SRI SURGICAL EXPRESS INC
Form 10-Q
August 09, 2006
Table of Contents

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2006

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission File Number: 000-20997

SRI/Surgical Express, Inc.

(Exact name of registrant as specified in its charter)

Florida	**59-3252632**
(State of Incorporation)	**(I.R.S. Employer Identification No.)**

12425 Race Track Road

Tampa, Florida 33626

(Address of Principal Executive Offices)

(813) 891-9550

(Registrant s Telephone Number)

Indicate by check whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (Check One):

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Number of outstanding shares of each class of registrant s common stock as of July 30, 2006:

Common Stock, par value $.001 6,459,021

Table of Contents

INDEX

		Page
PART I	**FINANCIAL INFORMATION**	
Item 1	Financial Statements	
	Balance Sheets as of June 30, 2006 (unaudited) and December 31, 2005	1
	Statements of Operations (unaudited) for the three months and six months ended June 30, 2006 and June 30, 2005	2
	Statements of Cash Flows (unaudited) for the six months ended June 30, 2006 and June 30, 2005	3
	Notes to Financial Statements (unaudited)	4
Item 2	Management s Discussion and Analysis of Financial Condition and Results of Operations	10
Item 3	Quantitative and Qualitative Disclosures About Market Risk	17
Item 4	Controls and Procedures	19
PART II	**OTHER INFORMATION**	
Item 1	Legal Proceedings	20
Item 6	Exhibits and Reports on Form 8-K	20
SIGNATURES		22

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

SRI/SURGICAL EXPRESS, INC.

BALANCE SHEETS

(In thousands)

	June 30, 2006 (unaudited)	December 31, 2005
ASSETS		
Cash and cash equivalents	$ 9	$ 653
Accounts receivable, net	10,714	11,354
Inventories, net	7,089	6,598
Prepaid expenses and other assets, net	1,612	1,671
Reusable surgical products, net	21,961	22,416
Property, plant and equipment, net	32,833	33,740
Total assets	$ 74,218	$ 76,432
LIABILITIES AND SHAREHOLDERS EQUITY		
Notes payable to bank	$ 2,500	$ 3,229
Accounts payable	5,447	5,550
Employee related accrued expenses	1,435	1,296
Other accrued expenses	2,903	2,856
Mortgage payable	4,646	4,769
Bonds payable	8,050	8,380
Deferred tax liability, net	1,888	2,269
Total liabilities	26,869	28,349
Shareholders equity		
Preferred stock-authorized 5,000,000 shares of $0.001 par value; no shares issued and outstanding at June 30, 2006 and December 31, 2005.		
Common stock-authorized 30,000,000 shares of $0.001 par value; issued and outstanding 6,459,021 at June 30, 2006 and 6,336,221 at December 31, 2005.	6	6
Additional paid-in capital	30,111	29,765
Retained earnings	17,232	18,312
Total shareholders equity	47,349	48,083
Total liabilities and shareholders equity	$ 74,218	$ 76,432

The accompanying notes are an integral part of these financial statements.

Table of Contents

SRI/SURGICAL EXPRESS, INC.

STATEMENTS OF OPERATIONS

(In thousands, except per share data)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues	$ 23,417	$ 23,205	$ 46,923	$ 46,459
Cost of revenues	18,206	17,329	35,830	34,664
Gross profit	5,211	5,876	11,093	11,795
Distribution expenses	1,512	1,501	3,089	3,088
Selling and administrative expenses	4,279	3,647	8,814	7,582
Income (loss) from operations	(580)	728	(810)	1,125
Interest expense, net	292	308	574	593
Income (loss) before income taxes	(872)	420	(1,384)	532
Income tax expense (benefit)	(70)	165	(304)	212
Net income (loss)	$ (802)	$ 255	$ (1,080)	$ 320
Earnings (loss) per share:				
Basic	$ (0.13)	$ 0.04	$ (0.17)	$ 0.05
Diluted	$ (0.13)	$ 0.04	$ (0.17)	$ 0.05
Weighted average common shares outstanding:				
Basic	6,338	6,263	6,337	6,263
Diluted	6,338	6,265	6,337	6,267

The accompanying notes are an integral part of these financial statements.

Table of Contents

SRI/SURGICAL EXPRESS, INC.

STATEMENTS OF CASH FLOWS

(In thousands)

(unaudited)

	Six Months Ended June 30, 2006	June 30, 2005
Cash flows from operating activities:		
Net (loss) income	$ (1,080)	$ 320
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	1,693	2,113
Amortization of reusable surgical products	2,430	2,744
Stock based compensation expense	330	
Provision for reusable surgical products shrinkage	781	1,080
Loss on disposal of property, plant and equipment		49
Deferred income taxes	(381)	(796)
Change in operating assets and liabilities:		
Decrease in accounts receivable, net	640	312
(Increase) decrease in inventories, net	(491)	975
Decrease in prepaid expenses and other assets, net	59	471
Decrease in accounts payable	(103)	(1,763)
Increase in employee related and other accrued expenses	186	518
Net cash provided by operating activities	4,064	6,023
Cash flows from investing activities:		
Purchases of property, plant and equipment	(786)	(443)
Purchases of reusable surgical products	(2,756)	(2,741)
Net cash used in investing activities	(3,542)	(3,184)
Cash flows from financing activities:		
Net repayment on notes payable to bank	(729)	(2,531)
Net repayment on mortgage payable	(119)	
Repayment of bonds payable	(330)	(330)
Proceeds from issuance of common stock	16	
Payments on obligation under capital lease	(4)	(93)
Net cash used in financing activities	(1,166)	(2,954)
Decrease in cash and cash equivalents	(644)	(115)
Cash and cash equivalents at beginning of period	653	413
Cash and cash equivalents at end of period	$ 9	$ 298
Supplemental cash flow information:		

Cash paid for interest	$ 475	$ 591
Cash paid for income taxes	$ 316	$ 195

The accompanying notes are an integral part of these financial statements.

Table of Contents

SRI/SURGICAL EXPRESS, INC.

NOTES TO FINANCIAL STATEMENTS

(unaudited)

NOTE A BASIS OF PRESENTATION

The accompanying unaudited financial statements of SRI/Surgical Express, Inc. (the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the Securities and Exchange Commission s (the SEC) instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they omit or condense footnotes and certain other information normally included in complete financial statements prepared in accordance with accounting principles generally accepted in the United States of America. In the opinion of management, all adjustments of a normal recurring nature that are necessary to present fairly the financial information for the interim periods reported have been made. The accompanying unaudited financial statements should be read in conjunction with the financial statements and notes included in the Company s Form 10-K for the year ended December 31, 2005, filed with the SEC. The results of operations for the three and six months ended June 30, 2006, are not necessarily indicative of the results that can be expected for the entire year ending December 31, 2006.

The Company presents an unclassified balance sheet as a result of the extended amortization period (predominantly three to six years) of its reusable surgical products. The Company provides reusable surgical products to its customers on a per use basis similar to a rental arrangement.

The Company operates on a 52-53 week fiscal year ending the Sunday nearest December 31. The unaudited financial statements are reflected as of June 30, 2006 and 2005 for presentation purposes only. The actual end of each period was July 2, 2006 and July 3, 2005, respectively. There are 26 weeks included for each of the six-month periods ended June 30, 2006 and June 30, 2005. There are 13 weeks included for each of the three-month periods ended June 30, 2006 and June 30, 2005.

NOTE B SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates

Management is required to make estimates and assumptions during the preparation of financial statements and accompanying notes in conformity with accounting principles generally accepted in the United States of America. These estimates and assumptions affect the amounts reported in the financial statements and accompanying notes. Actual results could differ materially from those estimates and assumptions.

Accounts Receivable, net

The Company has accounts receivable from hospitals and surgery centers. The Company does not believe that there are substantial credit risks associated with those receivables and does not require any form of collateral from its customers. The allowance for doubtful accounts as of June 30, 2006, and December 31, 2005, was approximately $345,000 and $441,000, respectively. The allowance for doubtful accounts relates to accounts receivable not expected to be collected and is based on management s assessment of specific customer balances, the overall aging of the balances, and the financial stability of the customers. The Company s write-offs for uncollectable accounts (determined based on specific account evaluations) are insignificant to its results of operations. The Company does not customarily charge interest on accounts receivable.

Table of Contents

Inventories, net

Inventories consist of raw materials, principally consumables, supplies, and disposable surgical products, and work in progress and finished goods consisting of company-assembled packs of various combinations of raw materials and reusable surgical products. Inventories are valued at the lower of cost or market, with cost being determined on the first-in, first-out method. As of June 30, 2006 and December 31, 2005, inventory consists of the following:

	June 30, 2006	December 31, 2005
	(in 000 s)	
Raw materials	$ 3,676	$ 3,450
Work in progress	189	176
Finished goods	3,562	3,295
	7,427	6,921
Less: Inventory reserve	(338)	(323)
	$ 7,089	$ 6,598

Reusable Surgical Products, net

The Company s reusable surgical products, consisting principally of linens (gowns, towels, drapes), basins (stainless steel medicine cups, carafes, trays, basins), and owned surgical instruments, are stated at cost. Amortization of linens and basins is computed on a basis similar to the units of production method. Estimated useful lives for each product are based on the estimated total number of available uses for each product. The expected total available usage for its linen products using the three principal fabrics (accounting for approximately 85% of the reusable surgical products) is 75, 100, and 125 uses, based on several factors, including the Company s actual historical experience with these products. The Company believes Radio Frequency Identification (RFID) technology enables it to evaluate the useful lives of linen products more efficiently. Basins are amortized over their estimated useful life, which ranges from 25 to 200 uses. Owned surgical instruments are amortized straight-line over a period of four years. Accumulated amortization as of June 30, 2006, and December 31, 2005, was approximately $12.2 million and $12.4 million respectively.

As of each of June 30, 2006, and December 31, 2005, the Company had reserves for shrinkage, obsolescence, and scrap related to reusable surgical products of approximately $1.5 million.

Revenue Recognition

Revenues are recognized as the agreed upon products and services are delivered, generally daily. Packing slips signed and dated by the customer evidence delivery of product. The Company s contractual relationships with its customers are primarily evidenced by purchase orders or service agreements with terms varying from one to five years, which are generally cancelable by either party.

The Company owns substantially all of the reusable surgical products provided to customers except the surgical instruments. A third party provides most of the surgical instruments that are included in the Company s comprehensive surgical procedure-based delivery and retrieval service. The Company pays a fee to the third party for the use of the surgical instruments. In accordance with Emerging Issues Task Force (EITF) No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*, the Company acts as a principal in this arrangement and has reported the revenue gross for the comprehensive surgical procedure-based delivery and retrieval service. The third party agent fee charged to the Company is included in cost of revenues in the statements of operations.

Table of Contents

Stock-Based Compensation

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standard No. 123R, *Share-Based Payment,* (SFAS 123R) for its share-based compensation plans. The Company previously accounted for these plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees,* (APB 25) and related interpretations and disclosure requirements established by Statement of Financial Accounting Standard No. 123, *Accounting for Stock-Based Compensation,* (SFAS 123), as amended by Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure.*

Under APB 25, no compensation expense was recorded in earnings for the Company s stock options granted under the Company s stock option plans. The pro forma effects on net income and earnings per share for stock options granted were instead disclosed in a footnote to the financial statements. Under SFAS 123R, all share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period.

The Company adopted SFAS 123R using the modified prospective method. Under this transition method, compensation cost to be recognized in fiscal year 2006 and later periods includes the cost for all share-based awards granted prior to, but not yet vested as of January 1, 2006. This cost was based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123. The cost for all share-based awards granted subsequent to December 31, 2005, represents the grant-date fair value that was estimated in accordance with the provisions of SFAS 123R, utilizing the binomial (Lattice) model. Results for prior periods have not been restated. Stock-based compensation expense for the three-month and six-month periods ended June 30, 2006 was $155,000 and $330,000, or $135,000 and $289,000 net of income tax respectively, which contributed to a $0.02 and $0.05 reduction in basic and diluted earnings per share for the three-month and six-month periods ended June 30, 2006, respectively.

The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair-value recognition provisions of SFAS 123 to all of its share-based compensation awards for periods prior to the adoption of SFAS 123R (in thousands, except per share data):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Reported net income	$ 255	$ 320
Compensation expense, net of tax	(127)	(271)
Pro forma net income for calculation of earnings per share	$ 128	$ 49
Earnings per share:		
Reported earnings per share - basic	$ 0.04	$ 0.05
Pro forma earnings per share - basic	$ 0.02	$ 0.01
Reported earnings per share - diluted	$ 0.04	$ 0.05
Pro forma earnings per share - diluted	$ 0.02	$ 0.01

There was $16,000 cash received from stock option exercises under all share-based payment arrangements for the three-month and six-month periods ended June 30, 2006. There was no cash received from stock option exercises under all share-based payment arrangements for the three-month or six-month periods ended June 30, 2005. There were no capitalized stock-based compensation costs at June 30, 2006.

Table of Contents

There were no modifications made to outstanding stock options before the adoption of Statement 123(R).

Stock Option Plans

The 1995 Stock Option Plan

The 1995 Stock Option Plan was designed to provide employees with incentive or non-qualified options to purchase up to 700,000 shares of common stock. The options vest ratably over four to five years from the date of the grant. All outstanding options vest upon a change in control of the Company. Options granted under this Plan expire no later than ten years after the date granted or sooner in the event of death, disability, retirement or termination of employment. As of June 30, 2006 and 2005, options to purchase 186,100 and 278,100 shares, respectively, were outstanding, and 0 and 176,700 options, respectively, were available to be granted under this Plan. The 1995 Stock Option Plan terminated on December 21, 2005, although that termination does not adversely affect any options outstanding under the Plan.

The 1996 Non-Employee Director Plan

As amended on May 16, 2001, the Non-Employee Plan is designed to provide for the grant of non-qualified stock options to purchase up to 200,000 shares of common stock to members of the Board of Directors who are not employees of the Company. At the completion of the Company s initial public offering, each non-employee director was granted options to purchase 4,000 shares of common stock for each full remaining year of the director s term. Thereafter, on the date on which a new non-employee director was first elected or appointed, he or she was automatically granted options to purchase 4,000 shares of common stock for each year of his or her initial term, and was granted options to purchase 4,000 shares of common stock for each year of any subsequent term to which he or she was elected. As of March 2006, the equity component of the director compensation plan was restructured, so that each non-employee director will receive an annual grant of options to purchase 7,500 shares of common stock as of the date of the Annual Shareholder Meeting, beginning with the 2006 Annual Meeting. All options become exercisable ratably over the director s three-year term and have an exercise price equal to the fair market value of the common stock on the date of grant. As of June 30, 2006 and 2005, options to purchase 182,000 and 177,500 shares, respectively, were outstanding, and 18,000 and 22,500 options, respectively, were available to be granted under this Plan. The 1996 Non-Employee Director Plan terminated on July 14, 2006, although that termination does not adversely affect any options outstanding under the Plan.

The 1998 Stock Option Plan

As amended on May 16, 2001, the 1998 Stock Option Plan is designed to provide employees with incentive or non-qualified options to purchase up to 600,000 shares of common stock. The options vest ratably over four to five years from the date of the grant. All outstanding options vest upon a change in control of the Company. Options granted under this Plan expire no later than ten years after the date granted or sooner in the event of death, disability, retirement, or termination of employment. As of June 30, 2006 and 2005, options to purchase 303,300 and 319,600 shares, respectively, were outstanding, and 277,284 and 262,984 options, respectively, were available to be granted under this Plan.

The 2004 Stock Compensation Plan

The 2004 Stock Compensation Plan is designed to further the interests of the Company and its shareholders by providing incentives in the form of stock options or restricted stock grants to key employees and non-employee directors who contribute materially to the success and profitability of the Company. The equity awards typically vest ratably over five years from the date of the grant. All outstanding grants vest upon a change in control of the Company. Options granted under this Plan expire no later than ten years after the date granted or sooner in the event of death, disability, retirement, or termination of employment. As of June 30, 2006 and 2005, options to purchase 328,800 and 223,000 shares respectively, were outstanding, and 170,400 and 277,000 shares, respectively, were available to be granted as options or restricted stock under this Plan.

Table of Contents

The following table summarizes option and restricted stock grant activity from January 1, 2006 through June 30, 2006:

	Shares Available for Grant	Options and Restricted Stock Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life
Balance at January 1, 2006	562,084	966,600	$ 8.91	6.04
Options expired				
Options granted	(25,000)	25,000	$ 6.23	
Options cancelled	48,600	(108,600)	$ 8.37	
Restricted stock awards	(120,000)	120,000		
Options exercised		(2,800)	$ 5.60	
Balance at June 30, 2006	465,684	1,000,200	$ 7.84	8.91
Exercisable at June 30, 2006		515,080	$ 11.27	5.12

The weighted-average grant date fair value of options granted during the six months ended June 30, 2006 and 2005 was $4.52 and $3.03, respectively. The total intrinsic value of options exercised in the six months ended June 30, 2006 was $10,000. There were no options exercised in the six months ended June 30, 2005. As of June 30, 2006, there was $635,000 of unrecognized compensation cost related to non-vested options that is expected to be recognized over a weighted average period of 4.75 years. The total fair value of options vested during the six months ended June 30, 2006 and 2005 was $265,000 and $441,000, respectively.

The Company consistently used the binomial model for estimating the fair value of options granted in the first fiscal quarter of 2006 and 2005, respectively. The Company used historical data to estimate the option exercise and employee departure behavior used in the binomial valuation model. The expected term of options granted is derived from the output of the option pricing model and represents the period of time that options granted are expected to be outstanding. The risk-free rates for periods within the contractual term of the options are based on the U.S. Treasury stripped coupon interest in effect at the end of the quarter. Because the binomial valuation model accommodates multiple input values, the risk free interest rates and expected term rates used in calculating the fair value of the options, are expressed in ranges.

Following are the weighted-average and range assumptions, where applicable, used for each respective period:

	Three Months Ended		Six Months Ended	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
		(Binomial)		(Binomial)
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Risk-free interest rate	4.92 to 5.19%	3.91 to 4.41%	4.70 to 5.19%	3.68 to 4.45%
Weighted-average expected volatility	60.6%	66.3%	60.0%	66.3%
Expected term	3.85 to 7.13 years	2.5 to 9.6 years	4.1 to 10.0 years	2.5 to 9.6 years
Respective service period	5 years	5 years	5 years	5 years

Table of Contents

Restricted Stock Awards

In fiscal year 2006, the Company granted unvested common stock awards (restricted stock) to certain key employees pursuant to the 2004 Stock Compensation Plan. The shares will vest ratably over five years.

The restricted stock awards granted in 2006 were accounted for using the measurement and recognition principles of SFAS 123R. Compensation for restricted stock awards is measured at fair value on the date of grant based on the number of shares expected to vest and the quoted market price of the Company s common stock. Compensation cost for all awards will be recognized in earnings, net of estimated forfeitures, on a straight-line basis over the requisite service period.

The Company recorded $36,000 and $65,000, respectively, in compensation expense related to the restricted stock that vested during the three-month and six-month periods ended June 30, 2006. As of June 30, 2006, there was $655,000 of total unrecognized compensation cost related to restricted stock awards granted under the Plan. That cost is expected to be recognized over a period of 4.50 years.

Notes Payable to Bank

On June 20, 2005, the Company entered into a three-year $30 million revolving credit facility with two financial institutions. The new credit facility is secured by substantially all of the Company s assets and has an interest rate that varies between 200 and 300 basis points over LIBOR (5.33% as of June 30, 2006) depending on the quarterly results under the Company s consolidated leverage ratio covenant. The credit facility agreement was amended in May 2006 to revise the funds flow coverage ratio from not less than 2.50 to 1.00 to not less than 2.25 to 1.00. The available credit under the facility is subject to limitation based upon the consolidated leverage ratio of the Company. The amended credit facility requires the Company to maintain (a) a quarterly consolidated leverage ratio of not more than 2.50 to 1.00 for fiscal quarters ending June 30, 2006 and thereafter; (b) a funds flow coverage ratio of not less than 2.25 to 1.00 for the fiscal quarters ending June 30, 2006 and thereafter until the fiscal quarter ending March 31, 2007 when it becomes not less than 2.50 to 1.00; (c) a tangible net worth at the end of each fiscal quarter beginning June 30, 2005, of at least $45 million plus 75% of cumulative net positive income generated after March 31, 2005. The credit facility places a number of restrictions on the Company, including without limitation: the paying of dividends, incurring additional indebtedness, making loans and investments, encumbering its assets, entering into a new business, and entering into certain merger, consolidation or liquidation transactions.

The Company s net loss for the second quarter of 2006 resulted in a funds flow coverage ratio of 1.98 to 1.00, which was below the requirement (2.25 to 1.00) of the amended credit agreement. Both financial institutions issued a waiver of the requirement for the period ended June 30, 2006. All other requirements under the credit agreement were complied with.

As of June 30, 2006, the Company had $18.9 million total available to be borrowed under the facility, which takes into consideration the amounts already outstanding. The amount available under the revolving credit facility is limited by letters of credit principally associated with the Company s bonds payable.

The credit facility allows the Company to repurchase its common stock through open market purchases at prevailing market prices. During the first six months of 2006 and fiscal year 2005, the Company did not repurchase any shares of its common stock.

Table of Contents

NOTE C EARNINGS (LOSS) PER SHARE

The following table sets forth the Company s computation of basic and diluted earnings (loss) per share:

	Three Months Ended		Six Months Ended	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
	(In thousands, except per share data)			
	(unaudited)			
Basic				
Numerator:				
Net income (loss)	$ (802)	$ 255	$ (1,080)	$ 320
Denominator:				
Weighted average shares outstanding	6,338	6,263	6,337	6,263
Earnings (loss) per common share, basic	$ (0.13)	$ 0.04	$ (0.17)	$ 0.05
Diluted				
Numerator:				
Net income (loss)	$ (802)	$ 255	$ (1,080)	$ 320
Denominator:				
Weighted average shares outstanding	6,338	6,263	6,337	6,263
Effect of dilutive securities - employee stock options		2		4
	6,338	6,265	6,337	6,267
Earnings (loss) per common share, diluted	$ (0.13)	$ 0.04	$ (0.17)	$ 0.05

Options to purchase 337,600 and 971,200 shares of common stock for the three-month periods ended June 30, 2006 and June 30, 2005, respectively, were not included for all or a portion of the computation of diluted earnings per common share, because the options exercise prices were greater than the average market price of the common shares, and therefore, the effect would be anti-dilutive. Options to purchase 357,600 and 956,200 shares of common stock for the six-month periods ended June 30, 2006 and June 30, 2005, respectively, were not included for the same reason. The dilutive effect of 662,600 and 642,600 options with an exercise price less than the average market price of the common shares were not included for the three-month and six-month periods ended June 30, 2006 respectively, because the effect would be anti-dilutive due to the Company s net loss for the period.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Overview

The following discussion and analysis should be read with our financial statements and the notes thereto included elsewhere in this report. This discussion and analysis contains trend analysis and might contain forward-looking statements. These statements are based on current expectations, and actual results might differ materially. Among the factors that could cause actual results to vary are those described in Critical Accounting Policies and Certain Considerations included in this report and Risk Factors included in our 2005 Annual Report on Form 10-K, filed with the Securities and Exchange Commission.

We provide daily processing, assembly and delivery of reusable and disposable products and instruments required for surgery through our state-of-the-art, FDA-regulated service centers. Our integrated closed-loop process starts with daily delivery of reusable and disposable surgical supplies and instruments to the healthcare provider. At the same time, we pick up the textiles, basins and instruments used in surgery and return

them to our processing facility. Used products arriving at our processing facility are sorted, cleaned, inspected, packaged, sterilized, and subsequently, shipped back to the healthcare providers.

Table of Contents

Our principal strategic opportunity to improve our operating results is to capitalize on our strong service capabilities and considerable infrastructure by leveraging our current relationships with existing customers and adding new customers. We plan to continue to focus on introducing our current and potential new customers to our physician-specific ReadyCase[SM] case cart management system. We believe that our ReadyCase[SM] growth strategy is a strong strategy. We have undertaken significant efforts to identify, recruit, and train new sales resources to help us fully execute these strategies.

We believe our facilities are strategically situated to capitalize on future market opportunities. These facilities have significant available capacity to access more of the national market. We continue to seek ways to better maximize the efficiency and effectiveness of our operating processes.

We derive our revenue from the sale and servicing of reusable and disposable surgical products and instruments. Reusable products include linens (gowns, towels and drapes) and basins (stainless steel cups, carafes, trays and basins). We sell our products and services through a direct sales force strategically located throughout the United States. Our revenue growth is primarily determined by the number of customers, the number and type of surgical procedures that we service for each customer, and pricing for our various types of surgical packs and procedures. Revenues are recognized as the agreed upon products and services are delivered, generally daily. Packing slips signed and dated by the customer evidence delivery of product. Our contractual relationships with our customers are primarily evidenced by purchase orders or service agreements with terms varying from one to five years, which are generally cancelable by either party.

We incur most of our cost of revenues from processing the reusable surgical products and instruments at our processing facilities. We amortize the cost of our reusable surgical products over their expected useful life based upon usage. We have implemented RFID technology into our reusable linen products to reduce shrinkage, monitor product quality testing and improve handling efficiencies.

Most of our surgical instrument supply arrangements with customers utilize instruments owned by Aesculap, Inc. (Aesculap), which receives an agreed upon fee for each procedure based on the number and kinds of procedures performed with its instruments and the number and combination of instruments used for each procedure. This arrangement allows us to limit our cost of capital for instrument programs. In addition to the Aesculap-owned instruments, we purchase surgical instruments from other vendors to service customers who have requirements that Aesculap cannot fulfill. Surgical instruments that we own are depreciated over a four-year life.

Our profitability is primarily determined by our revenues, the efficiency with which we deliver products and services to customers, and our ability to control our costs. We incurred operating and net losses for our three-month and six-month periods ended June 30, 2006. Our revenues for these periods were short of expectations. The investment made this year in the direct sales force has yet to deliver expected revenue increases and sales to customers who predominantly purchase reusable textiles declined. We continue to see growth in other products sold with our ReadyCase[SM] case cart management system. We also incurred increased product and production labor costs, severance, and equity-based compensation costs under SFAS 123R. We have implemented cost and expense reduction measures to better align spending with revenues.

We believe we are taking appropriate steps to impact our profitability. We have undertaken a significant investment in the size and training of our sales team. Although this investment has increased our selling expenses, we believe this investment is critical in our plan to break out from relatively flat sales in the past several years, and we remain committed to our aggressive growth plan.

We have engaged experts to assist us with a Lean Transformation at our Tampa facility. We are encouraged with the early results of this initiative, though the investment for this transformation will likely exceed cost savings in 2006. Cost savings in Tampa will be adopted by our other facilities. We expect this initiative will have a powerful and sustainable impact on our performance in the years ahead.

Table of Contents

Critical Accounting Policies

The preparation of our financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions, and estimates that affect the amounts reported in our financial statements and accompanying notes. On an ongoing basis, we evaluate our estimates and assumptions based upon historical experience and various other factors and circumstances. We believe that these estimates and assumptions are reasonable under the circumstances; however, actual results may vary from these estimates and assumptions. We identified the following critical accounting policies that affect the more significant judgments, assumptions and estimates used in preparing our financial statements:

Allowance for Doubtful Accounts. Our allowance for doubtful accounts is based on our assessment of the collectibility of specific customer accounts, the overall aging of the balances, and the financial stability of the customer. The use of different estimates or assumptions could produce different allowance balances. If a major customer s creditworthiness deteriorates or customer defaults run at a rate higher than historical experience, we would be required to increase this allowance, which could adversely affect our results of operations.

Reserves for Shrinkage, Obsolescence, and Scrap for Reusable Surgical Products and Instruments. We determine our reserves for shrinkage and obsolescence of our reusable surgical products and instruments based on historical experience. Any linen products not scanned by our RFID system for a 210-day period are considered lost and written off. We determine our reserve for scrap based upon quality assurance standards and historical evidence. We periodically verify the quantity of other reusable surgical products by counting and by applying observed turn rates. A third party, Aesculap, owns most of the surgical instruments that we use. We base our reserve for owned surgical instrument losses on our assessment of our historical loss experience, including periodic physical counts. Using different estimates or assumptions could produce different reserve balances for our reusable products and instruments. We review this reserve quarterly. If actual shrinkage, obsolescence or scrap differs from our estimates, our reserve would increase or decrease accordingly, which could adversely affect our results of operations.

Reserves for Shrinkage and Obsolescence for Inventories. We determine our reserves for shrinkage and obsolescence of our inventories based on historical data, including the results of cycle counts performed during the year and the evaluation of the aging of finished goods of reusable and disposable surgical products and instruments. Using different estimates or assumptions could produce different reserve balances. We review this reserve quarterly. If actual losses differ from our estimates, our reserve would increase or decrease accordingly, which could adversely affect our results of operations.

Amortization of Reusable Surgical Products and Instruments. Our reusable surgical products are stated at cost. We amortize linens and basins on a basis similar to the units of production method. Estimated useful lives for each product are based on the estimated total number of available uses for each product. The expected total available usage for our linen products using the three principal fabrics (accounting for approximately 85% of the reusable surgical products) is 75, 100, and 125 uses, based on several factors, including our actual historical experience with these products. We believe our RFID technology enables us to evaluate the useful lives of linen products more often. Basins are amortized over their estimated useful life, which ranges from 25 to 200 uses. In 2005, we began amortizing owned surgical instruments on the straight-line method based on a four-year useful life. If our actual use experience with these products is shorter than these assumptions, our amortization rates for reusable products and instruments would increase, which could adversely affect our results of operations.

Health Insurance Reserves. We offer employee benefit programs including health insurance to eligible employees. We retain a liability up to $75,000 annually for each health insurance claim. We accrue health insurance costs using estimates to approximate the liability for reported claims and claims incurred but not reported. Using different estimates or assumptions could produce different reserve balances. If actual claim results exceed our estimates, our health insurance reserve would increase, which could adversely affect our results of operations.

Table of Contents

Workers Compensation Insurance Reserve. In 2005, we converted our workers compensation insurance program to a large dollar deductible, self-funded plan. We retain a liability of $250,000 for each claim occurrence. Our policy has an annual aggregate liability limit of $1.25 million. We base our reserve on historical claims experience and reported claims. We accrue workers compensation insurance costs using estimates to approximate the liability for reported claims and claims incurred but not reported. We review this reserve quarterly. If actual claims differ from our estimates, the reserve would increase or decrease accordingly, which could adversely affect our results of operations.

Income Taxes. Our effective tax rate is based on expected income and statutory tax rates in the various jurisdictions in which we operate. Significant judgment is required in determining our effective tax rate and evaluating our tax positions. Our effective tax rate depends upon our forecast of tax expense or benefit based upon the expected results for the fiscal year. Each quarter, we evaluate our forecasted fiscal year results and adjust our tax provision to reflect the effective tax rate on a cumulative basis. This rate is applied to our quarterly operating results. Income taxes have been provided using the liability method in accordance with Statements of Financial Accounting Standards (SFAS) 109, *Accounting for Income Taxes*. In accordance with SFAS 109, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in the tax rate is recognized in operations in the period that includes the enactment date of the rate change. The tax benefits must be reduced by a valuation allowance in certain circumstances. Realization of the deferred tax benefits is dependent on generating sufficient taxable income prior to expiration of any net operating loss carry-forwards. We periodically review deferred tax assets for recoverability, and provide valuation allowances as necessary.

Stock-Based Compensation. In accordance with the provisions of Financial Accounting Standards Board Statement No. 123R, Share-Based Payment, (SFAS 123R) and the Security and Exchange Commission Staff Accounting Bulletin No. 107 (SAB 107), we began recognizing stock-based compensation expense in our consolidated statement of operations on January 1, 2006. We have elected to use the binomial model to determine the fair value of our issued options. Option pricing models require the input of subjective assumptions, including the expected life of the option, the price volatility of the underlying stock, expected interest rates and forfeitures. If actual results differ significantly from our assumptions, stock-based compensation could increase or decrease. For further discussion of our stock-based compensation, see *Note B-Summary of Significant Accounting Policies Stock-Based Compensation* to the Financial Statements.

Results of Operations

We operate on a 52-53 week fiscal year ending the Sunday nearest December 31. The unaudited financial statements are reflected as of June 30, 2006 and June 30, 2005 for presentation purposes only. The actual end of each period was July 2, 2006 and July 3, 2005, respectively. There are 13 weeks included for each of the three-month periods ended June 30, 2006 and June 30, 2005.

Table of Contents

The following table sets forth for the periods shown the percentage of revenues represented by certain items reflected in our statements of income:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	77.7	74.7	76.4	74.6
Gross profit	22.3	25.3	23.6	25.4
Distribution expenses	6.5	6.5	6.5	6.7
Selling and administrative expenses	18.3	15.7	18.8	16.3
Income (loss) from operations	(2.5)	3.1	(1.7)	2.4
Interest expense, net	1.2	1.3	1.2	1.3
Income (loss) before income taxes	(3.7)	1.8	(2.9)	1.1
Income tax expense (benefit)	(0.3)	0.7	(0.6)	0.4
Net income (loss)	(3.4)%	1.1%	(2.3)%	0.7%

Three and Six Months Ended June 30, 2006 Compared to Three and Six Months Ended June 30, 2005

Revenues. Revenues increased $212,000 or 0.9% to $23.4 million for the three months ended June 30, 2006, compared to $23.2 million for the three months ended June 30, 2005. For the six months ended June 30, 2006, revenues increased $464,000 or 1.0% to $46.9 million compared to $46.5 million for the six months ended June 30, 2005. The increase in revenues in the three-month and six-month periods ended June 30, 2006 is primarily attributable to the growth of our ReadyCase[SM] delivery system (combining instruments, reusable textiles, and disposable products), offset partially by declining sales to customers who predominantly purchase reusable textiles.

Gross Profit. Gross profit declined $665,000 and $702,000 for the three-month and six-month periods ended June 30, 2006, respectively, as compared to the same periods in the prior year. As a percentage of revenues, gross profit decreased by 3 percentage points and 1.8 percentage points for the three-month and six-month periods ended June 30, 2006, respectively, as compared to the same periods in the prior year, primarily due to lower average selling prices and the higher cost of components for disposable packs, production labor, reusable pack supplies and plant maintenance.

Distribution Expenses. Distribution expenses remained essentially unchanged at $1.5 million or 6.5% as a percent of revenues and $3.1 million or 6.6% as a percent of revenues for the three-month and six-month periods ended June 30, 2006, respectively, as compared to the same periods in the prior year.

Selling and Administrative Expenses. Selling and administrative expenses increased $632,000 or 17.3% for the three months ended June 30, 2006 from $3.6 million compared to the same period in the prior year. Selling and administrative expenses increased $1.2 million for the six months ended June 30, 2006 or 16.2% from $7.6 million compared to the same period in the prior year. The increase in selling and administrative expenses for the three-month and six-month periods ended June 30, 2006 is primarily attributable to increased compensation expense associated with expanding the direct sales force over the prior year and the recognition of stock-based compensation expense of $142,000 and $303,000 for the three-month and six-month periods ended June 30, 2006, respectively, as required by the new accounting statement SFAS 123(R), partially offset by reduced depreciation expense attributable to our computer system becoming fully depreciated.

Table of Contents

Income from Operations. Income from operations decreased $1.3 million or 179.7%, to a loss of $580,000 for the three months ended June 30, 2006 compared to the same period in the prior year. For the six months ended June 30, 2006, income from operations decreased $1.9 million or 172.0% to a loss of $810,000 compared to the same period in the prior year. The loss from operations for the three-month and six-month periods ended June 30, 2006 is attributable to lower gross profit and increased selling and administrative expenses.

Interest Expense, net. Interest expense decreased $16,000 or 5.2% to $292,000 for the three months ended June 30, 2006 compared to the same period in the prior year. For the six months ended June 30, 2006 interest expense decreased $19,000 or 3.2% to $574,000 compared to the same period in the prior year. The lower interest expense for the three-month and six-month periods ended June 30, 2006 as compared to last year is due primarily to the 2005 write-off of fees associated with the former line of credit that was replaced in June 2005, resulting in lower 2006 costs, partially offset by higher interest rates.

Income Tax Expense. Our effective tax rate is based on expected income and statutory tax rates in the various jurisdictions in which we operate. Income tax expense is a function of our net income and effective tax rate. The effective tax rate for the three months ended June 30, 2006 was 8.0% compared to 39.4% for the three months ended June 30, 2005. For the six months ended June 30, 2005 the effective tax rate was 22.0% compared to 39.9% for the six months ended June 30, 2005. The primary reason for the lower effective tax rate in the current year periods is the lower forecasted results for fiscal year 2006 and the permanent tax difference created by the non-deductibility of the portion of the stock option expense associated with incentive stock options granted. Our effective tax rate depends upon our forecast of tax expense or benefit based upon the expected results for the fiscal year. Each quarter, we evaluate our forecasted fiscal year results and adjust our tax provision to reflect the effective tax rate on a cumulative basis. Our effective tax rate may increase or decrease during the remainder of 2006 depending upon actual results of operations, which adjustments could be material in the future.

Liquidity and Capital Resources

Our principal sources of capital have been cash flows from operations and borrowings under our revolving credit facility. As of June 30, 2006, we had approximately $9,000 in cash and cash equivalents, compared to approximately $653,000 as of December 31, 2005. We used all available cash to reduce the outstanding balance of the credit facility from $3.2 million at December 31, 2005 to $2.5 million at June 30, 2006. As of June 30, 2006, we had $18.9 million available under our credit facility compared to $17.8 as of December 31, 2005. Net cash provided by operating activities for the six months ended June 30, 2006 was $4.1 million as compared to $6.0 million for the same period last year. The decrease in cash from operations in 2006 is primarily attributable to lower net income, higher inventory levels, reduced fixed asset depreciation and reusable surgical products amortization, and a smaller decrease in prepaid expenses, partially offset by a smaller decrease in accounts payable and improved collections of customer accounts.

Net cash used in investing activities in the six months ended June 30, 2006 was $3.5 million as compared to $3.2 million in the same period last year. This increase in cash used in investing activities is primarily attributable to increased purchases of equipment and computer hardware. We estimate that our expenditures in 2006 for reusable surgical products will be approximately $5.1 million, an amount that will fluctuate depending on the growth of our business. We estimate that our expenditures in 2006 for property, plant and equipment will be approximately $3.0 million, including approximately $1.5 million that we expect to spend in 2006 as part of a project to replace our existing IT infrastructure with an Enterprise Resource Planning system. We expect to complete the phase of selecting a vendor and implementation partner for this project in our fourth quarter of this year.

Net cash used in financing activities in the six months ended June 30, 2006 was $1.2 million compared to $3.0 million in 2005. The cash was used to pay down our revolving credit facility, mortgage and outstanding Industrial Revenue Bonds.

We have a three-year $30 million revolving credit facility with two financial institutions, which is scheduled to mature in June 2008. The amount available under the revolving credit facility is limited by letters of credit principally associated with our bonds payable described below. As noted below, we amended the

Table of Contents

credit facility in December 2005 to provide for mortgage financing in connection with the purchase of our headquarters facility. As of June 30, 2006, we had $18.9 million total available to be borrowed under the facility, including amounts already borrowed.

The new credit facility is secured by substantially all of our assets and has an interest rate that varies between 200 and 300 basis points over LIBOR (5.33% as of June 30, 2006) depending on the quarterly results under the Company s consolidated leverage ratio covenant, as well as an unused availability fee. The available credit under the facility is subject to limitation based upon our consolidated leverage ratio. The amended credit facility requires us to maintain (a) a quarterly consolidated leverage ratio of not more than 2.50 to 1.00 for fiscal quarters ending June 30, 2006 and thereafter; (b) a funds flow coverage ratio of not less than 2.25 to 1.00 for the fiscal quarters ending June 30, 2006 and thereafter until the fiscal quarter ending March 31, 2007 when it becomes not less than 2.50 to 1.00; (c) a tangible net worth at the end of each fiscal quarter beginning June 30, 2005, of at least $45 million plus 75% of cumulative net positive income generated after March 31, 2005. The credit facility places a number of restrictions on us, including without limitation: the paying of dividends, incurring additional indebtedness, making loans and investments, encumbering its assets, entering into a new business, and entering into certain merger, consolidation or liquidation transactions.

As previously disclosed, we amended our credit agreement in May 2006 to revise the funds flow coverage ratio for the period ended June 30, 2006, from not less than 2.50 to 1.00 to not less than 2.25 to 1.00. Our actual funds flow coverage ratio for this period of 1.98 to 1.00 was less than the amended requirement. Both financial institutions waived the requirement for the period ended June 30, 2006. We expect that the lenders will agree to amend the credit agreement to change this ratio requirement to a level for the third quarter of 2006 with which we can comply. In connection with the waiver, we paid a $20,000 amendment fee. We comply with all other credit agreement requirements, including the other financial covenants.

In December 2005, we purchased our Tampa corporate headquarters facility for approximately $5.3 million. We financed the purchase with a mortgage from our primary lenders for approximately $4.8 million and borrowing under our revolving credit facility, and amended our credit agreement to provide for this mortgage financing as a component of the credit facility. The mortgage has a term of five years and an amortization schedule based on 20 years, with a balloon payment of $3.6 million in 2010. The mortgage bears an interest rate of 250 basis points over LIBOR.

We have outstanding public bonds that we issued to fund the construction of two of our reusable processing facilities. Interest expense on these bonds adjusts based on rates that approximate LIBOR (5.33% at June 30, 2006). Starting in 2004, we began amortizing the bonds through quarterly payments of $165,000. Balloon principal payments of $3.1 million are due on the bonds in 2014. The bonds are secured by the two reusable processing facilities and backed by letters of credit issued by a financial institution. We paid a commitment fee of approximately $14,500 (125 basis points) for the letters of credit in the first six months of 2006. The letters of credit must be renewed each year through maturity in 2014.

Our contractual cash obligations for future minimum payments, including interest, under our notes payable to bank, bonds payable, mortgage and operating leases as of June 30, 2006, are as follows:

Contractual Obligations

Payments due by period (000 s)	Total	Less than 1 year	2-3 years	4-5 years	After 5 years
Notes payable to bank, mortgage and bonds payable	$ 21,089	$ 3,835	$ 2,935	$ 7,012	$ 7,307
Operating leases	9,381	2,722	3,691	2,016	951
Total contractual cash obligations	$ 30,470	$ 6,557	$ 6,626	$ 9,028	$ 8,258

Table of Contents

As part of our ReadyCase[SM] delivery system, we offer instruments for use and reprocessing pursuant to our Joint Marketing Agreement with Aesculap, Inc (Aesculap). Under the terms of this agreement, Aesculap furnishes and repairs the surgical instruments that we deliver to customers and receives an agreed upon fee for each procedure. We also have a procurement agreement with Standard Textile under which we agree to purchase 90% of our reusable surgical products from them. We are not bound to purchase any minimum quantity of products under these agreements; however, we expect to make payments under the contracts to fulfill our requirements. We estimate that our payments under these agreements will be between $14.0 and $16.0 million in 2006. Amounts paid under these agreements will vary based upon changes in customer demand, amortization rates, product prices, and other variables affecting our business.

We believe that our existing cash and cash equivalents together with expected cash provided by operations and the revolving credit facility will be adequate to finance our operations for at least the next 12 months, although it is difficult for us to predict our future liquidity needs with certainty and our ability to continue accessing the credit facility depends on our ability to comply with or satisfactorily restructure the funds flow coverage financial covenant term.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our principal exposure to market risk is change in interest rates under our various debt instruments and borrowings. The outstanding balances under our revolving credit facility were approximately $2.5 million for both periods ended June 30, 2006 and June 30, 2005. The credit facility s interest rate varies between 200 and 300 basis points over LIBOR (5.33% as of June 30, 2006), depending on our leverage ratio (earnings coverage of debt). We are subject to changes in our interest expense on this facility based on fluctuations in interest rates. Assuming an outstanding balance of this facility of $2.5 million, if LIBOR were to increase (decrease) by 100 basis points, our interest payments would increase (decrease) by $6,250 per quarter.

The outstanding balance under our real estate mortgage was approximately $4.6 million as of June 30, 2006. The mortgage bears an interest rate of 250 basis points over LIBOR. Assuming an outstanding balance of this facility of $4.6 million, if LIBOR were to increase (decrease) by 100 basis points, our interest payments would increase (decrease) by $11,500 per quarter.

Interest on our bonds that financed two of our facilities is at a rate that approximates LIBOR. We are subject to changes in our interest expense on these bonds based on fluctuations in interest rates. Assuming an outstanding balance of these bonds of $8.1 million, if LIBOR were to increase (decrease) by 100 basis points, our interest payments would increase (decrease) by $20,250 per quarter.

We do not have any other material market risk sensitive instruments.

Certain Considerations

This report, other documents that we publicly disseminate, and oral statements that we make contain or might contain both statements of historical fact and forward-looking statements. Examples of forward-looking statements include: (a) projections of revenue, earnings, capital structure, and other financial items, (b) statements of our plans and objectives, (c) statements of future economic performance, and (d) assumptions underlying statements regarding us or our business. The statements set forth below discuss important factors that could cause actual results to differ materially from any forward-looking statements. We assume no obligation to update these forward-looking statements.

Our future growth is dependent on the sales process and market acceptance of our products and services. Our future performance depends on our ability to maintain and increase revenues from new and existing customers. Our sales process to acquire new customers is typically extended in duration, because of industry factors such as the approval process in hospitals for purchases from new suppliers, the duration of existing supply contracts, and implementation delays pending termination of a hospital s previous supply relationships. Our future performance also depends on the market accepting our product and service offerings, which emphasize the supply of reusable surgical products to a market that predominantly uses disposable products. We are also regularly developing new instrument processing programs. We are subject to a risk that the market will not broadly accept these product offerings, which would adversely affect our revenues and operating results.

Table of Contents

We might need additional capital in the future, which might not be available. Our business is capital intensive and requires annual capital expenditures for additional surgical products. Should we need or otherwise decide to raise additional funds, we may not be able to obtain additional financing on favorable terms, if at all. If we cannot raise funds, if needed, on acceptable terms, we may not be able to develop or enhance our products, take advantage of future opportunities, respond to competitive pressures or unanticipated requirements or otherwise support our operations. Our results for our first and second quarters of 2006 caused us to not comply with a funds flow financial covenant in our credit facility, and our continuing access to that facility depends on our ability to comply with or satisfactorily restructure the financial covenant. See *Management s Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources* .

The inability of a key supplier to perform may leave us without a source of supplies and could adversely affect our operating results. We rely on Aesculap, Inc. (Aesculap) as our major source of supply of instruments for our instrument processing programs. Any failure of Aesculap to furnish instruments for any reason would materially and adversely affect our ability to service these programs until we secured one or more alternative suppliers. We also have a procurement agreement with Standard Textile Co., Inc. (Standard Textile) as our supply source for our reusable surgical products through August 2008. If Standard Textile were unable to perform under this agreement, we would be materially and adversely affected until we secured alternative suppliers.

The loss of a significant customer or purchasing organization could adversely affect our operating results. During the six months ended June 30, 2006, hospitals belonging to three group purchasing organizations (GPOs), Novation, LLC, HealthTrust Purchasing Group, L.P. and MedAssets, Inc. accounted for approximately 55% of our sales. No single health care provider accounts for more than 8% of our sales. Our business with these GPOs is pursuant to short-term agreements, which are subject to renewal from time to time through competitive processes. Although each GPO member hospital currently makes its purchasing decisions on an individual basis, the loss of a substantial portion of the GPO hospital s business would adversely affect our revenues and results of operations.

Intense competition in the markets in which we operate could adversely affect us. Our business is highly competitive. Competitors include a number of distributors and manufacturers, as well as the in-house reprocessing operations of hospitals. Certain of our existing and potential competitors possess substantially greater resources than we. Some of our competitors, including Allegiance Corporation (a subsidiary of Cardinal Health, Inc.) and Medline Industries, Inc., serve as the sole supplier of a wide assortment of products to a significant number of hospitals. While we have a substantial array of surgical products, many of our competitors have a greater number of products for the entire hospital, which in some instances is a competitive disadvantage for us. There is no assurance that we will be able to compete effectively with existing or potential competitors.

The loss of key executives and employees could adversely affect us. Our success depends upon the contributions of executives and key employees. The loss of executives and certain key employees in sales, operations and marketing could have a significant adverse effect on our ability to penetrate our markets, operate efficiently, and develop and sell new products and services. We also believe our success will depend in large part upon our ability to attract and retain additional highly skilled personnel.

Our ability to effectively grow depends on our ability to improve our operational systems. We have expanded our operations since inception and may continue to expand to pursue existing and potential market opportunities. This growth places a significant demand on management, financial and operational resources. To manage growth effectively, we must implement and improve our operational systems, procedures and controls on a timely basis and continue to invest in the operational infrastructure of our business.

Our product liability insurance may not be sufficient to cover all claims. The use of medical devices such as surgical instruments entails an inherent risk of product liability or other claims initiated by patients or hospitals. Any of those claims in excess of our insurance coverage or not covered by insurance could adversely affect our results of operations.

Table of Contents

Changes in federal or state regulations could materially adversely affect us. Significant aspects of our businesses are subject to federal, state and local statutes and regulations governing, among other things, medical waste-disposal and workplace health and safety. In addition, most of the products furnished or sold by us are subject to regulation as medical devices by the U.S. Food and Drug Administration (FDA), as well as by other federal, state and local agencies. Our facilities are subject to quality systems inspections by FDA officials. The FDA has the power to enjoin future violations, seize adulterated or misbranded devices, and require the manufacturer to remove products from the market, and publicize relevant facts. Federal, state or local governments might impose additional restrictions or adopt interpretations of existing laws that could materially adversely affect us.

Item 4. Controls and Procedures

Under the supervision and with the participation of our management, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of our most recent fiscal quarter. Based on that evaluation, we concluded that our disclosure controls and procedures are effective in timely alerting us to material information required to be included in our filings with the SEC.

We have also evaluated our internal controls for financial reporting, and there have been no changes that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

Any system of disclosure controls and internal controls, even if well conceived, is inherently limited in detecting and preventing all errors and fraud and provides reasonable, not absolute, assurance that its objectives are met. The design of a control system must reflect resource constraints. Inherent limitations include the potential for faulty judgments in decision-making, breakdowns because of simple errors or mistakes, and circumvention of controls by individual acts, collusion of two or more people, or management override of the controls.

We included certifications of our Chief Executive Officer and Chief Financial Officer as exhibits to this report as required by Section 302 of the Sarbanes-Oxley Act of 2002. The foregoing information concerning our evaluation of disclosure controls referenced in the Section 302 certifications should be read with the Section 302 certifications to more completely understand them.

Table of Contents

PART II OTHER INFORMATION

Item 1. Legal Proceedings

We are subject to other matters that arise in the ordinary course of our business, none of which we expect to be material.

Item 1A. Risk Factors

We have not materially amended our risk factors from those stated in our Annual Report on Form 10-K filed with the SEC on March 24, 2006. See Certain Considerations above.

Item 6. Exhibits and Reports on Form 8-K

Exhibit Number	Exhibit Description
3.1(1)	Restated Articles of Incorporation of the Company.
3.2(1)	Bylaws of the Company.
3.3(5)	First Amendment to Restated Articles of Incorporation dated as of August 31, 1998, of the Company (for Series A Preferred Stock).
3.4(21)	Amendment No. 2 to Bylaws of the Company.
31	Certifications by the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of the Company pursuant to Rule 13a-14 under the Securities Exchange Act of 1934 (the Exchange Act) in accordance with Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification by the CEO and CFO of the Company pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (Not deemed to be filed with the Securities and Exchange Commission).

Reports on Form 8-K

We filed a report on Form 8-K dated May 8, 2006 to furnish information related to our announcement of our operating results for our first quarter period ended March 31, 2006 (pursuant to Item 2.02 of Form 8-K).

We filed a report on Form 8-K dated June 27, 2006 to announce the appointment of Charles W. Federico to the Company s Board of Directors to fill the vacancy created by the previously reported death of Lee R. Kemberling (pursuant to Item 5.02 of Form 8-K).

---

(1) Incorporated by reference to the Registration Statement on Form S-1 filed by the Registrant on May 15, 1996.

(5) Incorporated by reference to the Current Report on Form 8-K dated August 31, 1998, and filed by the Registrant on September 9, 1998.

(21) Incorporated by reference to the Current Report on Form 8-K dated February 27, 2006, and filed by the Registrant March 3, 2006.

Table of Contents

EXHIBIT INDEX

Exhibit Number	Exhibit Description
3.1(1)	Restated Articles of Incorporation of the Company.
3.2(1)	Bylaws of the Company.
3.3(5)	First Amendment to Restated Articles of Incorporation dated as of August 31, 1998, of the Company (for Series A Preferred Stock).
3.4(21)	Amendment No. 2 to Bylaws of the Company.
31	Certifications by the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of the Company pursuant to Rule 13a-14 under the Securities Exchange Act of 1934 (the Exchange Act) in accordance with Section 302 of the Sarbanes-Oxley Act of 2002.
32	Amendment No. 2 to Bylaws of the Company. Certification by the CEO and CFO of the Company pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (Not deemed to be filed with the Securities and Exchange Commission).

(1) Incorporated by reference to the Registration Statement on Form S-1 filed by the Registrant on May 15, 1996.

(5) Incorporated by reference to the Current Report on Form 8-K dated August 31, 1998, and filed by the Registrant on September 9, 1998.

(21) Incorporated by reference to the Current Report on Form 8-K dated February 27, 2006, and filed by the Registrant March 3, 2006.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SRI/SURGICAL EXPRESS, INC.

Date: August 9, 2006

By: /s/ Christopher S. Carlton
President and Chief Executive Officer

Date: August 9, 2006

By: /s/ Wallace D. Ruiz
Sr. Vice President and Chief Financial Officer