Flaga Group hf.

Condensed Consolidated
Interim Financial Statements

1 January - 30 June 2007
USD

Flaga Group hf.
Lækjargata 4
101 Reykjavik

Reg. no. 581090-2189

Contents

Endorsement by the Board of Directors and the CEO

The Condensed Consolidated Interim Financial Statements of Flaga Group hf. ("the Company") for the period 1 January to 30 June 2007 have been prepared in accordance with International Financial Reporting Standards (IFRS) for Interim Financial Statements (IAS 34). The Condensed Consolidated Interim Financial Statements comprise the Interim Financial Statements of Flaga Group hf. and its subsidiaries ("the Group").

According to the Consolidated Income Statement, net loss amounted to USD 1.0 million for the first half of the year. According to the Consolidated Balance Sheet the stockholders' equity at period-end amounted to USD 39.2 million. As regards to changes in net equity the Board refers to the Statement of Changes in Equity.

The Board of Directors and CEO of Flaga Group hf. confirm the Company's Consolidated Interim Financial Statements for the period from 1 January to 30 June 2007 by means of their signatures.

Reykjavik, 29 August 2007.

Board of Directors:

Bogi Pálsson, Chairman
Eggert Dagbjartsson
Erlendur Hjaltason
Hákon Sigurhansson
Sveinn Þór Stefánsson

CEO:

David Baker

Independent Auditors' Review Report

To the Board of Directors of Flaga Group hf.

Introduction

We have reviewed the accompanying Condensed Consolidated Interim Balance Sheet of Flaga Group hf. as of 30 June 2007, and the related Consolidated Income Statement, Changes in Equity and Cash Flows for the six month period then ended and a summary of significant accounting policies and other explanatory notes. Management is responsible for the preparation and fair presentation of this interim financial information in accordance with the International Financial Reporting Standard IAS 34, *Interim Financial Reporting* . Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of review

We conducted our review in accordance with the International Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity." A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, we believe that, as the related operating results are poor, there are indications that there will be an impairment of goodwill in the Company's Sleep diagnostic system business segment at the end of the year. The carrying amount of the goodwill involved is 14.1 million USD, but we have not estimated the amount of impairment.

Apart from the point above, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of the financial positions of the entity as at 30 June 2007, and of its financial performance and its cash flows for the six-month period then ended in accordance with IAS 34, *Interim Financial Reporting* .

Reykjavik, 29 August 2007.

KPMG hf.

Eyvindur Albertsson
Símon Á. Gunnarsson

Consolidated Interim Income Statement

	Notes	Q2 2007 1.4.-30.6.	Q2 2006 1.4.-30.6.	YTD 2007 1.1.-30.6.	YTD 2006 1.1.-30.6.
Sales	5	8.855.158	7.934.489	16.059.105	15.317.968
Cost of goods sold		(3.445.095)	(3.221.746)	(6.256.206)	(5.952.880)
Gross profit		5.410.063	4.712.743	9.802.899	9.365.088
Sales and marketing expenses		(3.279.446)	(2.809.722)	(5.882.451)	(5.677.991)
General and administrative expenses		(1.593.817)	(1.551.406)	(3.321.404)	(2.948.801)
Research and development expenses		(718.769)	(506.480)	(1.294.789)	(1.341.000)
Restructuring costs	11	95.912	0	95.912	(267.487)
		(5.496.120)	(4.867.608)	(10.402.732)	(10.235.279)
Operating loss before financing costs		(86.057)	(154.865)	(599.833)	(870.191)
Net financing costs	7	(90.232)	(376.902)	(318.231)	(803.936)
Loss before taxes		(176.289)	(531.767)	(918.064)	(1.674.127)
Income tax	8	(251.421)	164.264	(114.837)	430.020
Net loss attributable to equity holders of the Company		(427.710)	(367.503)	(1.032.901)	(1.244.107)
Earnings per share	10				
Basic loss per share		(0,0006)	(0,0005)	(0,0014)	(0,0017)
Diluted loss per share		(0,0006)	(0,0005)	(0,0013)	(0,0016)

The notes on pages 9 to 13 are an integral part of these condensed consolidated interim financial statements.

Consolidated Interim Balance Sheet

Assets	Notes	30.6.2007	31.12.2006
Property and equipment		1.625.488	1.854.509
Intangible assets		38.694.352	38.944.093
Tax asset	8	4.214.985	4.176.318
Total non-current assets		44.534.825	44.974.920
Inventories		3.833.622	4.113.758
Trade and other receivables		11.500.352	11.575.802
Cash and cash equivalents		932.688	1.459.245
Total current assets		16.266.662	17.148.805
Total assets		60.801.487	62.123.725
Stockholders Equity			
Share capital	9	9.794.691	9.794.691
Additional paid-in capital		33.235.083	33.235.083
Translation reserve		(108.989)	(68.506)
Share based payments		262.855	221.501
Accumulated deficit		(4.002.374)	(2.969.473)
Total equity		39.181.266	40.213.296
Liabilities			
Interest bearing loans and borrowings		3.814.670	4.286.668
Total non-current liabilities		3.814.670	4.286.668
Bank loans		7.580.643	7.668.413
Interest-bearing loans and borrowings		5.003.848	5.003.848
Provisions	11	55.005	150.917
Trade and other payables		5.166.055	4.800.583
Total current liabilities		17.805.551	17.623.761
Total liabilities		21.620.221	21.910.429
Total equity and liabilities		60.801.487	62.123.725

The notes on pages 9 to 13 are an integral part of these condensed consolidated interim financial statements.

Consolidated Statement of Changes in Equity

Changes in Equity 1 January - 30 June 2006

	Share capital	Additional paid-in capital	Translation reserve	Share-based payments	Accumu-lated deficit	Total equity
Balance at 1 January 2006	9.794.691	33.235.083	9.701	192.487	(2.279.332)	40.952.630
Translation differences of foreign operations	0	0	(78.207)	0	0	(78.207)
Net income (expense) recognized directly in equity	0	0	(78.207)	0	0	(78.207)
Loss for the period	0	0	0	0	(690.141)	(690.141)
Total recognized income and expense for the year	0	0	(78.207)	0	(690.141)	(768.348)
Share-based payments	0	0	0	29.014	0	29.014
Balance at 30 June 2006	9.794.691	33.235.083	(68.506)	221.501	(2.969.473)	40.213.296

Changes in Equity 1 January - 30 June 2007

	Share capital	Additional paid-in capital	Translation reserve	Share-based payments	Accumu-lated deficit	Total equity
Balance at 1 January 2007	9.794.691	33.235.083	(68.506)	221.501	(2.969.473)	40.213.296
Translation differences of foreign operations	0	0	(40.483)	0	0	(40.483)
Net income (expense) recognized directly in equity	0	0	(40.483)	0	0	(40.483)
Loss for the period	0	0	0	0	(1.032.901)	(1.032.901)
Total recognized income and expense for the year	0	0	(40.483)	0	(1.032.901)	(1.073.384)
Share-based payments	0	0		41.354	0	41.354
Balance at 30 June 2007	9.794.691	33.235.083	(108.989)	262.855	(4.002.374)	39.181.266

The notes on pages 9 to 13 are an integral part of these condensed consolidated interim financial statements.

Consolidated Interim Statement of Cash Flows

	2007 1.1.-30.6.	2006 1.1.-30.6.
Working capital paid in operating activities	(463.797)	(578.589)
Change in operating assets and liabilities, interest and income taxes paid	681.823	(1.807.687)
Net cash from (to) operating activities	218.026	(2.386.276)
Cash flows to investing activities	(186.187)	(234.102)
Cash flows (to) from financing activities	(559.770)	2.145.004
Decrease in cash and cash equivalents	(527.931)	(475.374)
Cash and cash equivalents at beginning of the year	1.459.245	1.232.787
Effects of exchange rate fluctuations on cash held	1.374	1.932
Cash and cash equivalents at end of the period	932.688	759.345

The notes on pages 9 to 13 are an integral part of these condensed consolidated interim financial statements.

Notes to the Consolidated Financial Statements

Significant Accounting Policies

1. *Reporting entity*

Flaga Group hf. (the "Company") is a company incorporated and domiciled in Iceland. The Condensed Consolidated Interim Financial Statements of the Company for the period from 1 January to 30 June 2007 comprise the Company and its subsidiaries (together referred to as the "Group").

The Condensed Consolidated Interim Financial Statements were approved by the Board of Directors on 29 August 2007.

2. *Statement of Compliance*

These Consolidated Interim Financial Statements have been prepared in accordance with International Financial Reporting Standard (IFRS) IAS 34, *Interim Financial Reporting* as adopted by the EU.

They do not include all of the information required for full annual Financial Statements, and should be read in conjunction with the Consolidated Financial Statements of the Company as at and for the year ended 31 December 2006.

3. *Significant accounting policies*

The accounting policies and methods of computation applied by the Company in these Condensed Interim Consolidated Financial Statements are the same as those applied by the Company in its Consolidated Financial Statements as at and for the year ended 31 December 2006. The Financial Statements for the year 2006 are available at the Company's website, www.Flagagroup.com and at The Nordic Stock Exchange website, www.omxgroup.com.

The Condensed Consolidated Interim Financial Statements are prepared in USD. They are prepared on the historical cost basis except for derivative financial instruments which are stated at their fair value.

4. *Significant judgements and accounting estimates*

The preparation of Interim Financial Statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

In preparing these Condensed Interim Financial Statements, the significant judgements made by management in applying the Group's accounting policies and the key sources of estimation uncertainty were the same as those that applied to the Consolidated Financial Statements as at and for the year ended 31 December 2006.

Notes to the Consolidated Financial Statements

Segment reporting

5. The Group's business segments are sleep diagnostics systems and sleep diagnostics services.

For the six months ended 30 June 2007 **Business Segments**	**Sleep diagnostics systems**	**Sleep diagnostics services**	**Eliminations**	**Consolidated**
Revenue from external customers	9.564.330	6.494.775		16.059.105
Inter-segment revenue	2.235.012		(2.235.012)	0
Total revenue	11.799.342	6.494.775	(2.235.012)	16.059.105
Segment result	(1.682.967)	1.424.970	47.911	(210.086)
Unallocated expenses				(389.747)
Operating loss				(599.833)
Net financing cost				(318.231)
Income tax				(114.837)
Loss for the period				(1.032.901)

Quarterly Statements

6. Quarterly Income Statement for the year 2006 and first quarter 2007 (Amounts in thousands of USD):

	2007 Q2	2007 Q1	2006 Q4	2006 Q3	2006 Q2
Sales	8.855	7.204	9.659	7.498	7.934
Cost of goods sold	(3.445)	(2.811)	(4.149)	(3.066)	(3.222)
Gross profit	5.410	4.393	5.510	4.432	4.712
Sales, general and admin expenses	(4.873)	(4.331)	(4.467)	(3.968)	(4.361)
Research and development expenses	(719)	(576)	(564)	(458)	(506)
Restructuring cost	96	0	0	0	0
Profit (loss) from operations	(86)	(514)	480	6	(155)
Net financial expense	(90)	(228)	(158)	(109)	(377)
(Loss)/Profit before taxes	(176)	(742)	322	(103)	(532)
Taxes	(252)	137	341	(5)	164
(Loss) profit	(428)	(605)	662	(108)	(368)

EBITDA is specified as follows:

	2007 Q2	2007 Q1	2006 Q4	2006 Q3	2006 Q2
Revenue	8.855	7.204	9.659	7.498	7.934
Cost of sales	(3.445)	(2.811)	(4.149)	(3.066)	(3.222)
Gross profit	5.410	4.393	5.510	4.432	4.712
Operating expenses, less depreciation	(5.107)	(4.595)	(4.682)	(4.116)	(4.516)
EBITDA	303	(202)	828	316	196

Notes to the Consolidated Financial Statements

Net financing costs

7. Financial expenses and financial income are specified as follows:

	2007 1.1.-30.6.	2006 1.1.-30.6.
Interest income	1.575	1.294
Interest expenses	(629.300)	(721.582)
Currency exchange fluctuations	309.494	(83.648)
Net financial expenses	(318.231)	(803.936)

Deferred tax assets

8. The Groups deferred tax asset is specified as follows:

	30.6.2007	31.12.2006
Deferred tax asset at the beginning of year	4.176.318	3.537.121
Deferred tax (expenses) revenue in the income statement	(114.837)	819.857
Effects of movement in exchange rates	153.504	(180.660)
Calculated deferred income tax asset at year-end	4.214.985	4.176.318

The income tax charged to the income statement, is calculated for the subsidiary Embla ehf. in Iceland and the parent company, which have a taxable profit for the period. Due to uncertainty of utilization of carry forward tax losses in the USA, the deferred tax asset for the joint taxable subsidiaries in the USA has not been increased despite a taxable for the period. An impairment test will be performed on the income tax asset of USD 3.1. million at the year end.

Capital and Reserves

9. According to the Company´s Articles of Association the share capital at 30 June 2007 was 720,695.133 shares which equals to USD 9.8 million based on the conversion at the exchange rate at the payment date. Each share in the Company is of nominal value ISK 1 and carries one vote.

Earnings per share

Loss per share

10. The calculation of loss per share at June 2007 was based on the loss attributable to equity shareholders of the Company of USD 1.0 million and a weighted average number of ordinary shares outstanding during the period ended June 30, 2007 of 720.7 million shares, calculated as follows:

	2007 1.1.-30.6.	2006 1.1.-30.6.
Loss for the period attributable to equity holders of the Company	(1.032.901)	(1.244.107)
Total average number of shares outstanding during the period	720.695.133	720.695.133

Notes to the Consolidated Financial Statements

10. cont:

Diluted loss per share

The calculation of diluted loss per share at 30 June 2007 was based on loss attributable to ordinary equity holders of the Company of USD 1.0 millions and a weighted average number of ordinary shares outstanding after adjustment for the effects of all dilutive potential ordinary shares of 767.1 millions, calculated as follows:

Loss attributable to equity holders of the Company (diluted)	2007 1.1.-30.6.	2006 1.1.-30.6.
Loss for the year attributable to equity holders of the Company	(1.032.901)	(1.244.107)
Weighted average number of ordinary shares (diluted)		
Weighted average number of ordinary shares (basic)	720.695.133	720.695.133
Effects of convertible loan	46.400.000	43.500.000
Weighted average number of ordinary shares (diluted) at 30 June	767.095.133	764.195.133

Provisions

11. Provisions are specified as follows:	**Restruct. cost**	**Warranties**	**Total**
Balance at 1 January 2007	95.912	55.005	150.917
Provisions moved out during the period*	(95.912)		(95.912)
Balance at 30 June 2007	0	55.005	55.005

In February 2006 it was decided to move the hardware research and development team from Iceland to Denver, Colorado and prototyping and manufacturing design was outsourced as required. The restructuring costs related was estimated and a provision of USD 267 thousand was made in Q1 2006, the remaining figure at year end 2006 was USD 96 thousand. The restructuring is now fully completed, the remaining provision at year end 2006 was not used. This leads to reverse of cost in Q2 2007 of USD 96 thousand as shown in the income statement.

Related party transactions

12. **Identity of related parties:**

The Group has a related party relationship with its subsidiaries, one of its shareholders and with management.

All agreements are priced at arms length basis.

Notes to the Consolidated Financial Statements

Group entities

13. At June 30, 2007 the Company's subsidiaries were seven. The subsidiaries included in the Condensed Consolidated Interim Financial Statements are the following:

Name of subsidiary	Place of registration and operation	Ownership %	Principal activity
Embla Systems Inc., USA	USA	100%	Sleep diagnostics systems
Embla Systems B.V., the Netherlands	Netherlands	100%	Sleep diagnostics systems
Embla Systems GmbH, Germany	Germany	100%	Sleep diagnostics systems
Midwest Sleep & Neurodiagnostic Institute, USA	USA	100%	Sleep diagnostics systems
SleepTech LLC, USA	USA	100%	Sleep diagnostics services
Embla Systems Ltd, Canada	Canada	100%	Sleep diagnostics systems
Embla Systems ehf.	Iceland	100%	Sleep diagnostics systems

Financial ratios

14. The main financial ratios for the company are as follows:

Income Statement:	2007 1.1.-30.6.	2006 1.1.-30.6.
EBITDA	101.394	(142.111)
EBIT	(599.833)	(870.191)
Earnings per share - loss/weighted share capital	(0,0014)	(0,0017)

Balance Sheet:	2007 30.6.	2006 30.6.
Current assets/current liabilities	0,91	1,23
Equity/total capital	64%	66%