68	187	179	0	25.027	11	74.443	

Notes, contd.:

Interest-bearing loans and borrowings

30. Interest-bearing loans and borrowings are specified as follows:

	2005	2004
Bonds	10.366	0
Short-term loans from credit institutions	1.760	3.566
Non-current borrowings from credit institutions	27.542	13.789
Total interest-bearing loans and borrowings	<u>39.668</u>	<u>17.355</u>

The bonds are indexed and in ISK. They mature in 2012. Interest rate payments are yearly.

32. Non-current interest-bearing borrowings from credit institutions are specified as follows:

	2005		2004	
	Average interest rates	Remaining Balance	Average interest rates	Remaining Balance
Debt in USD	5,2%	26.701	3,9%	12.921
Debt in EUR	3,4%	240	3,3%	283
Debt in CHF	2,1%	58	2,0%	60
Debt in JPY	1,4%	57	1,1%	60
Debt in GBP	5,8%	23	6,3%	25
		<u>27.079</u>		<u>13.349</u>
Debt in ISK	6,7%	463	6,2%	440
Total non-current borrowings		<u>27.542</u>		<u>13.789</u>

31. Repayment of non-current interest-bearing borrowings are specified as follows:

Repayments in 2005		1.773
Repayments in 2006	11.573	1.213
Repayments in 2007	5.819	1.248
Repayments in 2008	3.080	2.827
Repayments in 2009	1.502	1.418
Repayments in 2010	2.295	2.195
Subsequent repayments	3.273	3.115
Total non-current borrowings	<u>27.542</u>	<u>13.789</u>

Deferred income tax liability

33. The Company's deferred income tax liability is specified as follows:

	2005	2004
Deferred income tax liability 1.1.	1.451	989
IFRS adoption	0 (60)
Deferred income tax liability of Bláfugl and Flugflutningar on acquisition	77	0
Exchange rate difference	109 (191)
Income tax expense	3.292	713
Income tax recognised in share premium account	(235)	0
Deferred income tax liability 31.12.	<u>4.694</u>	<u>1.451</u>

Notes, contd.:

33. Contd.:

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

	2005	2004
Securities	3.729	276
Other shares	37	73
Trade receivables	361	91
Deferred tax asset of a subsidiary	(194)	0
Operating assets	1.312	1.087
Other balance sheet items	(86)	(55)
	<u>5.159</u>	<u>1.472</u>
Tax losses carried forward	(465)	(21)
Deferred income tax liability 31.12.	<u>4.694</u>	<u>1.451</u>

Trade and other payables

34. Trade and other payables are specified as follows:

Trade payables	3.532	2.947
Other payables	7.018	4.343
Total trade and other payables	<u>10.550</u>	<u>7.290</u>

Prepaid income

35. Prepaid income is specified as follows:

Unused sold flight documents	2.152	1.683
Other prepayments	489	466
Total prepaid income	<u>2.641</u>	<u>2.149</u>

Risk management

36. The source of risks, arising from interest rates and foreign currencies, lies mostly in the aviation and tourism segment of the Group. Companies held by FL GROUP hf. operate on international markets and therefore the Company is subject to risks of fluctuation in currency, interest rates and oil prices. The Company has adopted a policy to decrease those risks with the use of derivatives. The risk management for companies held by FL GROUP hf. was, at the end of the year 2005 controlled by the risk management department of Icelandair ehf.

Notes, contd.:

36. Contd.:

Foreign currency risk

The Company's goal is to hedge 50-90% of exposure to currency risk in its cash flows. The primary source of currency risk is in Icelandair and therefore the Company places emphasis on hedging those risks. Other companies held by FL GROUP hf. are subject to relatively lesser currency risk, but never the less, companies where fluctuations in currency exchange rates can have significant effect on their operations, the risks are hedged. Before the currency risk is hedged the aim is to obtain inner balance in the relevant company's operations. Therefore, only the difference in outflows and inflows of foreign currencies are hedged. The largest differences are in net inflows of European currencies and net outflows in USD. This risk exposure arises mostly in the operations of Icelandair. The risk exposure is hedged with forward contracts and options 12 months into the future. The Company only deals with recognised banks as it aims to minimise its counterparty risk. At the end of the year 2005 approximately 80% of currency risk in Icelandair's cash flows was hedged. At the end of the year 2005 80% of the currency risk in Icelandair ehf.'s cash flows was hedged.

Interest rate risk

The Company's primary exposure to interest rate risk arises from financing of aircrafts. The Company sold bonds amounting to ISK 10,000 million and funded prepayments of 15 Boeing 737-800 by borrowing. The bonds carry fixed rates. The interest rate risk exposure arising from funding of the aircrafts has been hedged until 2010. The Company has hedged approximately 80% of that particular interest rate risk.

Oil price risk

Companies owned by FL GROUP hf. are exposed to substantial risks arising from fluctuations in jet fuel. The largest user of jet fuel in the Group is Icelandair. Fuel prices have increased significantly in the last few years. The policy of the Company is to hedge 40-80% of fuel price risks.

Liquidity risk

It is the Company's policy to always hold 25% of total income in cash, mortgage availability on assets and in short-term positions. The Company was well within those limits at the end of the year 2005.

Counterparty risk

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

Off-balance sheet items

37. At the end of October 2005 the Company entered into a contract regarding the acquisition of all outstanding shares in the airline Sterling Airlines A/S. According to the contract, the acquisition price of the shares amounts to DKK 1,500 million but a portion of the price is success related. The consideration is paid with DKK 1,100 million in cash and DKK 400 million with shares. FL GROUP hf. took over operations of the company on January 1, 2006 when the conditions in the acquisition agreement were fulfilled.

Notes, contd.:

38. The Company has in place operating leases for 17 aircrafts at the end of December 2005. The leases are for ten Boeing 757 aircrafts, three Boeing 767 aircrafts and four smaller aircrafts. The Company also has in place operating leases for storage facilities, accommodations, equipment and fixtures for its operations, the longest until the year 2018. At the end of the year 2005 the leases are payable as follows:

	Real estate	Aircrafts	Other	Total
In the year 2006	778	2.095	212	3.085
In the year 2007	605	1.935	123	2.663
In the year 2008	566	1.147	100	1.813
In the year 2009	556	931	5	1.492
In the year 2010	552	502	3	1.057
Subsequent	2.809	302	0	3.111
total	<u>5.866</u>	<u>6.912</u>	<u>443</u>	<u>13.221</u>

Cash flow statement

39. Other operating items in the cash flow statement are specified as follows:

	2005	2004
Changes in the fair value of securities	(12.940)	(1.727)
Changes in fair value of derivatives	(5.879)	0
Other items	2.726	544
Total other operating items	<u>(16.093)</u>	<u>(1.183)</u>

40. Net change in operating assets and liabilities in the cash flow statement are specified as follows:

Trade payables, increase	3.270	1.645
Other items	<u>(1.415)</u>	<u>(1.911)</u>
Net change in operating assets and liabilities	<u>1.855</u>	<u>(266)</u>

Related parties

Identity of related parties

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

Transaction with associates

During the year 2005 the Group purchased services from associates for an amount of ISK 238 million but the Group did not sell them any services. Transactions with associates are priced on an arm's length basis.

Notes, contd.:

41. Contd.:

Transactions with management and key personnel

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

	Salaries and benefits	Stock options	Shares held at year-end 2005
Board of Directors:			
Skarphéðinn Berg Steinarsson, Chairman of the Board	1,1		
Jón Ásgeir Jóhannesson	1,6		
Magnús Ármann	1,1		
Smári S. Sigurðsson	1,1		
Þorsteinn M. Jónsson	1,1		25
Árni Oddur Þórðarson, former board member	1,5		
Benedikt Sveinsson, former board member	1,8		
Einar Örn Jónsson, former board member	1,5		
Einar Ólafsson, former board member	0,7		
Gunnar Þorláksson, former board member	1,5		
Gylfi Ómar Héðinsson, former board member	2,1		
Hreggviður Jónsson, former board member	3,4		
Inga Jóna Þórðardóttir, former board member	0,7		
Jón Þorsteinn Jónsson, former board member	2,1		
Pálmi Kristinsson, former board member	0,8		
Sigurður Bollason, former board member	0,7		
Managing directors:			
Hannes Smáráson, CEO	53,8		1.159
Jón Karl Ólafsson, CEO of Icelandair hf.	21,3 ¹⁾	18	8
Ragnhildur Geirsdóttir, former CEO	23,8 ¹⁾		
Sigurður Helgason, former CEO	35,9 ¹⁾		

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

The Company entered into retirement agreements with Sigurður Helgason and Ragnhildur Geirsdóttir, both former CEOs of the Company. A liability in the amount of ISK 238 million has been recognised in the financial statements as a result of this.

* During the year Jón Karl Ólafsson exercised share options at the value of ISK 57.0 million, Ragnhildur Geirsdóttir at the value of ISK 65.2 million and Sigurður Helgason at the value of ISK 108.1 million.

Notes, contd.:

Group entities

42. The Company holds nineteen subsidiaries which all are included in the consolidated financial statements. The subsidiaries own thirteen subsidiaries which are also included. The subsidiaries included in the consolidated financial statements are specified as follows:

	Share
Investments:	
Flugleiðir fjárfestingafélag ehf.	100%
Aviation and tourist industry:	
Bílaleiga Flugleiða ehf.	100%
Bláfugl hf.	100%
Ferðaskrifstofa Íslands hf.	100%
Fjárvakur - fjármálaþjónusta ehf.	100%
FL Travel Group ehf.	100%
Flugfélag Íslands hf.	100%
Flugflutningar ehf.	100%
Flugleiðahótel hf.	100%
Flugleiðir - Frakt ehf.	100%
Flugþjónustan Keflavíkurflugvelli ehf.	100%
ICECAP, Guernsey	100%
Icelandair ehf.	100%
Icelandair Group ehf.	100%
Icelease ehf.	100%
Íslandsferðir ehf.	100%
Kynnisferðir ehf.	96%
Loftleiðir - Icelandic ehf.	100%
Tækniþjónustan Keflavíkurflugvelli ehf.	100%

FL Travel Group ehf. and Icelandair Group ehf. were established at the end of the year 2005. These two companies were dormant during the year.

Subsequent events

43. FL Group hf. sold its share in Ferðaskrifstofa Íslands hf. on January 23, 2006 to the company Exit hf. The buyer took over operations as of that date.

At the beginning of the year 2006 the Company announced its intentions to float Icelandair Group ehf. on the Icelandic Stock Exchange. The intention is that eleven of FL Group hf.'s subsidiaries will form Icelandair Group ehf.

Notes, contd.:

Changes due to Adoption of International Financial Reporting Standards

44. As stated in notes regarding significant accounting policies, these are the Group's first year consolidated financial statements prepared in accordance with IFRSs.

The accounting policies set out in notes regarding significant accounting policies have been applied in preparing the financial statements for the year, the comparative information presented in these financial statements for the year ended 31 December 2004 and in the preparation of an opening IFRS balance sheet at 1 January 2004 (the Group's date of transition).

In preparing its opening IFRS balance sheet, the Group has adjusted amounts reported previously in financial statements prepared in accordance with its old basis of accounting (previous GAAP). An explanation of how the transition from previous GAAP to IFRSs has affected the Group's financial position and financial performance is set out in the following tables and the notes that accompany the tables. No significant adjustments due to IFRS adoption were made to the cash flow statement previously published according to previous GAAP.

Equity 1.1. 2005:

Equity according to previous GAAP 31.12.2004	14.935
Equity according to IFRS 1.1.2005	14.740
Net change from previous GAAP to IFRSs	195

	1.1.2004	1.1.2005	Total
Changes in measurements:			
Intangible assets	IAS 38 (121)	4 (117)	
Fair value of stock options	IFRS 2 1 (21)	(20)	
Impairment of prepayments	IAS 36 (44)	4 (40)	
Pension liabilities	IAS 19 (9)	0 (9)	
Engine overhaul liability derecognised	IAS 16, 37 97	112 209	
Derivatives and financial assets to fair value	IAS 39 (180)	(180)	
Other changes	8	(46) (38)	
Net change from previous GAAP to IFRSs	(68)	(127) (195)	

Changes in equity are stated after the deduction of income tax

Changes in measurements

Some expenses that have been capitalized as intangible assets are not in compliance with IAS 38 on intangible assets, e.g. pilot training. This causes a decrease in the Group's equity by ISK 117 million, with regards to income tax effects. The comparative figures in the interim income statements have been adjusted accordingly.

The fair value of stock options was estimated based on the grant date according to IFRS 2. The fair value is measured at grant date and spread over the period during which the employees become unconditionally entitled to the options. The fair value of the options granted is measured using the Black Scholes model, taking into account the terms and conditions upon which the options were granted.

Prepayments recognized among long-term receivables have now been stated according to effective interest rates and therefore equity decreases by ISK 40 million, with regards to income tax effects.

Pension benefit obligation is recognized according to IAS 19. As a result equity decreases by ISK 9 million, with regards to income tax effects.

Notes, contd.:

44. Contd.:

The Company has in previous years expensed estimated costs of future overhauls of engines owned by the Company. According to IAS 37 a liability arising from future expenses such as this can not be recognized. As a result, the Group's equity increases by ISK 209 million, with regards to income tax effects. The comparative amounts in the interim income statements have been adjusted accordingly.

Unsettled derivatives at the end of the year 2004 and some financial assets are recognized at their fair value according to IAS 39. As a result equity decreases by ISK 180 million, with regards to income tax effects. The comparative figures in the income statement have not been adjusted as is permitted in IFRS 1.

Other changes comprise various adjustments in measurement of current assets.

Changes in Presentation

When adopting the standards some assets, previously presented as operating assets but classified as intangible assets according to IAS 38, have been transferred to intangible assets. Loan charges previously presented as intangible assets are now subtracted from relevant loans.

Next years use of engine hours has been presented as current assets but now this item is recognized among operating assets.

The Group's securities which were classified as cash and cash equivalents on December 31, 2004 do not fulfil the requirements of cash and cash equivalents according to IAS 7 and therefore presentation has been changed and they are presented as securities in the balance sheet.

Shares acquired with a forward contract and previously presented as securities are not recognised in the balance sheet according to IAS 39, instead the net fair value of the forward contract is recognised in the accounts.

In addition, minority interest in the Group's equity, previously included among current liabilities, is now presented as a separate item in equity.

Balance Sheet 1.1.2005

	Icelandic GAAP 31.12.2004	Changes in presentation	Changes in measurement	IFRSs
Assets:				
Cash and cash equivalents	5.898	(3.079)		2.819
Securities	13.246	(147)	(187)	12.912
Derivatives	0	462		462
Investments in companies	384			384
Inventories	832			832
Trade and other receivables	5.799	(441)	(91)	5.267
Operating assets	19.893	374	255	20.522
Intangible assets	501	(74)	(143)	284
Total assets	46.553	(2.905)	(166)	43.482
Equity:				
Share capital	2.525			2.525
Share premium	3.609			3.609
Reserves	895	(1.405)	(126)	(636)
Retained earnings	7.906	1.405	(69)	9.242
Total equity attributable to equity holders of the Parent	14.935	0	(195)	14.740
Minority interest		21		21
Total equity	14.935	21	(195)	14.761

Contd.:

44. Contd.:	Icelandic GAAP 31.12.2004	Changes in presentation	Changes in measurement	IFRSs
Liabilities:				
Interest-bearing loans and borrowings	20.545	(3.190)		17.355
Derivatives	0	285		285
Deferred income tax liability	1.466		(15)	1.451
Pension plan obligation	180		11	191
Trade and other payables	7.278	(21)	33	7.290
Prepaid income	2.149			2.149
Total liabilities	31.618	(2.926)	29	28.721
Total equity and liabilities	46.553	(2.905)	(166)	43.482

Balance sheet changes are presented without the effect of income tax, changes in equity were presented with regards to income tax effects.

Income statement for the year 2004

	Icelandic GAAP	Changes	IFRSs
Investment income:			
Profits from investments and derivatives	2.319		2.319
Interest income	545		545
Interest expenses	(924)	(4)	(928)
Net foreign exchange gain	218		218
	2.158	(4)	2.154
Operating expenses:			
Income from aviation services	31.234		31.234
Other income	11.352		11.352
	42.586	0	42.586
Operating expenses:			
Aviation services expenses	29.757	(235)	29.522
Other operating expenses	10.900		10.900
	40.657	(235)	40.422
Profit before income tax	4.087	231	4.318
Income tax expense	(668)	(45)	(713)
Profit for the year	3.419	186	3.605
Attributable to:			
Equity holders of the parent	3.419	183	3.602
Minority interest	0	3	3
Profit for the year	3.419	186	3.605

Contd.:

44. Contd.:

	Icelandic GAAP	Changes	IFRSs
Earnings per share:			
Basic earnings per share (ISK)	1,55		1,63
Diluted earnings per share (ISK)	1,53		1,61

Net profit attributable to the shareholders of the Parent Company increases by ISK 186 million, in the comparative figures in the financial statements for the year 2004 due to the adaptation of the standards.

Salaries and related expense decrease by ISK 109 million due to changes in the treatment of employee stock options.

Aviation services expenses decrease by ISK 235 million as a result of, among other things, the discontinuation of expensing estimated expenses of future engine overhaul.

Changes in the income tax for the period result from the changes discussed here above.

Minority interest in the performance for the year is now presented separately among profits for the period but the minority interest was previously expensed among financial income and financial expenses.

Ratios

45. The Group's primary ratios are specified as follows

	2005	2004
Working capital from operations	3.566	4.862
Equity ratio - equity / capital employed	56,1%	33,9%
Total equity to issued capital	12,83	5,84

Corporate governance

46. The Board of Directors of FL Group hf. places emphasis on maintaining appropriate corporate governance. The Board of Directors has put in place written guidelines which among other things include the division of duties between the Board and the CEO. The guidelines also include rules on the order of meetings, the ability of Board Members to take part in decision making, confidentiality obligation, the CEO's duties regarding the flow of information to the Board of Directors and etc. The Board of Directors negotiates the CEO's remuneration, has regular meetings with the Company's auditors and has hired an internal auditor. The Board of Directors satisfies the independence clauses set forth in article 2.6. in the guidelines from the Icelandic Stock Exchange on corporate governance.