

Flaga Group hf.
Condensed Consolidated
Interim Financial Statements
1 January - 31 March 2007
USD

Flaga Group hf.
Lækjargata 4
101 Reykjavík

Reg. no. 581090-2189

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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 31 March 2007 have been prepared in accordance with International Financial Reporting Standards (IFRS) for Interim Financial Statements (IAS 34). The Interim Financial Statements comprise the Consolidated Interim Financial Statements of Flaga Group hf. and its subsidiaries ("the Group").

According to the Consolidated Income Statement, net loss amounted to USD 0.6 million for the first three months of the year. According to the Consolidated Balance Sheet the stockholders' equity at period-end amounted to USD 39.6 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 31 March 2007 by means of their signatures.

Reykjavik, 31 May 2007.

Board of Directors:

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

CEO:

David Baker

Consolidated Interim Income Statement

	Notes	2007 1.1.-31.3.	2006 1.1.-31.3.
Sales	5	7.203.947	7.383.479
Cost of goods sold		(2.811.111)	(2.731.134)
Gross profit		<u>4.392.836</u>	<u>4.652.345</u>
Sales and marketing expenses		(2.603.005)	(2.088.634)
General and administrative expenses		(1.727.587)	(2.177.030)
Research and development expenses		(576.020)	(834.520)
Restructuring costs		0	(267.487)
		<u>(4.906.612)</u>	<u>(5.367.671)</u>
Operating loss before financing costs		(513.776)	(715.326)
Net financing costs	7	(227.999)	(427.034)
Loss before taxes		(741.775)	(1.142.360)
Income tax		136.584	265.756
Net loss attributable to equity holders of the Company		<u>(605.191)</u>	<u>(876.604)</u>
 Earnings per share	 9		
Basic loss per share		(0,0008)	(0,0012)
Diluted loss per share		(0,0008)	(0,0011)

The notes on pages 8 to 12 are an integral part of these condensed consolidated interim financial statements.

Consolidated Interim Balance Sheet

Assets	Notes	31.3.2007	31.12.2006
Property and equipment		1.787.046	1.854.509
Intangible assets		38.817.734	38.944.093
Tax asset		4.395.117	4.176.318
Total non-current assets		44.999.897	44.974.920
Inventories		4.126.073	4.113.758
Trade and other receivables		11.541.048	11.575.802
Cash and cash equivalents		490.204	1.459.245
Total current assets		16.157.325	17.148.805
Total assets		61.157.222	62.123.725
Stockholders Equity			
Share capital	8	9.794.691	9.794.691
Additional paid-in capital		33.235.083	33.235.083
Translation reserve		(86.515)	(68.506)
Share based payments		242.178	221.501
Accumulated deficit		(3.574.664)	(2.969.473)
Total equity		39.610.773	40.213.296
Liabilities			
Interest bearing loans and borrowings		3.863.168	4.286.668
Total non-current liabilities		3.863.168	4.286.668
Bank loans		7.645.207	7.668.413
Interest-bearing loans and borrowings		5.003.850	5.003.848
Provisions		150.917	150.917
Trade and other payables		4.883.307	4.800.583
Total current liabilities		17.683.281	17.623.761
Total liabilities		21.546.449	21.910.429
Total equity and liabilities		61.157.222	62.123.725

The notes on pages 8 to 12 are an integral part of these condensed consolidated interim financial statements.

Consolidated Statement of Changes in Equity

Changes in Equity 1 January - 31 December 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) recognised directly in equity.....	0	0	(78.207)	0	0	(78.207)
Loss for the year.....	0	0	0	0	(690.141)	(690.141)
Total recognised 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 31 December 2006.....	9.794.691	33.235.083	(68.506)	221.501	(2.969.473)	40.213.296

Changes in Equity 1 January - 31 March 2007

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	(18.009)	0	0	(18.009)
Net income (expense) recognised directly in equity.....	0	0	(18.009)	0	0	(18.009)
Loss for the year.....	0	0	0	0	(605.191)	(605.191)
Total recognised income and expense for the year.....	0	0	(18.009)	0	(605.191)	(623.200)
Share-based payments.....	0	0	0	20.677	0	20.677
Balance at 31 March 2007.....	9.794.691	33.235.083	(86.515)	242.178	(3.574.664)	39.610.773

The notes on pages 8 to 12 are an integral part of these condensed consolidated interim financial statements.

Consolidated Interim Statement of Cash Flows

	2007 1.1.-31.3.	2006 1.1.-31.3.
Working capital paid in by operating activities	(513.419)	(265.328)
Change in operating assets and liabilities, interest and income taxes paid	80.168	(1.079.313)
Net cash to operating activities	<u>(433.251)</u>	<u>(1.344.641)</u>
Cash flows to investing activities	<u>(90.469)</u>	<u>(150.385)</u>
Cash flows (to) from financing activities	<u>(446.706)</u>	<u>1.667.399</u>
(Decrease) increase in cash and cash equivalents	(970.426)	172.373
Cash and cash equivalents at 1 January	1.459.245	1.232.787
Effects of exchange rate fluctuations on cash held	<u>1.385</u>	<u>402</u>
Cash and cash equivalents at 31 March	<u><u>490.204</u></u>	<u><u>1.405.562</u></u>

The notes on pages 8 to 12 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 31 March 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 31 May 2007.

2. Statement of Compliance

These Condensed Consolidated Interim Financial Statements have been prepared in accordance with International Financial Reporting Standard IAS 34, Interim Financial Reporting.

They do not include all of the information required for a complete set of consolidated 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 Interim Consolidated 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 three months ended 31 March 2007				
Business Segments	Sleep diagnostics systems	Sleep diagnostics services	Eliminations	Consolidated
Revenue from external customers	4.096.234	3.107.713		7.203.947
Inter-segment revenue	997.766		(997.766)	0
Total revenue	5.094.000	3.107.713	(997.766)	7.203.947
Segment result	(899.188)	639.378	36.498	(223.312)
Unallocated expenses				(290.464)
Operating loss				(513.776)
Net financing cost				(227.999)
Income tax				136.584
Loss for the period				(605.191)

Geographical segments	America	Europe	Other regions	Consolidated
Revenue from external customers	5.113.547	1.878.519	211.881	7.203.947

For the three months ended 31 March 2006				
Business Segments	Sleep diagnostics systems	Sleep diagnostics services	Eliminations	Consolidated
Revenue from external customers	4.551.604	2.831.875		7.383.479
Inter-segment revenue	843.629		(843.629)	0
Total revenue	5.395.233	2.831.875	(843.629)	7.383.479
Segment result	(1.090.622)	573.014	2.195	(515.413)
Unallocated expenses				(199.913)
Operating loss				(715.326)
Net financing cost				(427.034)
Income tax				265.756
Loss for the year				(876.604)

Geographical segments	America	Europe	Other regions	Consolidated
Revenue from external customers	5.139.881	1.999.758	243.840	7.383.479

Notes to the Consolidated Financial Statements

Quarterly Statements

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

	2007 Q1	2006 Q4	2006 Q3	2006 Q2	2006 Q1
Sales	7.204	9.659	7.498	7.934	7.383
Cost of goods sold	(2.811)	(4.149)	(3.066)	(3.222)	(2.731)
Gross profit	4.393	5.510	4.432	4.712	4.652
Sales, general and admin expenses	(4.331)	(4.467)	(3.968)	(4.361)	(4.266)
Research and development expenses	(576)	(564)	(458)	(506)	(835)
Restructuring cost	0	0	0	0	(267)
Profit (loss) from operations	(514)	480	6	(155)	(716)
Net financial expense	(228)	(158)	(109)	(377)	(427)
(Loss)/Profit before taxes	(742)	322	(103)	(532)	(1.143)
Taxes	137	341	(5)	164	266
(Loss) profit	(605)	662	(108)	(368)	(877)

EBITDA is specified as follows:

Revenue	7.204	9.659	7.498	7.934	7.383
Cost of sales	(2.811)	(4.149)	(3.066)	(3.222)	(2.731)
Gross profit	4.393	5.510	4.432	4.712	4.652
Operating expenses, less depreciation	(4.595)	(4.682)	(4.116)	(4.516)	(4.990)
EBITDA	(202)	828	316	196	(338)

Net financing costs

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

	2007 1.1.-31.3.	2006 1.1.-31.3.
Interest income	996	344
Interest expenses	(312.739)	(389.127)
Currency exchange fluctuations	83.744	(38.251)
Net financial expenses	(227.999)	(427.034)

Notes to the Consolidated Financial Statements

Capital and Reserves

8. According to the Company's Articles of Association the share capital at 31 March 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

9. The calculation of loss per share at March 2007 was based on the loss attributable to equity shareholders of the Company of USD 0.6 million and a weighted average number of ordinary shares outstanding during the period ended March 31, 2007 of 720.7 million shares, calculated as follows:

	2007	2006
	1.1.-31.3.	1.1.-31.3.
Loss for the period attributable to equity holders of the Company.....	(605.191)	(876.604)
Total average number of shares outstanding during the period.....	<u>720.695.133</u>	<u>720.695.133</u>

Diluted loss per share

The calculation of diluted loss per share at 31 March 2007 was based on loss attributable to ordinary equity holders of the Company of USD 0.6 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:

	2007	2006
	1.1.-31.3.	1.1.-31.3.
<i>Loss attributable to equity holders of the Company (diluted)</i>		
Loss for the year attributable to equity holders of the Company.....	(605.191)	(876.604)

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 31 March.....	<u>767.095.133</u>	<u>764.195.133</u>

Notes to the Consolidated Financial Statements

Related party transactions

10. 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.

Group entities

11. At March 31, 2006 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

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

	2007	2006
Income Statement:	1.1.-31.3.	1.1.-31.3.
EBITDA	(202.349)	(338.388)
EBIT	(513.776)	(715.326)
Earnings per share - loss/weighted share capital	(0,0008)	0,0012
Balance Sheet:	2007	2006
	31.3.	31.3.
Current assets/current liabilities	0,91	1,23
Equity/total capital	65%	65%