FC 18106

Audited Financial Statements

Ukraine International Airlines

Years ended December 31, 1998 and 1997
with Report of Independent Auditors

NW £15 - 001104

Ukraine International Airlines

Audited Financial Statements

Years ended December 31, 1998 and 1997

Contents

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Report of Independent Auditors

The Board of Directors and Shareholders
Ukraine International Airlines

We have audited the accompanying balance sheets of Ukraine International Airlines ("the Company") as of December 31, 1998 and 1997, and the related statements of operations, shareholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with International Standards on Auditing issued by the International Federation of Accountants. Those Standards require that we plan and perform the audits 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 audits provide a reasonable basis for our opinion.

As discussed in Note 8 to the financial statements, the Company has not amortized its route rights intangible asset. International Accounting Standard No. 4, "Depreciation Accounting", requires that such assets be amortized. Based on straight line amortization, the route rights intangible asset would be reduced by accumulated amortization of $6.92 million, and the loss for the year and accumulated deficit would be increased by $2.16 million and $6.92 million, respectively ($2.16 million and $4.76 million for 1997, respectively).

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 1998 and 1997, and the results of its operations and its cash flows for the years then ended in accordance with International Accounting Standards issued by the International Accounting Standards Committee.

Without qualifying our opinion, we draw attention to Notes 1 and 3 to the financial statements which discuss the current economic and political situation in Ukraine and the Company's financial condition. In Ukraine, certain events which occurred during the second half of 1998, and which have continued into 1999, have created significant uncertainties for enterprises operating in Ukraine. These events combined with the Company's financial condition may affect the ability of the Company to realize its assets and discharge its liabilities in the normal course of operations. The financial position and future operations of the Company may be adversely affected by the final outcome of such events. The effects of these uncertainties on the Company's ability to continue its operations cannot presently be determined and these financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or classification of liabilities which may result from this situation.

ERNST & YOUNG

We have also audited the financial statements of the Company as of and for the years ended December 31, 1998 and 1997, not presented herewith, prepared in compliance with the regulations for bookkeeping and accounting for income tax and statutory reporting purposes in Ukraine and we expect to report separately on the statutory financial statements. The significant differences between accounting principles applied in preparing statutory financial statements and those applied for International Accounting Standards are summarized in Note 2 to the financial statements.

Ernst & Young Ukraine

May 20, 1999

Ukraine International Airlines

Balance Sheets

		December 31, 1998		1997
		(In thousands of US Dollars)		
Assets				
Current assets:				
Cash	$	**808**	$	496
Restricted cash (Note 4)		**500**		417
Due from shareholder (Note 10)		**3,016**		-
Accounts receivable, net (Note 5)		**2,867**		1,851
Inventories		**381**		406
Prepayments and other current assets		**1,424**		2,131
		8,996		5,301
Aircraft purchase deposits (Note 15b)		**175**		3,973
Restricted cash (Note 4)		**1,749**		800
Spare parts and rotables, net (Note 6)		**3,310**		2,496
Property and equipment, net (Note 7)		**886**		756
Route rights (Note 8)		**32,829**		32,829
Start up costs, net (Note 9)		**187**		-
Total assets	$	**48,132**	$	46,155
Liabilities and shareholders' equity				
Current liabilities:				
Short-term borrowings (Note 10)	$	**3,034**	$	3,164
Accounts payable and accrued expenses		**7,286**		5,041
Deferred revenue (Note 11)		**2,509**		1,858
Total current liabilities		**12,829**		10,063
Long-term borrowings (Note 10)		**4,634**		2,386
Commitments and contingent liabilities (Notes 15 and 16)				
Shareholders' equity:				
Common stock (Note 13)		**49,000**		49,000
Accumulated deficit		**(18,331)**		(15,294)
Total shareholders' equity		**30,669**		33,706
Total liabilities and shareholders' equity	$	**48,132**	$	46,155

See accompanying notes.

Ukraine International Airlines

Statements of Operations

	Year ended December 31, 1998	1997
	(In thousands of US Dollars)	
Operating revenues:		
Passenger services	$ **44,502**	$ 39,641
Charter services	**2,764**	1,811
Cargo and other services	**2,903**	3,150
Other revenues	**1,755**	805
	51,924	45,407
Operating expenses:		
Aircraft lease costs	**10,275**	9,365
Aircraft landing and handling	**8,053**	6,508
Fuel	**5,324**	5,357
Maintenance	**5,447**	4,381
Navigation	**4,912**	4,490
Salaries	**3,695**	3,234
Commissions	**2,750**	2,187
Catering	**2,665**	2,251
Sales and distribution costs	**1,615**	1,797
Block seat costs	**963**	1,133
Insurance	**933**	769
Depreciation	**510**	384
Administration	**3,569**	2,559
Representative office expenditures	**1,501**	1,829
Value-added tax	**-**	526
Bad debt expense	**173**	123
	52,385	46,893
Operating loss	**(461)**	(1,486)
Other income (expenses):		
Other income	**176**	1,031
Provision for impairment in value of construction-in-progress	**-**	(461)
Amortization of start-up costs	**(71)**	(374)
Interest expense	**(1,288)**	(402)
Other local taxes	**(1,271)**	(875)
Foreign exchange loss	**(122)**	(136)
Loss before income taxes	**(3,037)**	(2,703)
Income taxes (Note 12)	**-**	-
Net loss	$ **(3,037)**	$ (2,703)

See accompanying notes.

Ukraine International Airlines

Statements of Shareholders' Equity

Years ended December 31, 1998 and 1997

	Common Stock	Accumulated Deficit	Total
	(In thousands of US Dollars)		
Balances at December 31, 1996	$ 49,000	$ (12,591)	$ 36,409
Net loss	**-**	**(2,703)**	**(2,703)**
Balances at December 31, 1997	**49,000**	**(15,294)**	**33,706**
Net loss	-	**(3,037)**	**(3,037)**
Balances at December 31, 1998	**$ 49,000**	**$ (18,331)**	**$ (30,669)**

See accompanying notes.

Ukraine International Airlines

Statements of Cash Flows

	Year ended December 31, 1998	1997
	(In thousands of US Dollars)	
Operating activities		
Net loss	$ **(3,037)**	$ (2,703)
Adjustments to reconcile changes in net loss to net cash used in operating activities:		
Depreciation and amortization	**569**	758
Loss on disposal of property and equipment	**70**	40
Provision for doubtful accounts receivable	**41**	(180)
Provision for impairment in value of construction-in-progress	-	461
Operating cash flow before working capital changes	**(2,357)**	(1,624)
(Increase) decrease in accounts receivable	**(1,057)**	209
Decrease (increase) in inventories	**25**	(80)
Decrease (increase) in prepayments and other current assets	**707**	(656)
Increase in start up costs	**(258)**	-
Increase (decrease) in accounts payable and accrued expenses	**2,245**	(576)
Increase (decrease) in deferred revenue	**651**	(128)
Cash used in operating activities	**(44)**	(2,855)
Investing activities		
Aircraft purchase deposits returned (paid)	**782**	(3,973)
Purchases of spare parts and rotables	**(1,021)**	(142)
Purchases of property and equipment	**(491)**	(666)
Net cash used in investing activities	**(730)**	(4,781)
Financing activities		
Proceeds of sale of common shares	-	6,000
Net proceeds from borrowings	**2,118**	2,104
Deposits to restricted cash accounts	**(1,032)**	(472)
Net cash generated from financing activities	**1,086**	7,632
Net increase (decrease) in cash	**312**	(4)
Cash at beginning of year	**496**	500
Cash at end of year	**$ 808**	$ 496
Supplementary cash flow information:		
Interest paid	**1,161**	320
Income taxes paid	-	-

See accompanying notes.

(Amounts in tables in thousands of US Dollars)

1. Description of Business and Business Environment

Ukraine International Airlines (hereinafter referred to as "the Company"), formerly named Air Ukraine International Airlines, was incorporated in Ukraine on October 29, 1992 as a joint venture between the Ukrainian Association of Civil Aviation ("UACA") and Guinness Peat Aviation ("GPA"), a company incorporated in the Republic of Ireland. Pursuant to legislation enacted by the Ukrainian Government during 1994, the State Property Fund of Ukraine ("SPF") became the successor as shareholder to the UACA. These changes came into effect in May 1996 upon re-registration of the Company's charter. In November 1996, the Company was again re-registered to reflect the investment made by U.I.A. Beteiligungsgesellschaft GmbH ("UIAB"), a company incorporated in Austria and wholly-owned by Austrian Airlines and Swissair. In August 1998, GPA with the agreement of all shareholders, sold 50% of its shareholding in the Company to UIAB. In November 1998, GPA changed the name of their company to AERfi Group PLC ("AERfi"). Registration of these changes in the Company's charter are in progress. The shareholding reflected in the current charter of the Company is SPF: 335,000 shares, UIAB: 90,000 shares and GPA: 65,000 shares. The newly registered shareholding will be SPF: 335,000 shares, UIAB: 122,500 shares and AERfi: 32,500 shares, which represents 68.37%, 25% and 6.63% of the total authorized share capital, respectively.

The principal activities of the Company consist of the provision of commercial passenger and cargo transportation primarily between selected destinations in Western Europe, Ukraine and Russia. The Company's headquarters are located in Kyiv, Ukraine.

The economic situation in Ukraine was affected by the continuing political and economic crisis in the Russian Federation. There is currently a high level of economic instability and political uncertainty in Ukraine. As a result of the economic situation which developed in August 1998, all financial markets were subject to significant downward adjustments. The national currency was significantly devalued during this period and, although it remained stable during the fourth quarter of 1998, it is widely expected to devalue in 1999. These matters had a direct negative impact on the financial position and results of operations of the Company.

The final outcome of the uncertainties discussed in the preceding paragraph may have a significant adverse effect on the future operations of the Company. The Company's financial statements as of December 31, 1998 and for the year then ended do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts or classifications of liabilities that may result from the outcome of these uncertainties.

2. *Significant Accounting Policies*

Basis of Presentation

The accompanying financial statements have been prepared under the historical cost convention and in conformity with International Accounting Standards ("IAS").

The Company maintains its accounting records and prepares its financial statements in Ukrainian Hryvnia ("UAH") in accordance with the requirements of Ukrainian accounting and tax legislation. The accompanying financial statements differ from the financial statements prepared for statutory purposes in Ukraine in that they reflect certain adjustments, not recorded in the Company's accounting books, which are appropriate to present the financial position, results of operations and cash flows in accordance with IAS. The principal adjustments are related to provisions for doubtful debts, timing of revenue and expense recognition, accounting for low-value, short-life inventory, deferred income taxes, foreign currency translation, and depreciation and valuation of long term tangible and intangible assets. A reconciliation of the 1998 and 1997 loss as reported in the Ukrainian statutory financial statements to the 1998 and 1997 results of operations reported in the accompanying financial statements prepared in accordance with IAS is included in Note 17.

Certain 1997 balances have been reclassified to conform to the 1998 presentation.

Foreign Currency Translation

The Company's financial statements have been presented in US Dollars because it is the Company's functional currency, i.e. the majority of its revenues, costs, property and equipment purchased, and debt and trade liabilities are either priced, incurred, payable or otherwise measured in US Dollars. Accordingly, transactions and balances not already measured in US Dollars (primarily Ukrainian Hryvnia) have been remeasured into US Dollars in accordance with the temporal translation method. Under this remeasurement method, revenues, costs, capital and non-monetary assets and liabilities are translated at historical exchange rates prevailing on the transaction dates. Monetary assets and liabilities are translated at exchange rates prevailing on the balance sheet date. Exchange gains and losses arising from remeasurement of monetary assets and liabilities that are not denominated in US Dollars are credited or charged to operations.

The Hryvnia is not a convertible currency outside the territory of Ukraine. Within Ukraine, the official exchange rates are determined principally by the National Bank and are generally considered to be a reasonable approximation of market rates. The translation of Hryvnia denominated assets and liabilities into US Dollars for the purpose of these financial statements does not indicate that the Company could realize, settle or distribute in US Dollars the reported values of the assets, liabilities and capital.

2. Significant Accounting Policies (continued)

Foreign Currency Translation (continued)

The exchange rate used to translate the Ukrainian Hryvnia ("UAH") balances at December 31, 1998 was the official exchange rate of the National Bank of Ukraine of UAH 3.427 for one US Dollar (December 31, 1997: UAH 1.899 for one US Dollar). At May 20, 1999, the official exchange rate had changed to UAH 3.922 for one US Dollar. The effect of the devaluation of the Hryvnia since December 31, 1998 on monetary assets and liabilities has not been determined.

Use of Estimates

The preparation of financial statements in accordance with IAS requires management to make estimates and assumptions that affect the amounts and balances reported in the financial statements and accompanying notes. These estimates are based on information available as of the date of the financial statements. Actual results, therefore, could differ from those estimates.

Cash

The Company considers cash to include all cash on hand and cash held with banks.

Accounts Receivable

Accounts receivable are stated at their net realizable value. A provision is made for accounts specifically identified as doubtful of collection.

Spare Parts and Other Inventories

Spare parts and other inventories primarily consist of rotable aircraft spare parts and are stated at the lower of cost and net realizable value. Cost is based on the average unit cost method. Depreciation of rotable spare parts is computed on a straight-line basis using an estimated useful life of sixteen years. Net realizable value is based on the estimated selling price less any further costs expected to be incurred to disposal.

Property and Equipment

Office premises and equipment and vehicles are stated at historical cost and are depreciated on a straight-line basis using an estimated useful life of five years.

Operating Leases

Leases for aircraft and spare parts are classified and accounted for as operating leases in accordance with IAS No. 17, "Accounting for Leases".

2. Significant Accounting Policies (continued)

Start-up Costs

Expenditures incurred on the initial training of pilots, staff and other start-up costs relating to the development of new routes are capitalized and are amortized on a straight-line basis over five years. Costs related to on going training in subsequent years are charged to operations as incurred.

Leased Aircraft Maintenance

Operating lease payments, routine maintenance and airframe and engine overhauls for leased flight equipment are charged to operations when incurred. In addition, accruals for heavy airframe and engine overhaul are made through the payment of supplemental rental reserve charges. To the extent that the actual costs incurred associated with major engine and airframe overhauls exceed the cumulative supplemental rent charges, the Company pays and expenses the excess.

Borrowing Costs

Borrowing and interest costs are expensed as incurred.

Deferred Taxes

Deferred taxes are accounted for under the liability method and reflect the tax effect of all significant temporary differences between the tax basis of assets and liabilities and their reported amounts in the accompanying financial statements to the extent that there is a reasonable expectation of their realization.

Revenue Recognition and Revenue-based Taxes

Revenues are recognized net of value-added tax ("VAT") and other taxes charged to customers, in the period in which the transportation or other service is provided. Deferred revenue includes the air traffic liability, which represents the estimated value of sold but unused passenger tickets as well as amounts due to other carriers at year end.

Revenue-based taxes, which were levied at an effective rate of approximately 2.2% of revenue in 1998 (1997: 1.9%), are recorded as other local taxes.

Government Pension and Social Funds

The Company contributes to the Ukrainian state pension, social insurance, medical insurance and unemployment funds on behalf of its employees. The Company's total contributions in 1998 amount to approximately 46.6% (1997: 47.5%) of the employees' salaries and are expensed as incurred. During the year ended December 31, 1998, the total amount of the Company's contributions to the government pension fund on behalf of its employees was approximately $1.00 million (1997: $600,000).

2. Significant Accounting Policies (continued)

Non-monetary Transactions

As with many companies operating in Ukraine, a portion of the Company's business is conducted via non-monetary transactions. These transactions are accounted for at selling prices of the items transferred or services provided. During the year ended December 31, 1998, the total value of these transactions as reported in the accompanying financial statements amounted to approximately $197,000 (1997: $468,000).

Fair Value of Financial Instruments

The fair value of financial instruments, consisting of cash, deposits, receivables, payables and obligations under debt instruments, are considered to be equal to their carrying values.

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of excess cash holdings, deposits and accounts receivable. The Company places its deposits and excess cash with reputable companies and financial institutions and limits the amount of credit exposure to any one institution. Management constantly monitors the status of banks where deposits are maintained. The credit risk associated with trade accounts receivable is limited due to the Company's customer base and ongoing procedures which monitor the credit worthiness of customers.

3. Going Concern

As of December 31, 1998, the Company has incurred aggregate losses of $18.33 million (1997: $15.29 million), of which $3.04 million was incurred in 1998 (1997: $2.70 million), has a working capital deficiency of $3.83 million (1997: $4.76 million), and an operating cash flow deficit of $44,000 for 1998 (1997: $2.86 million). The losses are primarily the result of establishing the airline, building an operations infrastructure, developing the route network and the high cost short-term aircraft leasing. These facts have resulted in a deterioration of the Company's financial condition and, in the absence of sufficient corrective actions, raises doubt about its ability to continue as a going concern.

Management recognizes the Company must obtain additional sources of capital and improve operating performance. In this regard, management has taken the following actions in 1999.

- In March, 1999 the Company received $1.20 million advance pool revenue from Austrian Airlines.
- In April, 1999, the Company increased its credit facility from First Ukrainian International Bank from $2.50 million to $3.50 million.

3. Going Concern (continued)

- The Company received approximately $400,000 in cargo and charter deposits during the first four months of 1999.
- In March, 1999 the Company received a loan of $200,000 from Aviatech Bank.
- In order to increase aircraft utilization and generate new sources of income, the Company has signed a sub lease via a wet lease agreement with an Italian company to operate a B737-300 for six months with monthly payments in advance commencing June 1999 which is expected to provide revenue of $3.4 million. A deposit of $300,000 was received in April, 1999.
- In April, 1999 the Company took possession of a new B737-300 aircraft which it is leasing from Austrian Airlines for $235,000 per month. This new aircraft comes with full technical warranties which is expected to reduce maintenance costs in 1999.
- The Company has deferred delivery of a new B737-700 aircraft from 2001 to 2002 in order to designate additional cash for working capital purposes.

Management believes that the proceeding actions will be sufficient to enable the Company to continue its operations and settle its obligations in the ordinary course of business without substantial disposition of assets, externally forced revisions of its operations or similar actions, at least through January 1, 2000, however, there can be no assurances in this regard.

In addition management has recognized the need to obtain additional equity and/or debt financing for working capital and to fund future potential asset acquisitions. The Company's Board of Directors has approved in principle an increase in the Company's authorized share capital from $49 million to $60 million to facilitate raising $11 million in new equity. The Company has commenced negotiations with potential financiers for both equity and loan financing and is expecting to have new financing in place by November, 1999. In any event, in relation to the ability of the Company to raise the additional finance, there can be no assurances that these plans will be successful.

The accompanying financial statements, which were prepared on a going concern basis, do not include any adjustments relating to the recoverability and classification of recorded asset amounts or to amounts and classification of liabilities that may be necessary if the Company is unable to continue as a going concern.

4. Restricted Cash

The current portion of restricted cash consisted of deposits due within one year which the Company was required to provide for certain trade creditors, aircraft lessors and loan providers. The long-term portion of restricted cash consisted of deposits relating to agreements with aircraft lessors which do not expire within one year.

5. Accounts Receivable

Accounts receivable consisted of the following at December 31:

	1998	1997
Travel agents	$ 2,331	$ 946
Cargo agents and customers	641	887
Credit card companies	123	257
Other	64	12
	3,159	2,102
Provision for doubtful accounts receivable	(292)	(251)
	$ 2,867	$ 1,851

6. Spare Parts and Rotables

Spare parts and rotables consisted of the following at December 31:

	1998	1997
Spare parts and rotables	$ 3,947	$ 2,926
Accumulated depreciation	(637)	(430)
	$ 3,310	$ 2,496

7. Property and Equipment

Property and equipment consisted of the following at December 31:

	1998	1997
Cost:		
Office premises and equipment	$ 1,361	$ 1,136
Vehicles	440	420
Construction-in-progress	461	461
	2,262	2,107
Provision for impairment in value of construction-in-progress	(461)	(461)
	1,801	1,556
Accumulated depreciation:		
Office premises and equipment	(618)	(514)
Vehicles	(297)	(286)
	(915)	(800)
	$ 886	$ 756

7. Property and Equipment (continued)

A reconciliation of the carrying amount of property and equipment at December 31:

	1997	Additions	Disposals	Depreciation	1998
Office premises and equipment	$ 622	$ 379	$ (37)	$ (221)	$ **743**
Vehicles	134	112	(33)	(70)	**143**
	$ 756	$ 491	$ (70)	$ (291)	$ **886**

8. Route Rights

In April 1996, at a general assembly shareholder meeting, the shareholders agreed to several changes to the Company's authorized share capital. The contribution of the SPF to the authorized share capital was valued at $33.50 million which consisted of cash contributed of $671,318 and, as stated in the revised charter documents, "...the complex of measures aimed at increasing the Company's profits and ensuring it achieves its potential without a corresponding increase in active operations, including the predominant position on the air transport market...", which was valued at $32.83 million. To ensure this value was realized, the SPF, through the State Department of Aviation Transport of Ukraine, provided a guarantee of exclusive rights to the Company to operate twenty air routes until December 31, 2010 ("route rights"). The total value of the SPF share capital contributed is based on the same per share value as that paid in by other shareholders in cash. In addition, the Company may apply for and operate other air routes, but without the guarantee of exclusivity.

Management believes these route rights provide an ongoing benefit after the period of exclusivity and have not suffered economic depreciation in value and, accordingly, no amortization has been reflected in the financial statements. However, IAS No. 4, "Depreciation Accounting", requires that such assets be amortized. Based on straight line amortization over the period of guaranteed exclusivity, the route rights intangible asset would be reduced by accumulated amortization of $6.92 million, and the loss for the year and accumulated deficit would be increased by $2.16 million and $6.92 million, respectively ($2.16 million and $4.76 million for 1997, respectively).

9. Start-up Costs

Start-up costs consisted of the following at December 31:

		1998		1997
Cost:				
Guinness Peat Aviation	$	**3,118**	$	3,118
Ukrainian Association of Civil Aviation		**671**		671
Other		**258**		-
		4,047		3,789
Accumulated amortization		**(3,860)**		(3,789)
	$	**187**	$	-

10. Borrowings

Borrowings consisted of the following at December 31:

		1998		1997
First Ukrainian International Bank	$	**2,129**	$	2,386
Austrian Airlines		**2,914**		2,493
Ost-West Handelsbank		**1,027**		671
Guinness Peat Aviation		**1,403**		-
A.J Walter		**195**		-
		7,668		5,550
Non-current portion		**(4,634)**		(2,386)
	$	**3,034**	$	3,164

The Company first signed an agreement with First Ukrainian International Bank ("FUIB") whereby FUIB committed to provide up to $1.56 million of credit at an annual interest rate of 12% with repayment due in January 1997. The credit line was renewed in January 1997 and is secured by spare parts inventory, accounts receivable and cash flows through the account. The renewed credit line will terminate in February 1999, and is for $2.50 million of which $1.56 million can be used as working capital and the balance can only be drawn down for an aircraft purchase deposit. Interest charged on this account is fixed at 18%, charged monthly in arrears on the actual amount outstanding. In February 1999 this credit line was renewed to March 2000 at an annual interest rate of 20% and it is all available as working capital. In April 1999, the Company signed a loan agreement for a further $1.00 million with FUIB at an annual interest rate of 20%. This loan is for a one year period and can be used for maintenance and repairs to aircraft.

In connection with the purchase of a B737-300 aircraft, the Company entered into an agreement with Austrian Airlines Lease and Finance Company ("AALF") on July 3, 1997 whereby progress payments to the Boeing Company ("Boeing") would be financed by AALF. The total amount of financing to be provided by AALF was $5.46 million, of which $3.51 million was provided in 1997 and an amount of $1.92 million was provided in 1998. Interest accrued monthly at the 12 month LIBOR rate (fixed as of June 30, 1997

10. Borrowings (continued)

at 6.125%) plus 3.69%. Repayments of principal and interest were to be made monthly according to an agreed schedule, however in December 1998, the Company assigned the purchase agreement for the B737-300 aircraft to AALF, and simultaneously signed a lease agreement with Austrian Airlines to lease back the aircraft. Upon signing the lease assignment, AALF became liable for all deposits due on this aircraft and credited to the Company the deposits which had been paid. This resulted in the settlement of the total loan balance from AALF. In January, 1999 the amount due and receivable of $3.02 million from AALF relating to the lease assignment was used to further repay borrowings and other payables.

In March, 1998 the Company entered into a loan agreement for $3.00 million with Austrian Airlines. Repayment of the loan is over a 24 month period which commenced in November 1998 and interest is charged at 10% per annum. The loan is required to be fully repaid in October 2000.

On November 27, 1997 the Company entered into a credit agreement with Ost-West Handelsbank which expired on December 1, 1998 and was subsequently renewed to December 1, 1999. The agreement provides for a line of credit up to $1 million which is secured by the Company's hard currency assets and a $500,000 deposit. Interest is charged quarterly at an annual rate of 11%.

The Company signed a loan agreement with GPA in August 1998 for the amount of $1.50 million. The loan is repayable over 36 months from September 1998 and bears interest of 10%. The final payment is due in August 2001.

11. Deferred Revenue

Deferred revenue consisted of the following at December 31:

	1998	**1997**
Air traffic liability	**$ 1,909**	$ 1,858
Charter revenue	**600**	-
	2,509	1,858

12. Income Taxes

Ukraine is the only tax jurisdiction in which the Company's income is subject to tax.

The following is a reconciliation of the income tax expense to the amount that would arise by applying 30% to the loss before income taxes reported in the accompanying financial statements for the year ended December 31:

		1998		1997
Income tax benefit computed on accounting loss before taxes at statutory tax rate of 30%	$	**911**	$	810
Tax effects of permanent differences:				
Non-tax deductible expenses		**(621)**		(169)
Utilization of tax loss not previously recognized to offset taxable income of the first half of the year		-		(516)
Foreign exchange loss		**(37)**		(41)
Temporary differences not recognized as measured by the change in the valuation allowance and benefit of tax losses carried forward		**(253)**		(84)
Income tax expense reported in the accompanying financial statements	$	-	$	-

Deferred tax assets and liabilities, calculated by applying the statutory tax rate of 30% in effect at the balance sheet date to the temporary differences between the tax basis of assets and liabilities and the amounts reported in the accompanying financial statements, consisted of the following at December 31:

12. Income Taxes (continued)

	1998	1997
Deferred tax assets, arising from:		
Provision for doubtful debts	$ **244**	$ 75
Provision for impairment in value of construction-in-progress	**138**	138
Differences in depreciation and amortization	**-**	296
Revenue and expense recognition	**753**	450
	1,135	959
Deferred tax liabilities, arising from:		
Differences in depreciation and amortization	**(587)**	-
Accrual of revenue	**(484)**	(121)
Other	**(88)**	(324)
	(1,159)	(445)
Net deferred tax (liability) asset	**(24)**	514
Tax losses carried forward	**285**	-
Valuation allowance	**(261)**	(514)
Net deferred tax asset	$ **-**	$ -

For financial reporting purposes, a valuation allowance has been recognized because the environment encompassing the tax regime in Ukraine does not provide reasonable expectation of realization of deferred tax assets in excess of deferred tax liabilities.

13. Common Stock

The authorized share capital of the Company consists of 490,000 shares of common stock with a par value of $100 per share. All 490,000 common shares were issued and outstanding at December 31, 1998 and 1997.

Contributed common stock of the Company consisted of the following as of December 31:

	1998	1997
State Property Fund of Ukraine	$ **33,500**	$ 33,500
UIA Beteiligungsgesellschaft GmbH	**12,250**	9,000
AERfi	**3,250**	-
Guinness Peat Aviation	**-**	6,500
	$ **49,000**	$ 49,000

13. Common Stock (continued)

In May 1996, the Company was re-registered to reflect the transfer of ownership from UACA to the SPF of Ukraine pursuant to legislation enacted by the Ukrainian Government. It was again re-registered in 1996 to reflect the investment in the Company by UIAB. As of December 31, 1996, UIAB had only contributed $3.00 million of its share capital contribution. The remaining $6.00 million was received in the first quarter of 1997.

In accordance with Ukrainian regulations, the Company can distribute all statutory accounting profits as dividends or transfer them to reserves. The subsequent use of amounts transferred to reserves is legally restricted; amounts transferred to reserves must be used for the purpose designated when the transfer is made. Dividends may be declared from undistributed earnings as shown in the Ukrainian statutory financial statements. As of December 31, 1998 and 1997, there were no retained earnings available for distribution.

14. Related Party Transactions

In November 1997, a contract was signed to lease two Boeing 737-300 aircraft from February 1998 and April 1998, respectively. Austrian Airlines Lease and Finance have guaranteed these lease payments up to a maximum of $1.50 million. The Company pays Austrian Airlines a fee of $5,000 per aircraft, per month for this facility. The total amount paid in 1998 for this facility was $105,000, and was expensed as incurred. The Company has secured these guarantees with a deposit of $527,000 which is included in restricted cash.

Included in 1997 expenses were payments to General Electric Capital Aviation Services, a company responsible for the management of GPA's aircraft assets, in the amount of $4.10 million for aircraft rentals, maintenance reserves and political risk insurance. The amounts paid were on normal terms and conditions.

15. Commitments

a) Lease Commitments

The future minimum lease payments required under non-cancellable operating leases with terms greater than one year beyond the balance sheet date consisted of the following at December 31, 1998:

1999	$ **11,633**
2000	**7,272**
2001	**6,444**
2002	**5,907**
2003	**805**

This includes an additional B737-300 aircraft which from April 1999 the Company leased from Austrian Airlines.

15. Commitments (continued)

In addition to lease rental payments, the Company pays a per flight hour supplemental rent with respect to the heavy overhaul of the airframe, engines and landing gear to lessors.

Rentals under operating leases are charged to operations over the lease term. Supplemental rent for maintenance accruals is $251 and $280 per flight hour for the B737-200 aircraft and B737-300 aircraft, respectively, and is expensed as incurred.

b) Airplane Purchase Commitment

In 1997 the Company signed an agreement to purchase a Boeing 737-700 to be delivered in February 2002. Deposits of $174,911 have been paid to Boeing. The Company's future payment schedule has been agreed as follows, although certain discounts and concessions have been negotiated which will reduce the total payment:

1999	$ **543**
2000	**3,097**
2001	**2,543**
2002	**36,021**
	$ **42,204**

In March 1997 the Company signed an agreement to purchase a B737-300 aircraft from Boeing. In December 1998 the Company assigned the purchase agreement to AALF, and subsequently signed a one year lease agreement for this aircraft with Austrian Airlines with the option to extend this lease for a further four years. The Aircraft was delivered in April 1999 and has a monthly fixed lease rate of $235,000 (refer to Note 11).

16. Contingent Liabilities

Legislation and regulations regarding taxation, foreign currency transactions and licensing of foreign currency loans in Ukraine continue to evolve as the central government manages the transformation from a command to a market-oriented economy. The various legislation and regulations are not always clearly written and their interpretation is subject to the opinions of the local tax inspectors, National Bank officials and the Ministry of Finance. Instances of inconsistent opinions between local, regional and national tax authorities and between the National Bank and Ministry of Finance are not unusual.

The current regime of penalties and interest related to reported and discovered violations of Ukraine's laws, decrees and related regulations are severe. Fines are levied when an understatement of tax liability is discovered by the tax administration at a rate of 30% of the understatement. Interest is assessable at a rate of 120% of the National Bank of Ukraine discount rate or 0.3% per day of the balance outstanding, depending on the type of tax. As a result, penalties and interest can result in amounts that are multiples of any unreported taxes.

16. Contingent Liabilities (continued)

The Company believes that it has paid or accrued all taxes that are applicable. Where practice concerning the provision for taxes is unclear, the Company has accrued tax liabilities based on management's best estimate. The Company's policy is to accrue for contingencies in the accounting period in which a loss is deemed probable and the amount is reasonably determinable. No such accruals have been made.

A number of legislation and other changes occurred during 1998 and 1997 that have caused uncertainty as to the tax consequences related to certain costs and payments. In particular, this relates to the amount and extent of VAT and withholding tax on and tax-deductibility of imported services and offshore aircraft lease and related payments. The Company is reviewing its lease and imported services related payments and agreements and has considered the actions that are necessary and possible to mitigate these uncertainties. The Company has not been challenged by the tax authorities in relation to such payments and costs; however, there can be no assurances that it will not be challenged by the authorities and, if challenged, will not be assessed additional taxes as well as penalties.

Because of the uncertainties associated with the Ukrainian tax and legal systems, the ultimate amount of taxes, penalties and interest assessed, if any, may be in excess of the amount expensed to date and accrued at December 31, 1998. Although such amounts are possible and may be material, it is the opinion of the Company's management that these amounts are either not probable, not reasonably determinable, or both.

The Company's operations and financial position will continue to be affected by Ukrainian political developments, including the application of existing and future legislation and tax regulations. The likelihood of such occurrences and their effect on the Company could have a significant impact on the Company's operations. The Company does not believe that these contingencies, as related to its operations, are any more significant than those of similar enterprises in Ukraine.

17. Reconciliation of Ukrainian Statutory Financial Statements to Financial Statements Prepared in Accordance with International Accounting Standards

The following is a reconciliation of the 1998 and 1997 loss as reported in the Ukrainian statutory financial statements to the 1998 and 1997 results of operations reported in the accompanying financial statements prepared in accordance with IAS for the year ended December 31:

	1998	**1997**
Loss reported in the Ukrainian statutory financial statements	**$ (4,397)**	$ (1,406)
Adjustments to present financial statements in accordance with IAS:		
Differences in timing of revenue recognition	**1,338**	1,444
Ukrainian tax refunds and write-backs recognized in 1996 for IAS purposes	**-**	(1,000)
Differences in timing of expense recognition	**(324)**	(147)
Provision for impairment in value of construction-in-progress	**-**	(461)
Start-up costs	**187**	(374)
Depreciation of spare parts and rotables	**(206)**	(137)
Depreciation of property and equipment	**(68)**	(247)
Additional provision for doubtful debts	**(173)**	(123)
Foreign exchange loss (gain)	**532**	(136)
Other adjustments	**74**	(116)
Net loss in the IAS financial statements	**$ (3,037)**	$ (2,703)

18. Impact of the Year 2000 (unaudited)

The Year 2000 issue is the result of computer programs being written using two digits rather than four to define the applicable year. Any of the Company's computer programs that have time-sensitive software which is not "Year 2000 compliant" may recognize a date using "00" as the year 1900 rather than the year 2000. This could result in a system failure of miscalculations causing disruptions of operations, including, among other things, a temporary inability to process transactions or engage in normal business activities.

The Company has completed an assessment and has commenced the development of a modification plan to modify or replace portions of its software so that its computer systems will function properly with respect to dates in the year 2000 and thereafter. The total cost of modification or replacement of internal operating systems and computer systems on board aircraft is estimated at $267,000 which will be expensed as incurred. To date, the Company has not incurred and expensed a significant amount for the assessment of the Year 2000 Issue.

18. Impact of the Year 2000 (unaudited) (continued)

The Company believes that with modifications to existing software or conversion to new software, the Year 2000 Issue will not pose significant operational problems for its computer systems. If however, such modifications and conversions are not made, or are not completed timely, the Year 2000 Issue could not have a material impact on the operations of the Company.

It is unclear as to the extent that the Ukrainian government and other organizations who provide significant infrastructure services within Ukraine have addressed the Year 2000 Issue. Furthermore, the current events discussed in Note 1 could adversely affect the ability of the government and such organizations to fund adequate Year 2000 compliance programs. There is no guarantee that the systems of the government or of other organizations on which the Company relies will be timely converted and would not have an adverse effect on the Company and its systems.

The costs of the project and the date on which the Company believes it will complete the Year 2000 modifications are based on management's best estimates, which were derived utilizing numerous assumptions of future events, including the continued availability of certain resources and other factors. There can be no guarantee, however, that these estimates will be achieved and actual results could differ materially from those anticipated. The Company's financial statements as of December 31, 1998 and for the year then ended do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts or classifications of liabilities that may result from the outcome of this uncertainty.