FLAGA GROUP

Innovators in Sleep

Contents

Financial Overview

STATEMENT OF OPERATIONS

USD '000

	2006	2005	2004	2003*	2002*
Sales	32,474	34,747	26,446	19,134	10,151
Cost of goods sold	13,168	12,760	9,614	7,484	4,061
Gross profit	**19,307**	**21,987**	**16,832**	**11,650**	**6,090**
Operating expenses					
Sales, general and admin exp.	17,062	18,476	14,760	9,700	3,663
Research and development	2,363	2,693	2,529	2,507	1,825
Restructuring cost	267	2,059			
Total operating expenses	**19,692**	**23,228**	**17,289**	**12,207**	**5,488**
Operating profit (loss)	**-386**	**-1,241**	**-457**	**-557**	**602**
Net financial income (expenses)	-1,071	-1,152	-56	-647	-303
Amortization of goodwill and other expenses					-781
Operating profit (loss) bef. taxes	**-1,456**	**-2,393**	**-513**	**-1,204**	**-482**
Taxes	766	948	583	689	-14
Profit (loss)	**-690**	**-1,445**	**70**	**-515**	**-496**
EBITDA before restructuring cost	**1,268**	**2,727**			
EBITDA after restructuring costs	**1,001**	**668**	**765**	**172**	**860**

* Numbers before 2004 have not been restated according to IFRS Accounting Standards. Therefore years prior to 2004 are not fully comparable.

BALANCE SHEET

USD '000	Dec 31, 2006	Dec 31, 2005	Dec 31, 2004	Dec 31, 2003	Dec 31, 2002
Fixed assets	44,975	45,495	41,436	17,872	15,106
Current assets	17,149	16,259	15,619	13,314	9,503
Total assets	**62,124**	**61,754**	**57,055**	**31,186**	**24,609**
Equity	40,213	40,953	37,553	21,244	1,797
Subordinated loan	3,309	3,087	2,883	2,694	5,000
Long-term debt	4,288	3,957	6,703	2,406	3,281
Current liabilities	14,314	13,757	9,916	4,842	14,531
Equity and total liabilities	**62,124**	**61,754**	**57,055**	**31,186**	**24,609**

STATEMENT OF CASH FLOW

USD '000

	2006	2005	2004	2003	2002
Working capital from operations	1,414	545	964	-191	80
Net cash from operations	-1,351	980	-596	-4,067	432
Net cash used in investing activities	-658	-196	-24,489	1,921	-16,233
Net cash provided by financing activities	2,232	-589	24,729	6,499	-16,564
Change in Cash and Cash equivalents	**223**	**195**	**-356**	**511**	**763**

KEY RATIOS

	2006	2005	2004	2003	2002
Current ratio	1.20	1.18	1.59	2.75	0.65
Equity ratio	65%	66%	66%	68%	7%

The Company

Flaga Group has been a listed company on the Icelandic stock exchange since 2003 and has its corporate headquarters in Reykjavik, Iceland. The Company operates two separate companies in the international sleep business: Embla, a global leader in the design, manufacture, development and sale of sleep diagnostic systems; and SleepTech, a leading U.S. service provider for hospital-based sleep diagnostic centers in the New York metropolitan area.

The Sleep Market

A recent poll released by the National Sleep Foundation in the United States cited sleep-related issues as the most common reason people are late for work with three in ten working adults saying they have missed work or made errors at work because of sleep-related issues in the past three months. This is not a North American phenomenon, in a recent European study it was found that the incidence of auto accidents in patients with OSA was reduced fivefold by effective treatment. Sleep problems have been shown to impact 15 to 20% of the population and cost us over $100 billion annually in lost productivity, medical expenses, sick leave and property and environmental damage.

The sleep market is one of the fastest growing segments of the healthcare market and as awareness throughout the world continues to grow, the diagnosis of sleep-related problems will continue to play a larger role in the overall health and wellbeing of the population.

Company Vision

The Company's vision is to be the leading player in the global sleep diagnostics and related sleep services market. A corporate structure and strategy have been developed that captures opportunities across the broad spectrum of the sleep diagnostics marketplace.

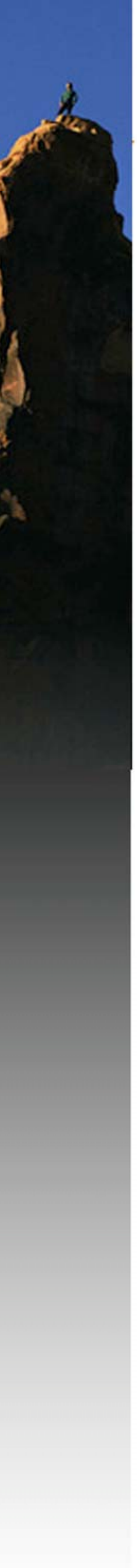
Corporate Structure

Under the umbrella of the Flaga Group, there are two companies: Embla and SleepTech.

Embla is a global leader in the design, manufacture development and sale of diagnostic sleep equipment and services.

The Embla corporate head office is located in Denver Colorado, USA with offices in Buffalo, New York, USA, Ottawa, Ontario, Canada and Amsterdam, Holland. Embla's core focus is on custom hardware and software solutions for the sleep diagnostic community and has an extensive network of distributors and direct sales personnel throughout the world.

Sleeptech is a regional sleep service provider to hospital-based sleep centers with headquarters in Kinnelon, New Jersey, USA. Sleeptech's business model is based on a scalable formula that has been developed into long-standing contracts with 18 hospitals in the New York metropolitan area. These contracts provide a range of services from developing centers to staffing and scoring of reports generated from the sleep diagnostic testing. SleepTech has been a pioneer of new quality services and a leader in its field.



Strategy

Embla

- Closer to our Customers -

Embla went through a major restructuring in 2006. This was completed on time, within budget, and with the focus of moving the company “Closer to our Customers”. This has become the Company’s new vision statement. The restructuring, which has touched every part of the organization, was initiated in 2005, substantially completed by the third quarter of 2006 and has positioned the organization to take full advantage of the growth in the sleep diagnostic business.

The company has one of the broadest ranges of sleep diagnostic equipment in the world and sells its products and services in countries throughout the world.

The market for sleep diagnostic equipment is estimated to be about US$230 million worldwide, which includes the full polysomnography (PSG) equipment; ambulatory and portable sleep diagnostic equipment, screeners and accessories and estimated to be growing at about 10 to 12% per year. Embla has world-class products in each of these categories, and its strong position in the world market will continue to be the company’s strength as it grows.

The Year 2006

This was a year of transition for Embla that touched every part of the company. Following a detailed analysis of the company activities, market and structure in 2005 the Company initiated far reaching changes in the first quarter of 2006 and substantially completed the transition by the third quarter. The impact of these changes has been seen throughout the company as they focused on streamlining the manufacturing and distribution, improving the quality system and rationalizing the product line.

The most visible change for the company in 2006 was the name change from Medcare to Embla. The new name has strong links to the history of the company and will not be confused with the US Medicare system. The transition to the new name is complete and has been very well accepted.

The company opened two new offices in 2006. The new corporate head office is now in the United States in Denver, Colorado and houses the global finance team, IT, US sales and customer service teams, the global marketing and product management teams together with the hardware research, development and repair facility. The new Canadian facility is in Ottawa and houses all the software research and development and the global technical support.

The company also restructured the European and Rest-of-World organization. This has included increasing our strength in Germany (the second biggest sleep market after the US) with a team of five direct sales staff and an enlarged technical service team. The enlarged office in Amsterdam now offers technical support, international training and customer service.

A key part of our European and Rest-of-World sales is the relationship with distributors. The company has continued to build on these relationships throughout the world and has initiated a far reaching training and educational program to support our distribution partners.

The Future

Through global teams providing cohesive support to our customers and distribution partners the company has built a strong and sustainable organization that is now very well positioned to take advantage of the sleep diagnostic market throughout the world.

We are forecasting above market growth in all our markets in 2007 and a return to profitability.

SleepTech

SleepTech continues to be the largest provider of sleep diagnostic and management services in the New York Metropolitan Area (New York, New Jersey and Connecticut). The company has service agreements with 18 hospitals/healthcare systems and provides remote access and on-line interpretation services for over 50 physicians through its state-of-the-art MySleepTech system. The market for sleep services is much larger and may be in excess of a billion dollars in the U.S. alone. This includes services ranging from technical and clinical support to sleep lab management and billing services.

The Year 2006

Calendar year 2006 represented another record year financially for SleepTech. The company has worked closely with its partner hospitals to improve efficiency and patient care. An example is the work SleepTech is doing in accreditation. Several hospitals that use SleepTech services are actively pursuing accreditation status by the American Academy of Sleep Medicine, which, when completed, will create one of the largest compilation of AASM accredited centers in the United States. SleepTech has and will continue to invest in clinical education and training programs, as well as commit technology and marketing resources towards creating a more flexible and efficient environment as we move into the future.

SleepTech has continued to invest in web-based services designed to assist sleep center operators and physicians alike to transfer and manage data to make their work more effective. Embla is working closely with SleepTech to develop these services. Examples of this work are the two software packages “Enterprise” and “MySleepTech”, developed out of the expertise and operational experience learned at SleepTech.

The Future

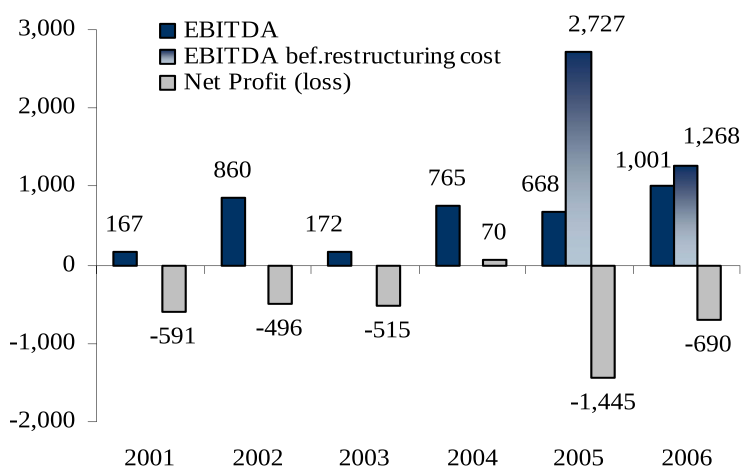
The future for SleepTech in 2007 and beyond continues to show significant positive financial results and forecasted annual growth rates at or above industry norms. Several current hospital partners are looking to expand their service capacity while numerous potential new clients are looking to partner with SleepTech.

2006 Financials

The Consolidated Financial Statements of Flaga Group hf. for the year 2006 cover the Parent Company and its subsidiaries: Embla Systems ehf., Iceland; Embla Systems Inc., USA; Sleeptech LLC, USA; Embla Systems BV., The Netherlands; Embla Systems GmbH, Germany; Embla Systems Ltd. Canada. The Financial Statements are presented in USD.

Net Income

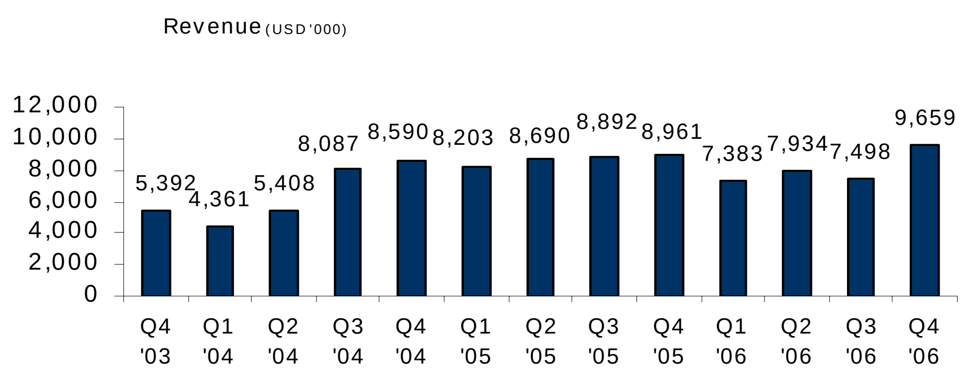
EBITDA was positive $1.27 million before restructuring costs, and $1.0 million after restructuring costs compared to $668k after restructuring costs in 2005.



Sales

Total sales in 2006 were $32.47 million, down from $34.7 million in 2005, a decrease of 6.4%. Reduced revenue was primarily a result of lower sales throughout the International distribution network, particularly in Europe, and large inventories of products built up by the distributors at the end of 2005.

The gross profit margin was 59%, compared to 63% in the previous year. The lower gross margin was due to higher costs in the services division and transition costs associated with the move of manufacturing from Iceland.



Operating Expenses

Sales, general and administrative costs totaled $17.1 million in 2006 compared to $18.4 million in 2005, a decrease of $1.4 million from 2005.

Research and development expenses were $2.36 million in 2006, compared to $2.69 million in 2005, a decrease of $330 thousand from the prior year or 7.8% of revenue compared to 7.3% of revenue in 2005.

Restructuring cost related to organizational changes of Embla were $267 thousand in 2006

Before restructuring costs total operating expenses in 2006 were $19.4 million compared to $21.1 million in 2005 a reduction in operating costs of $1.7 million dollars or 8%.

Taxes

Income tax assets are capitalized at year-end 2006 and income tax on the profit and loss are recognised in the income statement. As a result, there is a positive net tax contribution of $766 thousand for the year 2006. The same method was used for income statements in 2003, 2004, and 2005 but not for prior years.

Financial Expenses

Financial expenses amounted to $1.6 million in 2006, compared with $1.3 million in 2005. Currency exchange fluctuations were positive in 2006, representing $284 thousand, in comparison to negative $206 thousand in 2005.

Balance Sheet

Total assets at year-end were $62.12 million, up from $61.75 million from the beginning of the year.

Total liabilities amounted to $21.91 million, including current liabilities of $17.62 million. Total liabilities increased by $1.11 million during the year 2006.

Shareholders equity at year-end remained at $41 million in 2006.

Prospects in 2007

The company has completed a significant transition in 2006 and is well positioned to take advantage of the growing sleep market in 2007.

The revenue is expected to grow through 2007 as the new products, sales and marketing changes that have been made take effect in the U.S., Europe and the rest of world. The long-term profitability for both SleepTech and Embla remains good.

Auditing

The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU.

Governance

Flaga Group hf. complies in full with the guidelines on Corporate Governance set forth in March 2004 by the Icelandic Stock Exchange, the Icelandic Chamber of Commerce and SA-Confederation of Icelandic Employers. An Audit Committee and a Compensation Committee, each with their own charter directing their operation, have been in place since 2002. The majority of the Board and each of the committees are independent as defined by the above mentioned rules.

Board of Directors

Bogi Pálsson, Chairman of the Board

Bogi was elected to the Board at the Company's AGM in March 2004. He invested in Medcare Flaga hf. shortly before the AGM and became one of the Company's core investors. Bogi has been an innovator and an entrepreneur for 20 years. He was Managing Director of P. Samúelsson hf., which handles car imports, sales and service for companies, including Toyota and Lexus. Under the management of Bogi, the company was chosen marketing company of the year in 1991, and in 2002, he was elected marketing personality of the year. Bogi was chairman of Bílgreinsambandid, an organization for people in the motor vehicle sector in Iceland, between 1998 and 2001, and chairman of the Iceland Chamber of Commerce between 2000 and 2004. Bogi is currently the Executive Chairman and CEO of Stofn a diverse international investment company based in Iceland.

Eggert Dagbjartsson, Independent Board Member

Eggert was elected to the Board in 2002. Eggert lives in Boston, Massachusetts, USA and operates his own investment company, Equity Resources Group. The company operates specialized investment funds investing in real estate and real estate companies in the United States. He has, in addition, invested in high-growth technology companies. Eggert is on the board of several technology companies.

Erlendur Hjaltason, Independent Board Member and Chairman of the Compensation and Audit Committees

Erlendur Hjaltason is the CEO of Exista ehf, a holding company. He is an MBA graduate from Handelshøjskolen in Copenhagen (the Copenhagen Business School), and since graduating, Erlendur worked for Eimskipafélag Íslands (Eimskip). Eimskip is the largest transport group in Iceland, with operations in 11 countries, 1100 employees and a turnover of ISK 24 billion. Erlendur led various departments in Eimskip and played a key role in the development of the company's overseas operations as Head of Overseas Operations, increasing turnover abroad from 8% to 25% and eventually becoming CEO of Eimskip in 2002. Erlendur joined Exista in September 2004 as the Group's CEO, and was elected the chairman of the Iceland Chamber of Commerce in February 2006.

Sveinn Thór Stefánsson, Independent Board Member

Sveinn Thór became a regular board member in May 2005. He is the CFO of Exista ehf., a holding company. From 1995 to 2004, Sveinn Thór was the Financial Manager of Lýsing hf., a credit institution focused mainly on leasing financing for corporations in Iceland. He holds a degree in economics from the University of Iceland.

Hákon Sigurhansson, Independent Board Member

Hákon was elected to the Board at the company's annual general meeting in March 2006. He holds an MSc in Electronic Engineering from Aalborg University and an MBA from ESCP-EAP in Paris. Hákon has over 15 years of management experience in the telecommunication and software industries in Iceland and the US. He is currently working as an independent consultant.

Board Committees

Compensation Committee

The Compensation Committee reviews and determines salaries, bonuses and all other elements of the compensation packages offered to the CEO. The committee also establishes the general compensation policies of the Company.

The Company believes that its executive compensation programs should reflect the Company's financial and operating performance. In addition, individual contribution to the Company's success should be supported and rewarded.

Members of the Compensation committee are the following independent board members: Erlendur Hjaltason, Chairman, Eggert Dagbjartsson and Bogi Pálsson.

Audit Committee

The responsibilities of the Audit Committee are to independently monitor the Company’s internal control system and financial reporting process, to assess the efforts of the Company’s internal audit function and its independent auditors, and to maintain free and open channels of communication among the directors, the independent auditor, the internal auditor, and the management of the Company.

Members of the Audit Committee are independent board members: Erlendur Hjaltason and Bogi Pálsson.

Senior Management

David Baker, CEO of Flaga and President of Embla

Kevin Kelly, President of SleepTech

Rósa Steingrímsdóttir, Chief Financial Officer, Flaga Group hf.

Claude Buckles, Director of Sales, Embla, U.S.

Manfred Koch, Director of Sales, Embla, Europe and non-U.S. markets

Kassandra Keller, Global Product Manager and Marketing, Embla

Lisa Mallorey, Finance Controller, Embla

Mark Rose, Vice President of Information and Equipment Systems, SleepTech

Jacqueline Ohnmeiss, Director of Operations, SleepTech

Glenn Migliorino, Finance Controller, SleepTech

Shareholders

The Company’s shares are listed on the Iceland Stock Exchange Main List. Flaga Group’s ISIN code is IS0000008753, and the Company's ticker symbol in the trading system of the Iceland Stock Exchange is FLAGA. See www.icex.is for information on stock trading.

There were 464 shareholders in Flaga Group hf. at year end 2006 compared with 496 shareholders at year-end 2005.

Endorsement by the Board of Directors

The Consolidated Financial Statements of Flaga Group hf. are prepared and presented in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU. The Consolidated Financial Statements contain the Group operations for the year 2006. The Consolidated Financial Statements are stated in US Dollars and include the Consolidated Financial Statements of the Parent Company Flaga Group hf. (the "company") and its subsidiaries , Embla Systems ehf., Embla Systems Inc., USA, SleepTech LLC, USA, Embla Systems Ltd., Canada, Embla Systems B.V., the Netherlands, Embla Systems GmbH, Germany and Midwest Sleep and Neurodiagnostic Institute, USA (the "Group").

Flaga Group operates two separate companies in the international sleep business: Embla, a global leader in the design, manufacture, development and sale of sleep diagnostic systems and SleepTech, a leading U.S. service provider for hospital-based sleep diagnostic centers in the New York metropolitan area.

On the 31 May 2006, David Baker was appointed as Chief Executive Officer of the Flaga Group hf. David Baker will continue to act as president of Embla Systems and as the Chief Executive Officer will also be responsible for SleepTech.

At the Board meeting held on April 10 2006, the name of the sleep diagnostic company was changed from Medcare Systems to Embla Systems.

At a shareholders meeting held on March 23 2006, Hákon Sigurhansson replaced Ágúst Guðmudsson on the Board of Directors.

Embla opened two new offices in 2006, a new corporate head office in the United States in Denver, Colorado, and a new facility in Ottawa, Canada. Embla also restructured the European and Rest-of-World organization through increasing the Company's presence in Germany and enlarging the office in Amsterdam.

Sleeptech continues to be the largest provider of sleep diagnostic and management services in the New York Metropolitan Area (New York, New Jersey and Connecticut) and enjoyed another year of growth in its market.

Flaga Group hf. complies in full with the guideline on Corporate Governance set in March 2004 by the Icelandic Stock Exchange, the Icelandic Chamber of Commerce and SA-Confederation of Icelandic Employers. Since 2002 the Board has appointed an Audit Committee and a Compensation Committee which each has a charter that they operate by. The majority of the Board and each of the committees is independent as defined by the above mentioned rules.

The Group operating revenue amounted to USD 32.5 million based on the Consolidated Income Statement and the loss for the year 2006 amounted to USD 0.7 million. According to the Consolidated Balance Sheet, assets amounted to USD 62.1 million and the equity amounted to USD 40.2 million at year-end 2006.

There were 464 shareholders in Flaga Group hf. at year-end 2006 compared to 496 at the beginning of the year. The Company's capital stock amounted to ISK 720.7 million at year-end 2006 which equals USD 9.8 million based on a conversion into USD at the exchange rate of the date of payment. At the year-end three shareholders owned more than 10% of the shares in the Company: Exista B.V. which owned 21.7% of the shares, Kaupthing hf. owned 16.7% and Lífeyrissjóðir Bankastræti owned 11.3%.

The Board of Directors does not propose a payment of dividend to shareholders in the year 2007. As regards to changes in net equity the Board refers to the Statement of Changes in Equity.

The Board of Directors and the CEO of Flaga Group hf. hereby confirm the Group's Consolidated Financial Statements for the year 2006 with their signatures.

Reykjavik, 8 March 2007.

Bogi Pálsson, Chairman

Hákon Sigurhansson Eggert Dagbjartsson

Erlendur Hjaltason Sveinn Þór Stefánsson

David Baker, CEO

Independent Auditors Report

Board of Directors and Shareholders of Flaga Group hf.

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of Flaga Group hf. and its subsidiaries (the "Group"), which comprise the consolidated balance sheet as at 31 December 2006, and the consolidated income statement, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the EU. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements give a true and fair view of the consolidated financial position of Flaga Group hf. as of 31 December 2006, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU.

Reykjavik, 8 March 2007.

KPMG hf.

Eyvindur Albertsson

Símon Á. Gunnarsson

Consolidated Income Statement for the Year Ended December 31, 2006

	Notes	2006	2005
Revenue	5	32,474,364	34,747,432
Cost of sales		(13,167,854)	(12,760,083)
Gross profit		19,306,510	21,987,349
Sales and marketing expenses		(8,863,423)	(7,911,259)
General and administrative expenses		(8,198,601)	(10,564,540)
Research and development expenses		(2,362,926)	(2,693,297)
Restructuring costs	22	(267,487)	(2,059,172)
		(19,692,437)	(23,228,268)
Operating loss before financing costs		(385,927)	(1,240,919)
Finance income		574,658	105,570
Finance expense		(1,645,243)	(1,257,351)
Net financing costs	9	(1,070,585)	(1,151,781)
Loss before taxes		(1,456,512)	(2,392,700)
Income tax	10	766,371	947,852
Net loss attributable to equity holders of the Company		(690,141)	(1,444,848)
Earnings per share	18		
Basic loss per share (USD)		(0.0010)	(0.0021)
Diluted loss per share (USD)		(0.0009)	(0.0019)

The notes on pages 15 to 40 are an integral part of these consolidated financial statements.

Consolidated Balance Sheet

Assets	Notes	2006	2005
Property and equipment	11	1,854,509	2,556,927
Intangible assets	12	38,944,093	39,400,654
Deferred tax asset	13	4,176,318	3,537,121
Total non-current assets		44,974,920	45,494,702
Inventories	14	4,113,758	5,304,955
Trade and other receivables	15	11,575,802	9,721,192
Cash and cash equivalents	16	1,459,245	1,232,787
Total current assets		17,148,805	16,258,934
Total assets		62,123,725	61,753,636
Equity			
Share capital		9,794,691	9,794,691
Additional paid-in capital		33,235,083	33,235,083
Translation reserve		(68,506)	9,701
Share-based payments		221,501	192,487
Accumulated deficit		(2,969,473)	(2,279,332)
Total equity	17	40,213,296	40,952,630
Liabilities			
Loans and borrowings	19	4,286,668	7,043,951
Total non-current liabilities		4,286,668	7,043,951
Bank loans	20	7,668,413	5,708,324
Loans and borrowings, current maturities	19	5,003,848	1,975,000
Provisions	22	150,917	2,043,683
Trade and other payables	23	4,800,583	4,030,048
Total current liabilities		17,623,761	13,757,055
Total liabilities		21,910,429	20,801,006
Total equity and liabilities		62,123,725	61,753,636

The notes on pages 15 to 40 are an integral part of these consolidated financial statements.

Statement of Changes in Equity

Changes in Equity 1 January - 31 December 2005

	Share capital	Additional paid-in capital	Hedging reserve	Translation reserve	Share-based payments	Accumu-lated deficit	Total equity
Balance at 1 January 2005	8,969,691	29,116,901	196,081	(3,738)	95,603	(834,484)	37,540,054
Translation differences of foreign operations	0	0	0	13,439	0	0	13,439
Net change in fair value of cash flow hedges, net of tax	0	0	(196,081)	0	0	0	(196,081)
Net income (expense) recognised directly in equity	0	0	(196,081)	13,439	0	0	(182,642)
Loss for the year	0	0	0	0	0	(1,444,848)	(1,444,848)
Total recognised income and expense for the year	0	0	(196,081)	13,439	0	(1,444,848)	(1,627,490)
New shares issued	825,000	4,118,182	0	0	0	0	4,943,182
Share-based payments	0	0	0		96,884	0	96,884
Balance at 31 December 2005	9,794,691	33,235,083	0	9,701	192,487	(2,279,332)	40,952,630

Changes in Equity 1 January - 31 December 2006

	Share capital	Additional paid-in capital	Hedging reserve	Translation reserve	Share-based payments	Accumu-lated deficit	Total equity
Balance at 1 January 2006	9,794,691	33,235,083	0	9,701	192,487	(2,279,332)	40,952,630
Translation differences of foreign operations	0	0	0	(78,207)	0	0	(78,207)
Net income (expense) recognised directly in equity	0	0	0	(78,207)	0	0	(78,207)
Loss for the year	0	0	0	0	0	(690,141)	(690,141)
Total recognised income and expense for the year	0	0	0	(78,207)	0	(690,141)	(768,348)
Share-based payments	0	0	0	0	29,014	0	29,014
Balance at 31 December 2006	9,794,691	33,235,083	0	(68,506)	221,501	(2,969,473)	40,213,296

The notes on pages 15 to 40 are an integral part of these consolidated financial statements.

Consolidated Statement of Cash Flow 2006

	Notes	2006	2005
Cash flows from operating activities			
Net loss for the year		(690,141)	(1,444,848)
Adjustments for:			
Depreciation	11	1,410,768	1,909,354
Income tax	13	(639,197)	(947,852)
Net finance cost		1,354,255	945,929
Loss on sale and disposals of property and equipment		0	78,001
Other		(21,063)	4,402
Working capital provided by operating activities		1,414,622	544,986
Change in inventories		1,234,206	(462,875)
Change in trade and other receivables		(1,699,231)	(212,427)
Change in trade and other payables		(1,062,496)	1,885,203
Change in operating assets and liabilities		(1,527,521)	1,209,901
Interest paid		(1,139,182)	(693,731)
Income tax paid		(99,307)	(81,485)
Net cash (used in) provided by operating activities		(1,351,388)	979,671
Cash flows from investing activities			
Investment in intangible assets	12	(5,851)	(315,449)
Investment in property and equipment	11	(651,743)	(640,597)
Proceeds from sale of property and equipment		0	759,645
Cash flows from investing activities		(657,594)	(196,401)
Cash flows from financing activities			
Cost related to issue of new shares		0	(6,818)
Proceeds from loans and borrowings		6,222,146	0
Repayment of borrowings		(6,500,255)	(3,044,504)
Proceeds from new bank loans		2,509,763	2,462,716
Cash flows from financing activities		2,231,654	(588,606)
Net increase in cash and cash equivalents		222,672	194,664
Cash and cash equivalents at 1 January		1,232,787	1,041,608
Effects of exchange rate fluctuations on cash held		3,786	(3,485)
Cash and cash equivalents at 31 December		1,459,245	1,232,787

The notes on pages 15 to 40 are an integral part of these consolidated financial statements.

Notes to Consolidated Financial Statements

1) Reporting entity

"Flaga Group hf. (the ""Company"") is a company incorporated and domiciled in Iceland. The address of the Company´s registered office is Lækjargata 4, Reykjavik. The Consolidated Financial Statements of the Company for the year ended 31 December 2006 comprise the Company and its subsidiaries (together referred to as the ""Group""). The Group comprises the following main business segments: sleep diagnostics systems and sleep diagnostics services (see note 5).

2) Basis of Preparation

a) **Statement of Compliance**

The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU.

The Financial Statements were approved by the Board of Directors on 8 March 2007.

b) **Basis of measurement**

The Consolidated Financial Statements are presented in USD and have been prepared on the historical cost basis except for derivative financial instruments, which are measured at fair value.

The methods used to measure fair values are discussed further in note 4.

c) **Functional and presentation currency**

These Consolidated Financial Statements are presented in USD, which is the Company's functional currency.

d) **Use of estimates and judgments**

The preparation of Financial Statements requires management to make judgments, 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.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

In particular, information about significant areas of estimation uncertainty and critical judgments in applying accounting policies that have the most significant effect on the amount recognised in the financial statements are described in the following notes:

Note 12 Goodwill - measurement of the recoverable amounts of cash-generating units

Note 13 Utilization of tax losses

Note 15 Trade and other receivables

Note 21 Measurement of share-based payments

Note 22 Provisions

Note 24 Valuation of financial instruments

3) Significant accounting policies

The accounting policies set out below have been applied consistently to all periods presented in these consolidated financial statements, and have been applied consistently by Group entities.

a) Basis of Consolidation

i) Subsidiaries

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

ii) Transactions Eliminated on Consolidation

Intra-group balances and any unrealized income and expenses arising from intra-group transactions, are eliminated in preparing the Consolidated Financial Statements.

b) Foreign Currency

i) Foreign Currency Transactions

Transactions in foreign currencies are translated to the respective functional currencies of Group entities at exchange rates at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. The foreign currency gain or loss on monetary items is the difference between amortized cost in the functional currency at the beginning of the period, adjusted for effective interest and payments during the period, and the amortized cost in foreign currency translated at the exchange rate at the end of the period. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are retranslated to the functional currency at the exchange rate at the date that the fair value was determined. Foreign currency differences arising on retranslation are recognised in profit or loss, except for differences arising on the retranslation of available-for-sale assets.

ii) Foreign Operations

The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on consolidation, are translated to USD at foreign exchange rates ruling at the balance sheet date. The revenues and expenses of foreign operations are translated to USD at rates approximating to the foreign exchange rates ruling at the dates of the transactions. Foreign exchange differences arising on retranslation are recognised directly in a separate component of equity.

iii) Foreign Currency Capital

The Company's shares are denominated in Icelandic Krona (ISK). The share capital and the additional paid-in capital are translated to the USD at the foreign exchange rate ruling at the dates of the relevant capital transactions.

c) Financial instruments

i) Non-Derivative financial instruments

Non-derivative financial instruments comprise trade and other receivables, cash and cash equivalents, loans and borrowings, and trade and other payables.

Non-derivative financial instruments are recognised initially at fair value plus any directly attributable transaction costs. Subsequent to initial recognition non-derivative financial instruments are measured at amortized cost using the effective interest method, less any impairment losses.

A financial instrument is recognised if the Group becomes a party to the contractual provisions of the instrument. Financial assets are derecognised if the Group's contractual rights to the cash flows from the financial assets expire or if the Group transfers the financial asset to another party without retaining control or substantially all risks and rewards of the asset. Regular way purchases and sales of financial assets are accounted for at trade date, i.e., the date that the Group commits itself to purchase or sell the asset. Financial liabilities are derecognised if the Group's obligations specified in the contract expire or are discharged or cancelled.

ii) Derivative financial instruments

The Group holds derivative financial instruments to hedge its foreign currency and interest rate risk exposures. Embedded derivatives are separated from the host contract and accounted for separately if the economic characteristics and risks of the host contract and the embedded derivative are not closely related, a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative, and the combined instrument is not measured at fair value through profit or loss.

Derivatives are recognised initially at fair value; attributable transaction costs are recognised in profit or loss when incurred. Subsequent to initial recognition, derivatives are measured at fair value, and changes therein are accounted for as described below.

Cash flow hedges

Changes in the fair value of the derivative hedging instrument designated as a cash flow hedge are recognised directly in equity to the extent that the hedge is effective. To the extent that the hedge is ineffective, changes in fair value are recognised in profit or loss as finance income or expense.

If the hedging instrument no longer meets the criteria for hedge accounting, expires or is sold, terminated or exercised, then hedge accounting is discontinued prospectively. The cumulative gain or loss previously recognised in equity remains there until the forecast transaction occurs and it is transferred to profit or loss in the same period that the hedged item affects profit or loss as finance income and expenses.

iii) **Compound Financial Instruments**

Compound financial instruments issued by the Group comprise convertible notes that can be converted to share capital at the option of the holder, and the number of shares to be issued does not vary with changes in their fair value.

The liability component of a compound financial instrument is recognised initially at the fair value of a similar liability that does not have an equity conversion option. The equity component is recognised initially at the difference between the fair value of the compound financial instrument as a whole and the fair value of the liability component. Any directly attributable transaction costs are allocated to the liability and equity components in proportion to their initial carrying amounts.

Subsequent to initial recognition, the liability component of a compound financial instrument is measured at amortized cost using the effective interest method. The equity component of a compound financial instrument is not re-measured subsequent to initial recognition.

iv) **Share capital**

Incremental costs directly attributable to issue of ordinary shares are recognised as a deduction from equity.

Repurchase of share capital

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

d) **Property and Equipment**

i) **Recognition and measurement**

Items of property and equipment are stated at cost less accumulated depreciation and impairment losses.

Cost includes expenditures that are directly attributable to the acquisition of the asset. The cost of self-constructed assets includes the cost of materials and direct labor, any other costs directly attributable to bringing the asset to a working condition for its intended use, and the costs of dismantling and removing the items and restoring the site on which they are located. Purchased software that is integral to the functionality of the related equipment is capitalized as part of that equipment.

Where an item of property, plant and equipment comprises major components having different useful lives, they are accounted for as separate items of property and equipment.

ii) **Subsequent Costs**

The Group recognizes in the carrying amount of an item of property and equipment the cost of replacing part of such an item when that cost is incurred if it is probable that the future economic benefits embodied with the item will flow to the Group and the cost of the item can be measured reliably. All other costs are recognised in the Income Statement as an expense as incurred.

iii) **Depreciation**

Depreciation is recognised in the Income Statement on a straight-line basis over the estimated useful lives of each part of an item of property and equipment. Leased assets are depreciated over the shorter of the lease term and their useful lives. The estimated useful lives are as follows:

Computer service equipment	3 -5 years
Office equipment and machinery	3 -7 years

Depreciation methods, useful lives and residual values are reassessed at the reporting date.

e) **Intangible Assets**

i) **Goodwill**

Goodwill (negative goodwill) arises on the acquisition of subsidiaries.

Acquisition prior to 1 January 2003:

As part of its transition to IFRSs, the Group elected to restate only those business combinations that occurred on or after 1 January 2003. In respect of acquisitions prior to 1 January 2003, goodwill represents the amount recognised under the Group's previous accounting framework, Icelandic GAAP.

Acquisition on or after 1 January 2003:

For acquisitions on or after 1 January 2003, goodwill represents the excess of the cost of the acquisition over the Group's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of the acquiree. When the excess is negative (negative goodwill), it is recognised immediately in profit or loss.

Subsequent measurement:

Goodwill is measured at cost less accumulated impairment losses.

ii) **Research and development**

Expenditure on research and development activities, is recognised in the Income Statement as an expense as incurred.

iii) **Software**

Software that is acquired by the Group is stated at cost less accumulated amortization (see Note 12) and accumulated impairment losses.

iv) **Subsequent Expenditure**

Subsequent expenditure on capitalized intangible assets is capitalized only when it increases the future economic benefits embodied in the specific assets to which it relates. All other expenditure is expensed as incurred.

v) **Amortization**

Amortization is charged to the Income Statement on a straight-line basis over the estimated useful lives of intangible assets other than goodwill, from the date that they are available for use, unless such lives are indefinite. The estimated useful live of software is 3 to 5 years.

f) **Leased assets**

Leases in terms of which the Group assumes substantially all the risks and rewards of ownership are classified as finance leases. Upon initial recognition the leased asset is measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to that asset.

Other leases are classified as operating leases and the leased assets are not recognised on the Group's balance sheet.

g) **Inventories**

Inventories are measured at the lower of cost and net realizable value. The cost of inventories is based on the first-in first-out principle, and includes expenditure incurred in acquiring the inventories and bringing them to their existing location and condition. In the case of manufactured inventories and work in progress, cost includes an appropriate share of production overheads based on normal operating capacity. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and selling expenses.

h) **Impairment**

i) **Financial assets**

Financial assets that are stated at cost or amortized cost are reviewed at each reporting date to determine whether there is objective evidence of impairment. If any such indication exists, an impairment loss is recognised in income statement as the difference between the asset's carrying amount and the present value of the estimated future cash flows discounted at the financial asset's original effective interest rate.

If in a subsequent period the amount of an impairment loss recognised on a financial asset carried at amortized cost decreases and the decrease can be linked objectively to an event occurring after the write-down period, the impairment is reversed through income statement.

ii) **Non financial assets**

The carrying amounts of the Group's non-financial assets, other than inventories and deferred tax assets are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated. For goodwill and intangible assets that have indefinite lives or that are not yet available for use, recoverable amount is estimated at each reporting date.

An impairment loss is recognised if the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount. A cash-generating unit is the smallest identifiable asset group that generates cash flows that largely are independent from other assets and groups. Impairment losses are recognised in income statement. Impairment losses recognised in respect of cash-generating units are allocated first to reduce the carrying amount of any goodwill allocated to the units and then to reduce the carrying amount of the other assets in the unit (group of units) on a pro rata basis.

The recoverable amount of an asset or cash-generating unit is the greater of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

An impairment loss in respect of goodwill is not reversed. In respect of other assets, impairment losses recognised in prior periods are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset’s carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognised.

i) **Employee benefits**

Defined Contribution Plans

Obligations for contributions to defined contribution pension plans are recognised as an expense in the income statement when they are due.

Share-Based Payment Transactions

The grant date fair value of options granted to employees is recognised as an employee expense, with a corresponding increase in equity, over the period in which the employees become unconditionally entitled to the options. The amount recognised as an expense is adjusted to reflect the actual number of share options that vest.

j) **Provisions**

A provision is recognised in the balance sheet when the Group has a present legal or constructive obligation as a result of past event that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation. Provision are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability. If no reliable estimate can be made of the amount of the obligation, no provision is recorded and a disclosure is made in the notes to the consolidated financial statements.

Warranties

A provision for warranties is recognised when the underlying products or services are sold. The provision is based on historical warranty date and a weighting of all possible outcomes against their associated probabilities.

Restructuring

A provision for restructuring is recognised when the Group has approved a detailed and formal restructuring plan, and the restructuring either has commenced or has been announced publicly. Future operating costs are not provided for.

k) **Revenue**

i) **Goods sold**

Revenue from the sale of goods is measured at the fair value of the consideration received or receivable, net of returns and allowances, trade discounts and volume rebates. Revenue is recognised when the significant risks and rewards of ownership have been transferred to the buyer, recovery of the consideration is probable, the associated costs and possible return of goods can be estimated reliably, and there is no continuing management involvement with the goods.

ii) **Services**

Revenue from services rendered is recognised in profit or loss in proportion to the stage of completion of the transaction at the reporting date. The stage of completion is assessed by reference to surveys of work performed.

l) **Operating Lease Payments**

Payments made under operating leases are recognised in the Income Statement on a straight-line basis over the term of the lease. Lease incentives received are recognised as an integral part of the total lease expense, over the term of the lease.

m) **Finance income and expenses**

Finance income comprises interest income on funds invested, foreign currency gains. Interest income is recognised as it accrues, using the effective interest method.

Finance expenses comprise interest expense on loans and borrowings, bank loans, unwinding of the discount on provisions and foreign currency losses. All borrowing costs are recognised in profit or loss using the effective interest method.

n) **Income Tax**

Income tax on the profit or loss for the year comprises current and deferred tax. Income tax is recognised in the Income Statement except to the extent that it relates to items recognised directly to equity, in which case it is recognised in equity.

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

Deferred tax is recognised using the balance sheet method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is not recognised for the following temporary differences: the initial recognition of goodwill, the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit, and differences relating to investments in subsidiaries to the extent that they probably will not reverse in the foreseeable future. Deferred tax is measured at the tax rates that are expected to be applied to the temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the reporting date.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilized. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realized.

o) **Earnings per share**

The Group presents basic and diluted earnings per share (EPS) data for its ordinary shares. Basic EPS is calculated by dividing the profit or loss attributable to ordinary shareholders of the Company by the weighted average number of ordinary shares outstanding during the period. Diluted EPS is determined by adjusting the profit or loss attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding for the effects of all dilutive potential ordinary shares, which comprise convertible notes and share options granted to employees.

p) **Segment Reporting**

A segment is a distinguishable component of the Group that is engaged either in providing products or services (business segment), or in providing products or services within a particular economic environment (geographical segment), which is subject to risks and rewards that are different from those of other segments. The Group's primary format for segment reporting is based on business segments.

q) **New standards and interpretations not yet adopted**

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2006, and have not been applied in preparing these consolidated financial statements:

IFRS 7 Financial Instruments: Disclosures and the Amendment to IAS 1 Presentation of Financial Statements: Capital Disclosures require extensive disclosures about the significance of financial instruments for an entity's financial position and performance, and qualitative and quantitative disclosures on the nature and extent of risks.

IFRS 7 and amended IAS 1, which become mandatory for the Group's 2007 financial statements, will require extensive additional disclosures with respect to Group's financial instruments and share capital.

IFRS 8 Operating segments sets out requirements for disclosure of information about an entity's operating segments and also about the entity's products and services, the geographical areas in which it operates, and its major customers. If adopted by the EU, IFRS 8, which becomes mandatory for the Group's 2009 financial statements, is not expected to have any significant impact on the consolidated financial statements.

IFRIC 7 Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies addresses the application of IAS 29 when an economy first becomes hyperinflationary and in particular the accounting for deferred tax. IFRIC 7, which becomes mandatory for the Group's 2007 financial statements, is not expected to have any impact on the consolidated financial statements.

IFRIC 8 Scope of IFRS 2 Share-based Payment addresses the accounting for share-based payment transactions in which some or all of goods or services received cannot be specifically identified. IFRIC 8 will become mandatory for the Group's 2007 financial statements, with retrospective application required. The Group has not yet determined the potential effect of the interpretation.

IFRIC 9 Reassessment of Embedded Derivatives requires that a reassessment of whether embedded derivative should be separated from the underlying host contract should be made only when there are changes to the contract. IFRIC 9, which becomes mandatory for the Group's 2007 financial statements, is not expected to have any impact on the consolidated financial statements.

IFRIC 10 Interim Financial Reporting and Impairment prohibits the reversal of an impairment loss recognised in a previous interim period in respect of goodwill, an investment in an equity instrument or a financial asset carried at cost. If adopted by the EU, IFRIC 10 will become mandatory for the Group's 2007 financial statements.

IFRIC 11 IFRS 2 Group and Treasury Share Transactions deals with how certain types of agreements on securities related payments shall be recognised in the financial statements of a company and its subsidiaries. If adopted by the EU, IFRIC 11 applies for annual periods starting as of March 1, 2007.

FRIC 12 Service Concession Arrangements. If adopted by the EU, IFRIC 12 will become mandatory for the Group's 2007 financial statements. IFRIC 12 is not expected to have any impact on the consolidated financial statements of the Group.

4) Determination of fair values

A number of the Group's accounting policies and disclosures require the determination of fair value, for both financial and non-financial assets and liabilities. Fair values have been determined for measurement and / or disclosure purposes based on the following methods. Where applicable, further information about the assumptions made in determining fair values is disclosed in the notes specific to that asset or liability.

a) **Property, plant and equipment**

The fair value of property and equipment recognised as a result of a business combination is based on market values. The market value of items of plant, equipment, fixtures and fittings is based on the quoted market prices for similar items.

b) **Intangible assets**

The fair value of acquired software is based on the discounted cash flows expected to be derived from the use and eventual sale of the assets.

c) **Inventory**

The fair value of inventory acquired in a business combination is determined based on its estimated selling price in the ordinary course of business less the estimated costs of completion and sale, and a reasonable profit margin based on the effort required to complete and sell the inventory.

d) **Trade and other receivables**

The fair value of trade and other receivables, excluding construction work in progress, is estimated as the present value of future cash flows, discounted at the market rate of interest at the reporting date.

e) **Derivatives**

The fair value of forward exchange contracts is based on their listed market price, if available. If a listed market price is not available, then fair value is estimated by discounting the difference between the contractual forward price and the current forward price for the residual maturity of the contract using a risk-free interest rate (based on government bonds).

f) **Non-derivative financial liabilities**

Fair value, which is determined for disclosure purposes, is calculated based on the present value of future principal and interest cash flows, discounted at the market rate of interest at the reporting date. In respect of the liability component of convertible notes, the market rate of interest is determined by reference to similar liabilities that do not have a conversion option. For finance leases the market rate of interest is determined by reference to similar lease agreements.

g) **Share-based payment transactions**

The fair value of share appreciation rights is measured using the Black-Scholes formula. Measurement inputs include share price on measurement date, exercise price of the instrument, expected volatility (based on weighted average historic volatility adjusted for changes expected due to publicly available information), weighted average expected life of the instruments (based on historical experience and general option holder behavior), expected dividends, and the risk-free interest rate (based on government bonds). Service and non-market performance conditions attached to the transactions are not taken into account in determining fair value.

5) Segment Reporting

Segment information is presented in respect of the Group's business and geographical segments. The primary format, business segments, is based on the Group's management and internal reporting structure.

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

Segment results, assets and liabilities include items directly attributable to a segment as well as those that can be allocated on a reasonable basis. Unallocated items comprise mainly loans and borrowings and expenses, and corporate assets and expenses.

a) **Business Segments**

The Group comprises the following main business segments: 1) Sleep diagnostics systems. and 2) Sleep diagnostics services.

i) **Sleep diagnostic systems**

Sleep problems have been shown to impact 15 to 20% of the population and cost us over $100 billion annually in lost productivity, medical expenses, sick leave and property and environmental damage. The diagnosis of these sleep problems involves monitoring patients to measure their state of sleep and respiratory condition. The market has changed dramatically in the last 20 years from most tests being run in sleep laboratories to many now recorded in the home. The market is also changing to providing tools to help manage the sleep lab and how it is run as a business. This includes tracking patients before and after they are tested and investigating different disease management protocols that allow health care providers to reduce costs and treat more patients for the health care dollar.

ii) **Sleep diagnostic services**

The market of providing services to diagnose and treat the patients impacted by this debilitating disease is over a billion dollar business. The Reimbursement drives the standard and type of care that is provided and as time goes by these are shrinking and the successful service provider in the future will be one that can scale its operation to be efficient and at the same time provide high quality medicine to a more discerning and aware public.

b) **Geographical Segments**

The sale and service segments are managed on a worldwide basis, but operate in two principal geographical areas, Europe and America. In Europe, sales offices are operated in the Netherlands and Germany.

In presenting information on the basis of geographical segments, segment revenue is based on the geographical location of customers. Segment assets are based on the geographical location of the assets.

Note 5 continues on the next page.

Business Segments	Sleep diagnostics systems 2006	Sleep diagnostics systems 2005	Sleep diagnostics services 2006	Sleep diagnostics services 2005	Eliminations 2006	Eliminations 2005	Consolidated 2006	Consolidated 2005
Revenue from external customers	20,491,380	23,102,655	11,982,984	11,644,777			32,474,364	34,747,432
Inter-segment revenue	4,890,255	4,853,571			(4,890,255)	(4,853,571)	0	0
Total revenue	25,381,635	27,956,226	11,982,984	11,644,777	(4,890,255)	(4,853,571)	32,474,364	34,747,432
Segment result	(2,417,600)	(2,367,513)	2,630,567	2,380,993	(29,235)	(252,339)	183,732	(238,859)
Unallocated expenses							(569,659)	(1,002,060)
Operating loss							(385,927)	(1,240,919)
Net financing cost							(1,070,585)	(1,151,781)
Income tax							766,371	947,852
Loss for the year							(690,141)	(1,444,848)
Segment assets	29,345,474	29,213,214	28,799,988	29,097,652			58,145,462	58,310,866
Unallocated assets							3,978,263	3,442,770
Total assets							62,123,725	61,753,636
Segment liabilities	4,350,820	5,814,192	1,751,154	844,686			6,101,974	6,658,878
Unallocated liabilities							15,808,455	14,142,128
Total liabilities							21,910,429	20,801,006
Capital expenditure	959,864	545,158	70,852	192,597	170,234	97,158	860,482	640,597
Depreciation	564,636	963,452	434,394	496,752	(140,999)	(65,710)	858,031	1,384,635
Amortisation of intangible assets	268,375	241,495	284,362	283,224	0	0	552,737	524,719

Geographical segments	America	America	Europe	Europe	Other regions	Other regions	Consolidated	Consolidated
Revenue from external customers	22,314,608	22,150,088	8,629,154	8,934,340	1,530,602	3,663,004	32,474,364	34,747,432
Segment assets	47,888,614	47,901,858	10,256,848	10,409,008	0	0	58,145,462	58,310,866

6) Quarterly Statements

Quarterly Income Statement for the year 2005 and 2006 (amounts are in thousands of US$)

	2006 Q4	2006 Q3	2006 Q2	2006 Q1	2006 Total
Revenue	9,659	7,498	7,934	7,383	32,474
Cost of sales	(4,149)	(3,066)	(3,222)	(2,731)	(13,168)
Gross profit	5,509	4,433	4,713	4,652	19,307
Sales, general and admin expenses	(4,467)	(3,968)	(4,361)	(4,266)	(17,062)
Research and development expenses	(564)	(458)	(506)	(835)	(2,363)
Restructuring cost	0	0	0	(267)	(267)
Profit (loss) profit from operations	478	7	(154)	(716)	(385)
Net financial expense	(158)	(109)	(377)	(427)	(1,071)
Profit (loss) before taxes	320	(102)	(531)	(1,143)	(1,456)
Taxes	341	(5)	164	266	766
Profit (loss)	661	(107)	(367)	(877)	(690)

EBITDA is specified as follows:

	2006 Q4	2006 Q3	2006 Q2	2006 Q1	2006 Total
Revenue	9,659	7,498	7,934	7,383	32,474
Cost of sales	(4,149)	(3,066)	(3,222)	(2,731)	(13,168)
Gross profit	5,509	4,432	4,712	4,652	19,305
Operating expenses, less depreciation	(4,682)	(4,116)	(4,516)	(4,990)	(18,304)
EBITDA	827	316	196	(338)	1,001

	2005 Q4	2005 Q3	2005 Q2	2005 Q1	2005 Total
Revenue	8,961	8,893	8,690	8,203	34,747
Cost of sales	(3,425)	(3,283)	(3,028)	(3,024)	(12,760)
Gross profit	5,536	5,610	5,662	5,179	21,987
Sales, general and admin expenses	(4,381)	(3,806)	(5,027)	(5,262)	(18,476)
Research and development expenses	(567)	(615)	(615)	(896)	(2,693)
Restructuring cost	(2,059)	0	0	0	(2,059)
(Loss) profit from operations	(1,471)	1,189	20	(979)	(1,241)
Net financial expense	(261)	(276)	(89)	(526)	(1,152)
(Loss)/Profit before taxes	(1,732)	913	(69)	(1,505)	(2,393)
Taxes	566	(113)	95	400	948
(Loss) profit	(1,166)	800	26	(1,105)	(1,445)

EBITDA is specified as follows:

	2005 Q4	2005 Q3	2005 Q2	2005 Q1	2005 Total
Revenue	8,961	8,893	8,690	8,203	34,747
Cost of sales	(3,425)	(3,283)	(3,028)	(3,024)	(12,760)
Gross profit	5,536	5,610	5,662	5,179	21,987
Operating expenses, less depreciation	(6,522)	(3,962)	(5,151)	(5,684)	(21,319)
EBITDA	(986)	1,648	511	(505)	668

7) Other Operating Expenses

Fees to auditors of the Company

	2006	2005
Audit of the Financial Statements	199,862	129,543
Review of interim Financial Statements	76,673	56,178
Other services	117,284	145,159
Total	393,819	330,880
Whereof payment to the auditors of the parent company	138,017	209,527

8) Personnel expenses

Salaries, salary-related expenses and other payroll expenses are specified as follows:

	2006	2005
Salaries	14,015,749	14,789,806
Contribution to defined contribution pension plans	381,969	593,049
Salary-related expenses	2,130,190	1,922,641
Share-based payments	29,014	96,885
Total salaries and salary-related expenses	16,556,922	17,402,381
Number of employees at the year-end	203	213
Average number of employees	193	221

Salaries and salary-related expenses are not presented as a separate item in the Income Statement but are allocated as follows:

	2006	2005
Cost of sales	4,703,208	5,583,949
Sales and marketing expenses	7,723,021	5,464,848
General and administrative expenses	1,643,934	3,682,548
Research and development expenses	2,486,759	2,671,036
Total salaries and salary-related expenses	16,556,922	17,402,381

Salaries of the Management of the Company, stock options and ownership are specified as follows:

	Salary and benefits USD	Stock option (number of shares)	Ownership 31.12.2006 (number of shares)
Board of Directors:			
Bogi Pálsson	11,551		73,860,000
Eggert Dagbjartsson	5,776		10,627,895
Erlendur Hjaltason	5,776		0
Hákon Sigurhansson	5,776		467,894
Sveinn Þór Stefánsson	5,776		0

	Salary and benefits USD	Stock option (number of shares)	Ownership 31.12.2006 (number of shares)
Managers of Subsidiaries/Sales:			
David Baker	306,600	3,000,000	5,449,000
Claude Buckles	163,277		0
Kevin Kelly	241,249		1,019,698

Ownership by Board members and management at year-end represents shares held either in their own names or through companies which they control.

The Management's stock options are at share price of ISK 6. The stock options contracts were made in the years 2002-2005 and are exercisable in the years 2006–2010, see note 21.

9) Finance income and expense

Finance income and expense are specified as follows:

	2006	2005
Interest income	5,544	3,932
Foreign exchange gain	569,114	101,638
Finance income	574,658	105,570
Interest expense	(1,359,799)	(949,861)
Foreign exchange loss	(285,444)	(307,490)
Finance expense	(1,645,243)	(1,257,351)
Net finance income and expense	(1,070,585)	(1,151,781)

10) Income Tax Revenue

Recognised in the income statement:

	2006	2005
Current Tax Expense		
Income tax payable	(53,486)	(105,250)
Deferred Tax Asset		
Changes in temporary differences	639,197	1,010,061
Currency difference	180,660	0
Other changes	0	43,041
	819,857	1,053,102
Total income tax revenue in the income statement	766,371	947,852

Reconciliation of Effective Tax Rate

	2006	2006	2005	2005
Loss before tax		(1,456,512)		(2,392,700)
Income tax using the company´s domestic tax rate	18%	262,141	18%	430,686
Effect of tax rates in foreign jurisdictions	14%	198,414	11%	274,032
Effect of tax asset not recognised in subsidiaries	-64%	(927,918)	-19%	(461,055)
Non-deductible expenses	41%	599,917	-2%	(54,384)
Permanent difference due to taxable amortization of goodv	43%	624,182	42%	994,651
Currency difference	0%	0	-2%	(38,605)
Other differences	1%	9,635	-8%	(197,473)
	53%	766,371	40%	947,852

11) Property and Equipment

Cost	**Computer and service equipment**	**Office equipment and machinery**	**Real estate**	**Total**
Balance at 1 January 2005	5,284,480	1,359,608	808,820	7,452,908
Additions during the year	487,141	131,731	0	618,872
Disposals and sale	(121,637)	(9,179)	(808,820)	(939,636)
Effects of foreign exchange movement	(7,566)	(2,820)	0	(10,386)
Balance at 31 December 2005	5,642,418	1,479,340	0	7,121,758
Balance at 1 January 2006	5,642,418	1,479,340	0	7,121,758
Additions during the year	482,422	169,321	0	651,743
Effects of foreign exchange movement	9,080	1,911	0	10,991
Balance at 31 December 2006	6,133,920	1,650,572	0	7,784,492
Depreciation				
Balance at 1 January 2005	2,764,117	520,561	0	3,284,678
Depreciation	1,222,661	161,974	0	1,384,635
Disposals	(113,133)	11,156	0	(101,977)
Effects of foreign exchange movement	(1,385)	(1,120)	0	(2,505)
Balance at 31 December 2005	3,872,260	692,571	0	4,564,831
Balance at 1 January 2006	3,872,260	692,571	0	4,564,831
Depreciation	836,319	525,455	0	1,361,774
Effects of foreign exchange movement	2,305	1,073	0	3,378
Balance at 31 December 2006	4,710,884	1,219,099	0	5,929,983
Carrying amounts				
At 1 January 2005	2,520,363	839,047	808,820	4,168,230
At 31 December 2005	1,770,158	786,769	0	2,556,927
At 1 January 2006	1,770,158	786,769	0	2,556,927
At 31 December 2006	1,423,036	431,473	0	1,854,509
Depreciation ratios	20-33%	17-33%		

Depreciation and amortisation of Assets

Depreciation of assets is not presented as a separate item in the Income Statement but is divided between cost of goods sold and general administrative expenses and is specified as follows:

	2006	2005
Depreciation/Amortisation is allocated in income statement as follows:		
Cost of sales	738,783	825,280
Sales and marketing expenses	145,487	179,437
General and administrative expenses	893,144	719,507
Research and development expenses	137,097	185,130
Total depreciation and amortisation	1,914,511	1,909,354
- Thereof charged to provision for restructuring cost	(503,743)	0
Depreciation and amortisation recognised in the income statement	1,410,768	1,909,354
Depreciation of property and equipment	1,361,774	1,384,635
Amortisation of intangible assets, see note 12	552,737	524,719
Total depreciation and amortisation	1,914,511	1,909,354

Insurance Value

Insurance value of computer equipment, tools and machinery at year-end 2006 is USD 4.0 million.

Mortgages

Sleep Tech a subsidiary of the Company has USD 1.0 million line of credit. Borrowings are secured by Sleep Tech personal property and fixtures. The loan agreement contains certain covenants which require the maintenance of minimum tangible net worth and certain financial ratios. As of December 31, Sleep Tech was in compliance with the covenant requirements.

12) Intangible assets

Intangible assets are specified as follows:

	Goodwill	Capitalized software	Total
Cost			
Balance at 1 January 2005	33,173,815	1,885,823	35,059,638
Additions during the year	4,950,000	315,449	5,265,449
Effects of foreign exchange movement	(123,572)	0	(123,572)
Balance at 31 December 2005	38,000,243	2,201,272	40,201,515
Balance at 1 January 2006	38,000,243	2,201,272	40,201,515
Additions during the year	0	5,851	5,851
Effects of foreign exchange movement	90,325	0	90,325
Balance at 31 December 2006	38,090,568	2,207,123	40,297,691
Amortisation			
Balance at 1 January 2005	0	276,142	276,142
Amortisation for the year	0	524,719	524,719
Balance at 31 December 2005	0	800,861	800,861
Balance at 1 January 2006	0	800,861	800,861
Amortisation for the year	0	552,737	552,737
Balance at 31 December 2006	0	1,353,598	1,353,598
Carrying amounts			
At 1 January 2005	33,173,815	1,609,681	34,783,496
At 31 December 2005	38,000,243	1,400,411	39,400,654
At 1 January 2006	38,000,243	1,400,411	39,400,654
At 31 December 2006	38,090,568	853,525	38,944,093

For the purpose of impairment testing on goodwill, goodwill is allocated to the Group's segments which represent the lowest level within the Group, at which the goodwill is monitored for internal management purpose.

The following units have significant carrying amounts of goodwill:	2006	2005
Embla Systems Inc	13,179,706	13,179,706
SleepTech, LLC	24,018,793	24,018,793
Other, without significant goodwill	892,069	801,744
	38,090,568	38,000,243

For the purpose of impairment testing on goodwill, fair value less cost to sell is determined by discounting the future cash flows generated from the continuing use of each unit and was based on the following key assumptions:

Cash flows were projected based on actual operating results and the 5-year business plan. Cash flows were extrapolated for determining the residual value using a 3% constant growth rate which was consistent with the long term average growth rate for the industry. Management believes that this forecast period was justified due to the long term nature of the business. The anticipated average annual revenue growth included in the cash flow projections the years 2007 to 2011 was 23% and 13% for Embla Systems and SleepTech respectively. An after-tax discount rate of 9.75% and 9.55% was used for Embla Systems and SleepTech respectively in determining the recoverable amount of the units. The discount rate was estimated based on an industry average weighted average cost of capital, which was based on a 15% debt leveraging.

13) Deferred tax assets

The Groups deferred tax asset is specified as follows:	2006	2005
Deferred tax asset at the beginning of year..	3,537,121	2,484,018
Deferred tax revenue in the income statement..	639,197	1,010,061
Deferred tax of derivatives recognised directly in equity..	0	43,042
Calculated deferred income tax asset at year-end	4,176,318	3,537,121

Deferred income tax assets and liabilites are attributable to the following:

	Assets		Liabilities		Net	
	2006	2005	2006	2005	2006	2005
Property and equipment.	0		(529,358)	(503,674)	(529,358)	(503,674)
Trade and other receivabl	0		(55,553)	(13,726)	(55,553)	(13,726)
Inventories......................	0		(25,960)		(25,960)	0
Trade and other payables	50,380	331,280	0		50,380	331,280
Intercompany interest.....	783,676	379,675	0		783,676	379,675
Carry forward tax loss	3,953,133	3,343,566	0		3,953,133	3,343,566
Deferred tax asset at year-end 2006...............	4,787,189	4,054,521	(610,871)	(517,400)	4,176,318	3,537,121

Movement in temporary differences during the year:

	Balance 1.1.2006	Recognised in income	Recognised in equity	Balance 31.12 2006
Property and equipment..	(503,674)	(25,684)	0	(529,358)
Trade and other receivables...	(13,726)	(41,827)	0	(55,553)
Inventories..	0	(25,960)		(25,960)
Trade and other payables...	331,280	(280,900)	0	50,380
Intercompany interest...	379,675	404,001	0	783,676
Carry forward tax loss	3,343,566	609,567	0	3,953,133
Deferred tax asset at year-end	3,537,121	639,197	0	4,176,318

	Balance 1.1.2005	Recognised in income statement	Recognised in equity	Balance 31.12 2005
Property and equipment	(73,960)	(429,714)		(503,674)
Trade and other receivables	22,514	(36,240)		(13,726)
Trade and other payables	133,000	198,280		331,280
Unrealized gain	(43,042)		43,042	0
Intercompany interest		379,675		379,675
Carry forward tax loss	2,445,506	898,060		3,343,566
Deferred tax asset at year-end	2,484,018	1,010,061	43,042	3,537,121

Unrecognised deferred tax assets

The Group's total deferred tax asset year-end amounted to USD 5.7 million. Due to uncertainty regarding the utilisation of tax asset arising from carry forward tax losses it is not recognised in full.

Tax asset based on carry forward tax losses	5,695,808
Impairment based on uncertainty regarding utilisation	(1,519,490)
Carrying amount of income tax asset	4,176,318

14) Inventories

Inventories are specified as follows:

	2006	2005
Material and components purchased	363,865	1,818,078
Fully processed goods and goods for resale	3,749,893	3,486,877
Inventories at end of the year	4,113,758	5,304,955

The insurance value of inventories amounted to USD 2.2 million at the year-end 2006.

Mortgages

To secure payments of the Company's debt to its commercial bank the Company has pledged its inventories as they are at any given time. In addition the Company's subsidiaries, Embla Systems Inc. has guaranteed payment of the Parent Company's debt in a guarantee agreement where inventories are pledged as collateral. The Company's debt with its commercial bank amounted to USD 16 million at December 31, 2006.

Sleep Tech a subsidiary of the Company has USD 1.0 million line of credit. Borrowings are secured by Sleep Tech inventories. The loan agreement contains certain covenants which require the maintenance of minimum tangible net worth and certain financial ratios. As of December 31, Sleep Tech was in compliance with the covenant requirements.

15) Trade and other receivables

Trade and other receivables are specified as follows:

	2006	2005
Trade receivables	11,226,698	9,251,298
Other receivables and pre-payments	669,235	619,303
Impairment losses	(320,131)	(149,409)
Trade and other receivables at year end	11,575,802	9,721,192

Impairment losses have been recognised for doubtful accounts. Impairment losses are determined by management with reference to past default experience. The impairment losses do not represent a final write-off.

The directors believe that the carrying amount of trade receivables approximates their fair value.

Impairment losses on trade receivables are specified as follows:

	2006	2005
Balance at the beginning of the year	149,409	206,813
Write off during the year	(97,732)	(129,899)
Impairment loss for the year	268,454	72,495
Balance at year end	320,131	149,409

Mortgages

To secure payments of the Company's debt to its commercial bank the Company has pledged its accounts receivables as they are at any given time. In addition the Company's subsidiary, Embla Systems Inc., has guaranteed payment of the Parent Company's debt in a guarantee agreement where accounts receivables are pledged as collateral. The Company's debt with its commercial bank amounted to USD 16 million at December 31, 2006.

Sleep Tech a subsidiary of the Company has USD 1.0 million line of credit. Borrowings are secured by Sleep Tech accounts receivables. The loan agreement contains certain covenants which require the maintenance of minimum tangible net worth and certain financial ratios. As of December 31, Sleep Tech was in compliance with the covenant requirements.

16) Cash and Cash Equivalents

Cash and cash equivalents comprise only bank balances.

17) Capital and Reserves

According to the Company's Articles of Association the share capital at 31 December 2006 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.

Changes in the nominal value of share capital:	ISK	USD
Share capital at the beginning of the year	720,695,133	9,794,691
Share capital at end of year	720,695,133	9,794,691

The Articles of Association of the Company authorize the Board of Directors to issue new shares for the following purposes:

- Up to 80 million shares to meet obligations of stock option contracts.

- Issue new shares to fulfill the obligations of the convertible bond

- Up to 36 million shares to offer for sale, valid until June 2007"

Translation Reserve

The translation reserve comprises all foreign exchange differences arising from their translation of the financial statements of foreign operations that are not integral to the operations of the Company, as well as from the translation of liabilities that hedge the Company's net investment in foreign subsidiary.

Hedging reserve

The hedging reserve comprises the effective portion of the cumulative net change in the fair value of cash flow hedging instruments related to hedged transactions that have not yet occurred. At the end of the year 2006 no hedging contract was active.

Stock Option Contracts

Stock option contracts allow Company employees to purchase shares in the Company. In the period from January 1, 2003 to August 31, 2008 employees have the right to purchase up to 62.6 million shares at a weighted average price of ISK 6.0 per share. The fair value of services received in return for share options granted are measured by reference to the fair value of the share options granted.

18) Loss per Share

The calculation of loss per share at December 2006 was based on the loss attributable to equity holders of the company of USD 0.7 million and a weighted average number of ordinary shares outstanding during the year ended December 31, 2006 of 720.7 million shares, calculated as follows:

	2006	2005
Loss for the year attributable to equity holders of the Company	(690,141)	(1,444,848)
Total average number of shares outstanding during the year	720,695,133	700,729,551
Weighted average number of ordinary shares		
Issued shares at January 1	720,695,133	670,509,232
Effect of shares issued in March 2005	0	26,787,900
Effect of shares issued in May 2005	0	3,432,419
Weighted average number of ordinary shares	720,695,133	700,729,551

Diluted loss per share

The calculation of diluted loss per share at 31 December 2006 was based on loss attributable to ordinary equity holders of the Company of USD 0.7 millions (2005: USD 1.4 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 (2005: 744.2 millions), calculated as follows:

Loss attributable to equity holders of the Company (diluted)	2006	2005
Loss for the year attributable to equity holders of the Company	(690,141)	(1,444,848)
Weighted average number of ordinary shares (diluted)		
Weighted average number of ordinary shares (basic)..	720,695,133	700,729,551
Effects of convertible loan..	46,400,000	43,500,000
Weighted average number of ordinary shares (diluted) at 31 December.........................	767,095,133	744,229,551

The stock options granted to employees (see notes 21 and 26) are antidilutive potential ordinary shares because their exercise price exceeds the average market price of the Company's ordinary shares during the periods presented in these consolidated financial statements. Accordingly, they have not been included in the calculation of diluted earnings per share.

19) Loans and Borrowings

The Company’s loans and borrowings are specified as follows:

	Weighted average interest rate	**2006 Carrying amount**	**2005 Carrying amount**
Secured loans in USD	7.2%	5,980,670	5,931,250
Secured loans in USD, subordinated loans	7.0%	3,309,846	3,087,701
		9,290,516	9,018,951
Current maturities		(5,003,848)	(1,975,000)
Loans and borrowings in the Balance Sheet total		4,286,668	7,043,951

Aggregate annual maturities at year-end are specified as follows:

On demand or within 12 months	5,003,848	1,975,000
Within 24 months	1,661,668	4,843,951
Within 36 months	1,500,000	1,100,000
Within 48 months	1,125,000	1,100,000
Total loans and borrowings, including current maturities	9,290,516	9,018,951

Subordinated convertible loan

The Company was granted a subordinated convertible loan by Kaupthing hf. in the amount of USD 5.0 million in the year 2002. The loan bears a fixed interest of 7% during the loan period and shall be repaid with interest on September 15, 2007. In November 2003 part of the loan was converted into shares in accordance with the loan terms. At December 31, 2006 the subordinated convertible loan amounted to USD 3.3 million. Interest capitalized on the loan in the year 2006 amounts to USD 222 thousand. The convertibility right grants the creditor the right to convert the principal and earned interest into shares in the Company as follows: Shares in the

Company for a nominal value of ISK 14.5 are received for each USD 1, however a maximum of 1/5 of the original principal plus interest for each year.

Fair value comparison of the company's convertible loan versus a similar liability without equity option, did not indicate any equity component.

20) Bank Loans

Bank loans amount to USD 7.7 million at year end. The Company has USD 7.0 million line of credit at year end which is payable to Kaupthing hf. The line of credit bears 7.26% interest rate at year end. As of December 31, 2006, The Company has borrowing of USD 6.7 millions under this line of credit. The line of Credit has no certain payback time. Borrowings are secured by the Company accounts receivable and inventories. In addition the Company's subsidiary, Embla Systems Inc., has guaranteed payment of the Parent Company's debt in a guarantee agreement where accounts receivables and inventories are pledged as collateral.

Sleep Tech a subsidiary of the Company has USD 1.0 million line of credit which bear interest at the prime rate 8.25% at year end and is payable in full on May 1, 2007. As of December 31, 2006, the Sleep Tech has borrowings of USD 1.0 million under this line of credit. Borrowings are secured by Sleep Tech accounts receivable, inventory and personal property and fixtures. The loan agreement contains certain covenants which require the maintenance of minimum tangible net worth and certain financial ratios. As of December 31, Sleep Tech was in compliance with the covenant requirements.

21) Share Based Loans

Stock option contracts allow Company employees to purchase shares in the Company. In the period from January 1, 2003 to August 31, 2008 employees have the right to purchase up to 15.7 million shares at a weighted average price of ISK 6.0 per share. The recognition and measurement principles in IFRS 2 have been applied

The terms and conditions of the grants are as follows, whereby all options are settled by physical delivery of shares:

Grant date/employees entitled		Vesting conditions	Contractual life of options
Option granted to employees at 1 January 2003	7,750,000	Three individual periods, one year apart with three years of service for each perio	5
Option granted to employees at 3 April 2003	4,092,000	Three individual periods, one year apart with three years of service for each perio	5
Option granted to employees at 15 September 2003	880,000	Three individual periods, one year apart with three years of service for each perio	5
Option granted to employees at 1 April 2005	3,000,000	Three individual periods, one year apart with three years of service for each perio	5
Total share options	15,722,000		

The number and weighted average exercise prices of share options is as follows:

	Price 2006	Number of options 2006	Price 2005	Number of options 2005
Outstanding at the beginning of the period	6	18,709,000	6	15,709,000
Forfeited during the period	6	(2,987,000)		0
Granted during the period	6	0	6	3,000,000
Outstanding at the end of the period	6	15,722,000	6	18,709,000
Exercisable at the end of the period	6	2,820,000	6	167,000

The options outstanding at 31 December 2006 have an exercise price of ISK 6 per share six and a weighted average contractual life of 3.4 years.

Employee expenses		**2006**	**2005**
Share options granted in 2003		17,822	94,237
Share options granted in 2005		11,192	2,648
Total expense recognised as employee costs	Note 8	29,014	96,885

The fair value of services received in return for share options granted, based on the fair value of share options granted, measured using a Black-Scholes model, with the following inputs:

Fair value at grant date, average 12, 24, and 36 month options	1.441	1.441
Share price	6	6
Expected volatility (weighted average volatility)	25-30	25-30
Option life (expected weighted average life)	3.4	3.6
Risk-free interest rate (based on government bonds)	8.8%	8.8%

22) Provisions

Provisions are specified as follows:	**Restruct. cost**	**Warranties**	**Total**
Balance at 1 January 2006	1,967,615	76,068	2,043,683
Provisions made during the year	267,487	(21,063)	246,424
Provisions used during the years	(2,139,190)		(2,139,190)
Balance at 31 December 2006	95,912	55,005	150,917

Restructuring

In November 2005 the Company established Embla Systems Ltd. in Ottawa, Canada. The subsidiary was established in connection with the restructuring of the Company. The software development and technical support teams have been moved from Iceland and USA to the office in Ottawa. The restructuring costs amounted to USD 2.2 million during the year ended 31 December 2005, a provision of USD 1.9 million was made to cover the estimated costs of restructuring. The actual costs are currently on schedule. In February 2006 it was decided to also move the hardware research and development team from Iceland to Denver, Colorado and prototyping and manufacturing design will be outsourced as required. The restructuring costs related to this have been estimated and a provision of USD 267 thousand was made in Q1 2006. The restructuring is on plan and is completed. Provisions used are according to budget and balance at 31 December 2006 will cover some minor remaining expenses.

Warranties

The provision for warranties relates to equipment sold during the year ended 31 December 2004 and 2005. The provision is based on estimates made from historical warranty experience. The Group expects to incur the liability over the next year.

23) Trade and other Payables

Trade and other payables are specified as follows:	**2006**	**2005**
Trade payables	3,596,451	2,376,678
Other payables	1,204,132	1,653,370
Balance at year end	4,800,583	4,030,048

Financial instruments

Exposure to currency risks arises in the normal course of the Group's business. Derivative financial instruments are used to hedge exposure to fluctuations in exchange rates.

a) **Financial risk factors**

The Group's activities expose it to a variety of financial risks: market risk (including foreign exchange risk), credit risk, liquidity risk, cash flow interest rate risk and fair value interest rate risk. The Group's overall risk management program focuses on the unpredictability of financial markets and seeks to minimize potential adverse effects on the Group's financial performance. The Group uses derivative financial instruments to hedge certain risk exposures. Risk management is carried out within the group where applicable under policies approved by the Board of Directors.

b) **Credit risk**

The Group has no significant concentrations of credit risk. The Group has policies in place to ensure that sales of products and services are made to customers with an appropriate credit history and products not delivered until payments are secured. The Group has policies that limit the amount of credit exposure to any of the subsidiaries.

c) **Liquidity risk**

Prudent liquidity risk management implies maintaining sufficient cash, the availability of funding through an adequate amount of committed credit facilities. Due to the dynamic nature of the underlying businesses, the Group aims to maintain flexibility in funding by keeping committed credit lines available.

d) **Cash flow interest rate risk**

The Group's income and operating cash flows are substantially independent of changes in market interest rates. The Group's cash flow interest rate risk arises from long-term borrowings. Borrowings issued at variable rates expose the Group to cash flow interest rate risk. Borrowings issued at fixed rates expose the Group interest rate risk.

The Group operates internationally and is exposed to foreign exchange risk arising from various currency exposures primarily with respect to euros and Icelandic krona. The Group uses forward contracts to manage its foreign exchange risk arising from future commercial transactions, recognised assets and liabilities. Foreign exchange risk arises when future commercial transactions, recognised assets and liabilities are denominated in a currency that is not the entity's functional currency.

e) **Foreign currency risk**

The Group is exposed to foreign currency risk on sales of goods and services, purchases of material and supplies, and borrowings that are denominated in a currency other than USD. The currencies giving rise to this risk are primarily ISK, Euros and Pounds Sterling

24) Operating Leases

The Group as a Lessee

	2006	2005
Lease payments recognised as an expense in income statement for the year	867,526	992,007

At the balance sheet date, the Group had outstanding commitments under non-cancellable operating leases, which fall due as follows:

	2006	2005
On demand or within 12 months	681,580	1,006,322
Within 24 months	261,603	684,888
Within 36 months	177,850	515,258
Within 48 months	170,894	401,116
Subsequent years	0	629,307
	1,291,927	3,236,891

The Company has entered into lease agreements on buildings for its operations in Iceland, USA, Canada, Germany and The Netherlands. The total obligation at year-end was USD 1.2 million. Expensed lease payments in the Income Statement for the year 2006 were USD 770 thousand (2005: USD 898 thousand). The lease periods are from 1-5 years.

The Company has entered into operational lease agreements regarding vehicles and machinery. At year-end obligations regarding this lease amounted to USD 70 thousand. Expensed lease payments in the Income Statement for 2006 amounted to a total of USD 97 thousand (2005:USD 94 thousand).

25) Related party transactions

Identity of related parties:

The Group has a related party relationship with its subsidiaries (see note 27), one of its shareholders and with management.

Transactions with key management

See note 8

Loans payable to related parties were as follows:

	2006	2005
Shareholder		
Kaupthing hf.	15,715,378	3,658,652

All agreements are priced at an arms length basis.

26) Group Entities

At December 31, 2006 the Company's subsidiaries were seven. The subsidiaries included in the Consolidated 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