

**Flaga Group hf.**  
**Condensed Consolidated**  
**Interim Financial Statements**  
**1 January - 31 March 2008**  
**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**

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The Condensed Consolidated Interim Financial Statements of Flaga Group hf. ("the Company") for the period 1 January to 31 March 2008 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 95,310 for the first three months of the year. According to the Consolidated Balance Sheet the stockholders' equity at period-end amounted to USD 27,154,190 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 2008 by means of their signatures.

Reykjavik, May 8, 2008.

**Board of Directors:**

Bogi Pálsson  
Eggert Dagbjartsson  
Erlendur Hjaltason  
Hildur Árnadóttir  
Hákon Sigurhansson

**Chief Executive Officer:**

David Baker

## Consolidated Interim Income Statement

		2008	2007
	Notes	1.1.-31.3.	1.1.-31.3.
Sales .....	5	8,739,102	7,203,947
Cost of goods sold .....		<u>( 3,671,181)</u>	<u>( 2,811,111)</u>
<b>Gross profit</b> .....		5,067,921	4,392,836
Sale of Iceland distribution business .....		339,160	0
Sales,marketing, general and administrative expenses .....		<u>( 4,757,414)</u>	<u>( 4,330,592)</u>
Research and development expenses .....		<u>( 445,930)</u>	<u>( 576,020)</u>
		<u>( 4,864,184)</u>	<u>( 4,906,612)</u>
<b>Operating Profit (loss) before financing costs</b> .....		203,737	( 513,776)
<b>Net financing costs</b> .....	7	<u>( 183,476)</u>	<u>( 227,999)</u>
<b>Profit (Loss) before taxes</b> .....		20,261	( 741,775)
Income tax .....		<u>( 115,571)</u>	<u>136,584</u>
<b>Net loss attributable to equity holders of the Company</b> .....		<u>( 95,310)</u>	<u>( 605,191)</u>
 <b>Earnings per share</b>	 9		
Basic loss per share .....		( 0.0001)	( 0.0008)
Diluted loss per share .....		( 0.0001)	( 0.0008)

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

## Consolidated Interim Balance Sheet

Assets	Notes	31.3.2008	31.12.2007
Property and equipment .....		1,396,172	1,498,738
Intangible assets .....		27,745,568	27,731,757
Tax asset .....		3,975,007	4,360,688
<b>Total non-current assets</b> .....		33,116,747	33,591,183
Inventories .....		3,402,547	3,362,621
Trade and other receivables .....		9,428,186	9,590,735
Cash and cash equivalents .....		2,170,681	1,394,240
<b>Total current assets</b> .....		15,001,414	14,347,596
<b>Total assets</b> .....		48,118,161	47,938,779
<b>Stockholders Equity</b>			
Share capital .....	8	9,794,691	9,794,691
Additional paid-in capital .....		33,235,083	33,235,083
Translation reserve .....		( 471,112)	( 281,530)
Share based payments .....		112,752	98,693
Accumulated deficit .....		( 15,517,224)	( 15,421,914)
<b>Total equity</b> .....		27,154,190	27,425,023
<b>Liabilities</b>			
Interest bearing loans and borrowings .....		2,879,035	3,312,097
<b>Total non-current liabilities</b> .....		2,879,035	3,312,097
Bank loans .....		7,652,214	7,558,577
Interest-bearing loans and borrowings .....		4,855,271	4,659,417
Provisions .....			55,000
Trade and other payables .....		5,577,451	4,928,665
<b>Total current liabilities</b> .....		18,084,936	17,201,659
<b>Total liabilities</b> .....		20,963,971	20,513,756
<b>Total equity and liabilities</b> .....		48,118,161	47,938,779

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 March 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	( 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

### Changes in Equity 1 January - 31 March 2008

Balance at 1 January 2008.....	9,794,691	33,235,083	( 281,530)	98,693	(15,421,914)	27,425,023
Translation differences of foreign operations.....	0	0	( 189,582)	0	0	( 189,582)
Net income (expense) recognised directly in equity.....	0	0	( 189,582)	0	0	( 189,582)
Loss for the period.....	0	0	0	0	( 95,310)	( 95,310)
Total recognised income and expense for the year.....	0	0	( 189,582)	0	( 95,310)	( 284,892)
Share-based payments.....	0	0	0	14,059	0	14,059
Balance at 31 March 2008.....	9,794,691	33,235,083	( 471,112)	112,752	(15,517,224)	27,154,190

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

## Consolidated Interim Statement of Cash Flows

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	2008	2007
	1.1.-31.3.	1.1.-31.3.
<b>Working capital provided (paid in) by operating activities</b> .....	341,380	( 513,419)
Change in operating assets and liabilities, interest and income taxes paid	664,984	80,168
<b>Net cash from (to) operating activities</b> .....	<u>1,006,364</u>	<u>( 433,251)</u>
<b>Cash flows to investing activities</b> .....	<u>( 86,951)</u>	<u>( 90,469)</u>
<b>Cash flows to financing activities</b> .....	<u>( 237,211)</u>	<u>( 446,706)</u>
Increase (Decrease) in cash and cash equivalents .....	682,202	( 970,426)
Cash and cash equivalents at 1 January .....	1,498,738	1,459,245
Effects of exchange rate fluctuations on cash held .....	<u>( 10,259)</u>	<u>1,385</u>
<b>Cash and cash equivalents at 31 March</b> .....	<u><u>2,170,681</u></u>	<u><u>490,204</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

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## 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 2008 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 May 8 2008.

### 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 2007.

### 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 2007. The Financial Statements for the year 2007 are available at the Company's website, [www.Flagagroup.com](http://www.Flagagroup.com) and at The Nordic Stock Exchange website, [www.omxgroup.com](http://www.omxgroup.com)

The Condensed Interim Consolidated Financial Statements are prepared in USD and are prepared on the historical cost.

### 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 2007.



# Notes to the Consolidated Financial Statements

## Segment reporting

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

<b>For the three months ended 31 March 2008</b>				
<b>Business Segments</b>	<b>Sleep diagnostics systems</b>	<b>Sleep diagnostics services</b>	<b>Eliminations</b>	<b>Consolidated</b>
Revenue from external customers .....	7,002,787	2,905,599	( 1,169,284)	8,739,102
Inter-segment revenue .....	1,169,284			1,169,284
Total revenue .....	<u>8,172,071</u>	<u>2,905,599</u>	<u>( 1,169,284)</u>	<u>9,908,386</u>
Segment result .....	<u>83,369</u>	<u>300,901</u>		384,270
Unallocated expenses .....				( 180,533)
Operating loss .....				203,737
Net financing cost .....				( 183,476)
Income tax .....				( 115,571)
Loss for the period .....				<u>( 95,310)</u>

<b>Geographical segments</b>	<b>America</b>	<b>Europe</b>	<b>Other regions</b>	<b>Consolidated</b>
Revenue from external customers .....	<u>5,252,062</u>	<u>3,181,880</u>	<u>305,160</u>	<u>8,739,102</u>

<b>For the three months ended 31 March 2007</b>				
<b>Business Segments</b>	<b>Sleep diagnostics systems</b>	<b>Sleep diagnostics services</b>	<b>Eliminations</b>	<b>Consolidated</b>
Revenue from external customers .....	4,096,234	3,107,713		7,203,947
Inter-segment revenue .....	997,766		( 997,766)	0
Total revenue .....	<u>5,094,000</u>	<u>3,107,713</u>	<u>( 997,766)</u>	<u>7,203,947</u>
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 year .....				<u>( 605,191)</u>

<b>Geographical segments</b>	<b>America</b>	<b>Europe</b>	<b>Other regions</b>	<b>Consolidated</b>
Revenue from external customers .....	<u>5,113,547</u>	<u>1,878,519</u>	<u>211,881</u>	<u>7,203,947</u>

# Notes to the Consolidated Financial Statements

## Quarterly Statements

6. Quarterly Income Statement for the year 2007 and first quarter 2008 (Amounts in thousands of USD):

	2008 Q1	2007 Q4	2007 Q3	2007 Q2	2007 Q1
Sales .....	8,739	9,199	7,903	8,855	7,204
Cost of goods sold .....	( 3,671)	( 4,638)	( 3,162)	( 3,445)	( 2,811)
Gross profit .....	5,068	4,561	4,741	5,410	4,393
Sales, general and admin expenses .....	( 4,757)	( 4,442)	( 4,082)	( 4,873)	( 4,332)
Research and development expenses .....	( 446)	( 736)	( 622)	( 719)	( 576)
Restructuring cost recovery .....	0	0	0	96	0
Sale of Icelandic distribution business .....	339				
Profit (loss) from Operations .....	204	( 617)	37	( 86)	( 515)
Net financial expense .....	( 183)	( 303)	( 7)	( 90)	( 229)
Impairment loss .....	0	( 10,800)	0	0	0
Profit (loss) before taxes .....	21	( 11,720)	30	( 176)	( 744)
Taxes .....	( 116)	175	( 84)	( 252)	137
Profit (loss) .....	( 95)	( 11,545)	( 54)	( 428)	( 607)

EBITDA is specified as follows:

Revenue .....	8,739	9,199	7,903	8,855	7,204
Cost of sales .....	( 3,671)	( 4,638)	( 3,162)	( 3,445)	( 2,811)
Gross profit .....	5,068	4,561	4,741	5,410	4,393
Operating expenses, less depreciation .....	( 4,966)	( 4,895)	( 4,381)	( 5,107)	( 4,595)
Sale of Icelandic distribution business .....	339	0	0	0	0
EBITDA .....	441	( 334)	360	303	( 202)

## Net financing costs

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

	2008 1.1.-31.3.	2007 1.1.-31.3.
Interest income .....	5,567	996
Interest expenses .....	( 290,119)	( 312,739)
Currency exchange fluctuations .....	101,076	83,744
Net financial expenses .....	( 183,476)	( 227,999)

# Notes to the Consolidated Financial Statements

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## Capital and Reserves

8. According to the Company's Articles of Association the share capital at 31 March 2008 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 profit per share at March 2008 was based on the loss attributable to equity shareholders of the Company of USD 95,310 and a weighted average number of ordinary shares outstanding during the period ended March 31, 2008 of 720.7 million shares, calculated as follows:

	2008	2007
	1.1.-31.3.	1.1.-31.3.
Profit (loss) for the period attributable to equity holders of the Company.....	( 95,310)	( 605,191)
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 profit per share at 31 March 2007 was based on loss attributable to ordinary equity holders of the Company of USD 95,310 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:

	2008	2007
	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.....	( 95,310)	( 605,191)

### **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	46,400,000
Weighted average number of ordinary shares (diluted) at 31 March.....	<u>767,095,133</u>	<u>767,095,133</u>

# Notes to the Consolidated Financial Statements

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## Loans and borrowings

### Subordinated loan

The Company received an extension of the convertible loan through January 2009.

### Bank loans

The Company's line of credit with its commercial bank has been extended through November 2008.

## 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, 2008 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:

	2008	2007
	1.1.-31.3.	1.1.-31.3.
Income Statement:		
EBITDA .....	441,442 (	202,349)
EBIT .....	203,737 (	513,776)
Earnings per share - loss/weighted share capital .....	( 0.0001) (	0.0008)
Balance Sheet:	2008	2007
	31.3.	31.12.
Current assets/current liabilities .....	0.83	0.83
Equity/total capital .....	56%	57%