

CHOLESTECH CORPORATION

Form 10-Q

November 06, 2003

Table of Contents

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

For the quarterly period ended September 26, 2003

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: 000-20198

CHOLESTECH CORPORATION

(Exact name of registrant as specified in its charter)

California

(State or other jurisdiction of
incorporation or organization)

94-3065493

(I.R.S. Employer Identification No.)

3347 Investment Boulevard, Hayward, CA 94545

(Address of principal executive offices) (Zip Code)

(510) 732-7200

(Registrant's telephone number, including area code)

Indicate by check mark 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 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 No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of September 26, 2003, 13,986,277 shares of the registrant's common stock were outstanding.

TABLE OF CONTENTS

PART I - FINANCIAL INFORMATION

ITEM 1. CONDENSED FINANCIAL STATEMENTS

CONDENSED BALANCE SHEETS

CONDENSED STATEMENTS OF INCOME

CONDENSED STATEMENTS OF CASH FLOWS

NOTES TO CONDENSED FINANCIAL STATEMENTS

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

ITEM 4. CONTROLS AND PROCEDURES

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

SIGNATURES

INDEX TO EXHIBITS

EXHIBIT 10.29

EXHIBIT 31

EXHIBIT 32

Table of Contents

**CHOLESTECH CORPORATION
INDEX**

	Page
PART I	
	FINANCIAL INFORMATION
ITEM 1.	CONDENSED FINANCIAL STATEMENTS (unaudited)
	Condensed Balance Sheets as of September 26, 2003 and March 28, 2003
	3
	Condensed Statements of Income for the thirteen weeks and twenty-six weeks ended September 26, 2003 and September 27, 2002
	4
	Condensed Statements of Cash Flows for the twenty-six weeks ended September 26, 2003 and September 27, 2002
	5
	Notes to Condensed Financial Statements
	6
ITEM 2.	MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
	14
ITEM 3.	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
	36
ITEM 4.	CONTROLS AND PROCEDURES
	37
PART II	
	OTHER INFORMATION
ITEM 1.	LEGAL PROCEEDINGS
	37
ITEM 4.	SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS
	39
ITEM 6.	EXHIBITS AND REPORTS ON FORM 8-K
	40
	SIGNATURES
	41

Table of Contents**PART I - FINANCIAL INFORMATION****ITEM 1. CONDENSED FINANCIAL STATEMENTS**

CHOLESTECH CORPORATION
CONDENSED BALANCE SHEETS
(in thousands)

	<u>September 26, 2003</u>	<u>March 28, 2003 (1)</u>
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 7,361	\$ 8,747
Marketable securities	8,510	4,776
Accounts receivable, net	7,449	5,195
Inventories, net	5,937	6,806
Note receivable	250	250
Prepaid expenses	2,187	1,989
Deferred tax assets	2,100	2,100
	<u>33,794</u>	<u>29,863</u>
Total current assets	33,794	29,863
Property and equipment, net	8,268	7,491
Long-term investments	11,459	12,558
Long-term deferred tax assets	1,027	2,100
	<u>54,548</u>	<u>52,012</u>
Total assets	\$ 54,548	\$ 52,012
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable and accrued expenses	\$ 3,389	\$ 3,971
Accrued payroll and benefits	2,638	3,173
Other liabilities	112	140
	<u>6,139</u>	<u>7,284</u>
Total current liabilities	6,139	7,284
Contingencies (note 8)		
Shareholders' equity:		
Common stock, no par value; 25,000,000 shares authorized; 13,836,782 and 13,579,108 shares issued and outstanding at September 26, 2003 and March 28, 2002, respectively	83,679	82,242
Accumulated other comprehensive income	108	73
Accumulated deficit	(35,378)	(37,587)
	<u>48,409</u>	<u>44,728</u>
Total shareholders' equity	48,409	44,728
Total liabilities and shareholders' equity	\$ 54,548	\$ 52,012

(1) The information in this column was derived from the Company's audited consolidated financial statements as of the fiscal year ended, March 28, 2003.

Table of Contents

CONDENSED STATEMENTS OF INCOME
(in thousands, except per share data)
(unaudited)

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	Sept. 26, 2003	Sept. 27, 2002	Sept. 26, 2003	Sept. 27, 2002
Revenue	\$ 13,357	\$ 11,907	\$ 27,071	\$ 23,039
Cost of goods sold	5,617	5,245	11,162	9,278
Gross profit	7,740	6,662	15,909	13,761
Operating expenses:				
Sales and marketing	3,072	2,781	6,077	5,822
Research and development	765	628	1,606	1,253
General and administrative	2,341	1,591	4,603	3,058
Other operating costs	250		250	
Total operating expenses	6,428	5,000	12,536	10,133
Income from operations	1,312	1,662	3,373	3,628
Interest and other income, net	44	131	209	217
Income before provision for income taxes	1,356	1,793	3,582	3,845
Provision for income taxes	440	74	1,397	155
Income from continuing operations	916	1,719	2,185	3,690
Gain (loss) from discontinued operations	13	(620)	39	(1,201)
Tax provision (benefit) from discontinued operations	4	(25)	15	(48)
Income (loss) from discontinued operations	9	(595)	24	(1,153)
Net income	\$ 925	\$ 1,124	\$ 2,209	\$ 2,537
Income from continuing operations per share:				
Basic	\$ 0.07	\$ 0.13	\$ 0.16	\$ 0.27
Diluted	\$ 0.06	\$ 0.12	\$ 0.15	\$ 0.26
Income (loss) from discontinued operations per share:				
Basic	\$ 0.00	\$ (0.05)	\$ 0.00	\$ (0.08)
Diluted	\$ 0.00	\$ (0.04)	\$ 0.00	\$ (0.08)
Net income per share:				
Basic	\$ 0.07	\$ 0.08	\$ 0.16	\$ 0.19
Diluted	\$ 0.06	\$ 0.08	\$ 0.15	\$ 0.18

Edgar Filing: CHOLESTECH CORPORATION - Form 10-Q

Shares used to compute income per share:				
Basic	13,899	13,605	13,826	13,472
Diluted	14,273	14,263	14,306	14,372

See Notes to Condensed Financial Statements

Table of Contents**CONDENSED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

	Twenty-six Weeks ended	
	Sept. 26, 2003	Sept. 27, 2002
Cash flows from operating activities:		
Net income	\$ 2,209	\$ 2,537
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,278	1,244
Change in allowance for losses on accounts receivable	62	11
Change in inventory reserve	160	70
Stock acceleration charge		(63)
Change in allowance for sales returns		36
Changes in assets and liabilities:		
Accounts receivable	(2,316)	(845)
Inventories	709	(357)
Prepaid expenses and other assets	(198)	(666)
Accounts payable and accrued expenses	(582)	428
Accrued payroll and benefits	(535)	(406)
Deferred tax assets	1,073	
Other liabilities	(28)	(15)
	<u>1,832</u>	<u>1,974</u>
Net cash provided by operating activities	1,832	1,974
Cash flows from investing activities:		
Sales and maturities of marketable securities	29,352	19,605
Purchases of marketable securities	(31,952)	(24,300)
Purchases of property and equipment	(2,055)	(1,020)
	<u>(4,655)</u>	<u>(5,715)</u>
Net cash used in investing activities	(4,655)	(5,715)
Cash flows from financing activities:		
Purchase of treasury stock		(76)
Issuance of common stock	1,437	2,653
	<u>1,437</u>	<u>2,577</u>
Net cash provided by financing activities	1,437	2,577
Net decrease in cash and cash equivalents	(1,386)	(1,164)
Cash and cash equivalents at beginning of period	8,747	8,800
	<u>8,747</u>	<u>8,800</u>
Cash and cash equivalents at end of period	\$ 7,361	\$ 7,636
	<u>\$ 7,361</u>	<u>\$ 7,636</u>

See Notes to Condensed Financial Statements

Table of Contents

NOTES TO CONDENSED FINANCIAL STATEMENTS

1. Interim Results

The interim unaudited financial information of Cholestech Corporation (the Company) is prepared in conformity with accounting principles generally accepted in the United States of America. The financial information included herein has been prepared by management, without audit by independent auditors, and should be read in conjunction with the audited consolidated financial statements contained in the Annual Report on Form 10-K for the fiscal year ended March 28, 2003. The information furnished includes all adjustments and accruals consisting only of normal recurring accrual adjustments that are, in the opinion of management, necessary for a fair presentation of results for the interim periods. Certain information or footnote disclosure normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America has been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

The interim results are not necessarily indicative of the results of operations for the full fiscal year ending March 26, 2004. Certain financial statement items have been reclassified to conform to the current year format.

2. Balance Sheet Data

The components of inventories are as follows (in thousands):

	<u>September 26, 2003</u>	<u>March 28, 2003</u>
Raw materials	\$ 1,994	\$ 2,388
Work-in-process	2,072	1,762
Finished goods	1,871	2,656
	<u>\$5,937</u>	<u>\$6,806</u>

3. Sale of WellCheck

On December 23, 2002, the Company completed the sale of certain assets and the assignment of certain obligations of its wholly owned subsidiary WellCheck Inc. (WellCheck). The sale was made pursuant to the terms and conditions of a Stock Purchase Agreement (the Agreement) dated December 23, 2002 by and among the Company, WellCheck and ImpactHealth.com, Inc. Under the terms of the Agreement, the Company received a secured promissory note in the aggregate principal amount of \$250,000 (the Note) due on the first anniversary of the issuance of the Note, the right to receive an additional \$200,000 contingent upon the attainment of certain performance measures and a royalty per participant tested with TEAMS for three years after the date of the agreement. Information presented in the financial statements for prior periods have been adjusted to reflect WellCheck as Discontinued Operations.

Table of Contents

As a result of the sale, the Company recorded a loss of \$4.4 million for the fiscal year ended March 28, 2003. The components of the loss are as follows (in thousands):

Net book value of WellCheck assets	\$4,695
Less note receivable	(250)
	<u> </u>
Net loss	\$4,445
	<u> </u>

Revenues and losses of the Company's discontinued operations for the thirteen and twenty-six weeks ended September 26, 2003 and September 27, 2002 (in thousands of dollars) were as follows:

	<u>Thirteen Weeks Ended</u>		<u>Twenty-Six Weeks Ended</u>	
	<u>Sept. 26, 2003</u>	<u>Sept. 27, 2002</u>	<u>Sept. 26, 2003</u>	<u>Sept. 27, 2002</u>
Revenues	\$ 7	\$ 246	\$ 12	\$ 681
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Income (loss) before provision for income taxes	13	(620)	39	(1,201)
Income tax provision (benefit)	4	(25)	15	(48)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net income (loss)	\$ 9	\$(595)	\$ 24	\$(1,153)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

Contingent sales proceeds, including TEAMS royalty and performance remuneration, will be recognized as earned as a component of discontinued operations.

4. Derivative Financial Instruments

At September 26, 2003, the Company had outstanding forward contracts to purchase £796,000 for approximately \$1.3 million. The open contracts mature at various dates through February 13, 2004 and hedge certain forecasted inventory purchases denominated in the British Pound Sterling. The unrealized gain on the forward contracts at September 26, 2003 was \$68,000, all of which is expected to be reclassified to earnings within the next 12 months. There was no gain or loss recorded in the period from hedge ineffectiveness or from forecasted transactions no longer expected to occur.

5. Earnings Per Share

Basic earnings per share (EPS) is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per share gives effect to all potential common stock outstanding during a period, if dilutive.

Table of Contents

A reconciliation of the basic and diluted earnings per share calculations follows:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	Sept. 26, 2003	Sept. 27, 2002	Sept. 26, 2003	Sept. 27, 2002
(in thousands, except per share data)				
Income				
Income from continuing operations	\$ 916	\$ 1,719	\$ 2,185	\$ 3,690
Income (loss) from discontinued operations	9	(595)	24	(1,153)
Net income	\$ 925	\$ 1,124	\$ 2,209	\$ 2,537
Shares				
Basic	13,899	13,605	13,826	13,472
Effect of dilutive securities	374	658	480	900
Diluted	14,273	14,263	14,306	14,372
Per share continuing operations:				
Basic	\$ 0.07	\$ 0.13	\$ 0.16	\$ 0.27
Effect of dilutive securities	(0.01)	(0.01)	(0.01)	(0.01)
Diluted	\$ 0.06	\$ 0.12	\$ 0.15	\$ 0.26
Per share discontinued operations:				
Basic	\$ 0.00	\$ (0.05)	\$ 0.00	\$ (0.08)
Effect of dilutive securities	0.00	0.01	0.00	0.00
Diluted	\$ 0.00	\$ (0.04)	\$ 0.00	(0.08)
Per share net income				
Basic	\$ 0.07	\$ 0.08	\$ 0.16	\$ 0.19
Effect of dilutive securities	(0.01)	(0.00)	(0.01)	(0.01)
Diluted	\$ 0.06	\$ 0.08	\$ 0.15	\$ 0.18

As of September 26, 2003, options to purchase 892,383 shares of common stock were considered anti-dilutive because the respective exercise prices were greater than the average fair market value of the common stock. As of September 27, 2002, options to purchase 780,147 shares of common stock were considered anti-dilutive because the respective exercise prices were greater than the average fair market value of the common stock.

6. Stock-Based Compensation

The Company accounts for its stock-based compensation plans in accordance with Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* as amended by SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*. As permitted under SFAS No. 148, the Company uses the intrinsic value-based method of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, to account for its employee stock-based compensation plans. Under APB Opinion No. 25, compensation expense is based on the difference, if any, on the date of grant, between the fair value of the Company's common shares and the exercise price of the option. Compensation costs for stock options, if any, are realized ratably over the vesting period.

Table of Contents

Had compensation costs for the Company's stock option and stock purchase plans been determined based on the fair market value of the options at the grant dates, as prescribed in SFAS No. 123, the Company's net income and net income per share would have been as follows:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	Sept. 26, 2003	Sept. 27, 2002	Sept. 26, 2003	Sept. 27, 2002
(in thousands, except per share data)				
Net income as reported	\$ 925	\$ 1,124	\$ 2,209	\$ 2,537
Deduct total stock-based employee compensation expense determined under fair value based method for all awards	723	580	1,426	1,075
Net income pro forma	\$ 202	\$ 544	\$ 783	\$ 1,462
Net income per share:				
Basic				
As reported	\$ 0.06	\$ 0.08	\$ 0.16	\$ 0.19
Pro forma	\$ 0.01	\$ 0.04	\$ 0.05	\$ 0.10
Diluted				
As reported	\$ 0.06	\$ 0.08	\$ 0.15	\$ 0.18
Pro forma	\$ 0.01	\$ 0.04	\$ 0.05	\$ 0.10

Such pro forma disclosure may not be representative of future compensation costs because options vest over several years and additional grants are anticipated to be made each year. The fair value of each stock option is estimated on the date of the grant using the Black-Scholes valuation model, with the following assumptions used for grants during the applicable periods:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	Sept. 26, 2003	Sept. 27, 2002	Sept. 26, 2003	Sept. 27, 2002
Risk free interest rate	1.04%	1.73%	1.04%	1.73%
Expected life	7 Years	7 Years	7 Years	7 Years
Expected volatility	92.26%	95.13%	92.26%	95.13%
Dividend yield	0.0%	0.0%	0.0%	0.0%

7. Recent Accounting Pronouncements

In May 2003, the Financial Accounting Standard Board (FASB) issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. This standard is effective for financial instruments entered into or modified after May 31, 2003. The Company adopted this standard and the adoption of this standard had no material impact on its financial statements.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 of Derivative Instruments and Hedging Activities*. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts. This standard is effective for contracts entered into or modified after June 30,

Table of Contents

2003. The Company adopted this standard and the adoption of this standard had no material impact on its financial statements.

8. Contingencies

On August 2, 2002, N.V. Euromedix (Euromedix) filed suit against the Company in the Commercial Court in Leuven Belgium (No. F5700-02), seeking damages for the wrongful termination of an implied distribution agreement with the Company for Europe and parts of the Middle East. On November 7, 2002, the court dismissed the suit. On December 31, 2002, Euromedix filed suit against the Company in the Commercial Court in Leuven Belgium (No. F8756-02), seeking damages in the amount of approximately 3.5 million for the wrongful termination of an implied distribution agreement with the Company for Europe and parts of the Middle East. A hearing was held on April 29, 2003 regarding certain procedural issues. In a judgment rendered on May 27, 2003, the court referred the complaint to the Constitutional Court before rendering a final decision. The court asked the Constitutional Court to render an opinion regarding certain constitutional issues related to the trademark infringement arguments the Company raised at the hearing. Hearings in the Constitutional Court were held on July 8, 2003 and September 9, 2003. The court has not yet rendered its opinion. The Company believes these claims are without merit and intends to continue to defend the claims vigorously.

On December 23, 1999, Roche Diagnostics GmbH (Roche) filed suit against the Company and two of its distributors, Health Care Solutions AG and Euromedix N.V./SA, in the Canton Court of the Canton Zug in Zug, Switzerland (No. ES580/1999), seeking a cease and desist order barring the Company from selling HDL assay single use test cassettes in Switzerland. The complaint alleges that the Company violated a Roche European patent for HDL. On July 11, 2000, the court denied Roche's request for an injunction and ordered it to pay a portion of the Company's legal fees. On May 2, 2002, in response to our motion, the court ruled that it did not have local jurisdiction over the matter and ordered Roche to pay the Company's legal fees. Roche subsequently appealed the May 2, 2002 decision by the Canton Court of the Canton Zug. On October 7, 2002, the Swiss Federal Tribunal referred the matter back to the Canton Court but rejected the jurisdiction aspect of Roche's appeal. At this point in time, no schedule has been set regarding additional court activity. The Company believes the claim is without merit and intends to continue to defend the claim vigorously.

In January 2000, Roche filed suit against the Company and two of its distributors, Micro-Medical GmbH and Euromedix N.V./SA, in the District Court in Dusseldorf, Germany (No. 4aO4/00), seeking a cease and desist order barring the Company from selling HDL single use test cassettes in Germany. The complaint alleges the Company violated a Roche German priority patent for HDL by selling its single use test cassette containing a HDL assay in Germany. On December 4, 2001, a hearing was held in Dusseldorf, Germany at which witnesses for Roche and the Company testified. On October 29, 2002, the District Court held a hearing on the merits of the case. The court rendered its decision on December 19, 2002, ruling that (i) the Company is not allowed to further distribute HDL test cassettes which correspond to the German Roche patent, (ii) the Company's distributors must destroy HDL products in their possession, (iii) the Company and its distributors are subject to unspecified damages based on all sales which occurred in Germany since December 8, 1995 and (iv) the Company and its distributors must pay the legal fees of the litigation. However, the decision is not enforceable until Roche posts a bond of security in the amount of 2.5 million, approximately \$2.9 million. Roche has not yet posted

Table of Contents

the bond, nor has it notified the Company of an intention to post the bond. On January 10, 2003, the Company appealed this ruling with the Appeal Court in Dusseldorf. The appeal court has set a date of July 1, 2004 for oral arguments. The Company believes the claim is without merit and intends to continue to defend the claim vigorously.

On August 2, 2000, the Company filed suit against Roche in the Federal Patent Court in Munich, Germany (No. 3 Ni 40/00), seeking the nullification of Roche's German patent for measurement of HDL cholesterol. On December 6, 2001, a hearing was held on the merits of the nullification complaint. The court partially voided the Roche German patent while clarifying the remaining claim with additional restrictions. On February 20, 2002, the Company filed an appeal with the Federal Supreme Court.

In September 2000, Roche filed suit against the Company and one of its distributors in the Commercial Court in Vienna, Austria (No. Ei/Ti ROCH 04002), seeking a cease and desist order barring the Company from distributing HDL assay single use test cassettes in Austria. The complaint alleges that the Company violated a Roche European patent for HDL. On August 9, 2002, the court ruled in the Company's favor and dismissed the patent infringement claim. There can be no assurance as to whether Roche will take any additional action.

On March 3, 2003, Roche Diagnostics Corporation and Roche Diagnostics GmbH filed suit against the Company in the United States District Court for the Southern District of Indiana (Indianapolis) (No. 03-CV-0303-LJM-WTL), seeking a preliminary and permanent injunction, damages and attorneys fees for patent infringement. The Company was served with the suit on June 30, 2003. The complaint alleges that the Company is violating three Roche U.S. patents for HDL. On July 21, 2003, the Company filed an answer and counter claim with the U.S. District Court for the Southern District of Indiana. The Company believes the claim is without merit and intends to defend the claim vigorously.

Based upon consultation with outside counsel handling the Company's defense in these matters and a discussion of potential results, the Company does not consider a negative litigation outcome to be probable and has not accrued any amounts for potential losses related to these proceedings. Because of uncertainties related to both the amount and range of loss on the pending litigation, management is unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, the Company will assess the potential liability related to its pending litigation. The Company will record accruals for losses if and when the Company determines the negative outcome of such matters to be probable and reasonably estimable. The Company's estimates regarding such losses could differ from actual results. Revisions in the Company's estimates of the potential liability could materially impact the Company's results of operations and financial position. The Company is also subject to various additional legal claims and assessments in the ordinary course of business, none of which are expected by management to result in a material adverse effect on the consolidated financial statements.

Table of Contents**9. Comprehensive Income**

The Company's total comprehensive income was as follows (in thousands):

(unaudited)	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	Sept. 26, 2003	Sept. 27, 2002	Sept. 26, 2003	Sept. 27, 2002
Net income	\$925	\$1,124	\$2,209	\$2,537
Change in unrealized gain on investments, net	(68)	20	(90)	82
Change in future currency contracts	85	12	125	16
Total comprehensive income	\$942	\$1,156	\$2,244	\$2,635

10. Income Taxes

For the twenty-six weeks ended September 26, 2003, the Company recorded a provision for income taxes of \$1.4 million, primarily resulting from the recognition of deferred tax expense for the value of net operating losses utilized. Based on the Company's continued positive operating results, in the fourth quarter of fiscal 2003, the Company determined that it was increasingly likely that it would be able to realize a portion of its net operating loss carryforwards in future periods thereby reducing taxes to be paid in those periods. As such, a valuation allowance of \$4.2 million for deferred tax assets was released for the amount of net operating loss carryforwards expected to be utilized in fiscal 2004 and 2005. For the twenty-six weeks ended September 27, 2002, the Company recorded a provision for income tax of \$107,000, primarily resulting from the estimated alternative minimum tax, since the Company had significant federal net operating losses and both federal and California state tax credit carryforwards.

Table of Contents**11. Warranties**

The Company records an accrual for estimated warranty costs when revenue is recognized. Warranty costs cover the costs of repairing the LDX Analyzer and replacing defective single use test cassettes. The warranty period of the LDX Analyzer is one year and single use test cassettes are warranted for the shelf-life of the product. The warranty costs of the GDY Analyzer and test cartridges are the responsibility of the vendor. The Company has processes in place to estimate accruals for warranty exposure. The processes include estimated LDX Analyzer failure rates, costs to repair the analyzer and estimated replacement rates for single use test cassettes. Although the Company believes it has the ability to reasonably estimate warranty expenses, unforeseeable changes in factors impacting the estimate for warranty could occur and such changes could cause a material change in the Company's warranty accrual estimate. Such a change would be recorded in the period in which the change was identified. Changes in the Company's product warranty liability during the twenty-six weeks ended September 26, 2003 were as follows (in thousands):

	Twenty-Six Weeks Ended Sept. 26, 2003
Balance at the beginning of the year	\$ 116
Accruals and charges for warranty for the year	145
Cost of repairs and replacements	(149)
	<hr/>
Balance at September 26, 2003	\$ 112

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain statements in this Quarterly Report on Form 10-Q are forward-looking statements within the meaning of federal securities laws. These statements relate to future events or our future financial performance and involve known and unknown risks, uncertainties and other factors that may cause our or our industry's actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by the forward-looking statements. These risks and other factors include those listed under Factors Affecting Future Operating Results and elsewhere in this Quarterly Report on Form 10-Q. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, plan, anticipate, believe, estimate, predict, potential, continue or the negative of these terms or other comparable terminology. Forward-looking statements include, but are not limited to, the following statements: our expectation regarding the source of a majority of our future revenue; plans related to our long term growth strategy; the opportunities provided by recent legislative developments and potential FDA approvals; our expectation regarding future sales and marketing expenses, legal expenses and outside professional services expenses; our expected income from securities investments; the possible recognition of additional deferred tax benefits in future periods; the sufficiency of our cash, cash equivalents, marketable securities, cash flows and line of credit to satisfy our anticipated operating requirements and our defenses to legal proceedings and litigation matters. In evaluating these statements, you should specifically consider various factors, including the risks outlined under Factors Affecting Future Operating Results. These factors may cause our actual results to differ materially from any forward-looking statement.

Although we believe the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we nor any other person assumes responsibility for the accuracy and completeness of these forward-looking statements. We are under no duty to update any of the forward-looking statements after the date of this Quarterly Report on Form 10-Q to conform our prior statements to actual results.

Overview

We develop, manufacture and market products that perform diagnostic testing at sites outside of traditional hospital and clinical laboratories to assist in assessing for risk of heart disease, diabetes and certain liver diseases and in the monitoring of therapy to treat those diseases. Currently, we manufacture and sell the LDX System, which consists of an analyzer, a test cassette, a printer and accessories, and sell the GDx System, which consists of an analyzer, a test cartridge and accessories.

Until December 2002, our subsidiary WellCheck conducted consumer testing within the United States to help assess the risk of heart disease and other diseases. Using the LDX System and its Test Event Activity Management Software (TEAMS), WellCheck collected test results and other patient data and aggregated that data for testing event sponsors' use in marketing programs.

In December 2002, we completed the sale of certain assets and the assignment of certain obligations of WellCheck to ImpactHealth. We received a secured promissory note in the aggregate principal amount of \$250,000 due on the first anniversary of the issuance of the note, the right to receive an additional \$200,000 contingent upon the attainment of certain performance measures and a royalty per participant tested with TEAMS for three years after the date of the agreement. In addition, we entered

Table of Contents

into a three-year renewable supply agreement with ImpactHealth involving the purchase of the LDX System and single use test cassettes by ImpactHealth on an exclusive basis.

Today, our revenue is from sales of diagnostic products, test cassettes, test cartridges and related accessories. Although we began marketing and distributing the GDX System in July 2002, we expect that a substantial majority of our revenue will continue to be generated from sales of our LDX product for the foreseeable future.

In connection with our long term growth strategy, we plan to dedicate additional resources in sales and marketing to enhance our market penetration of the physician office laboratory market. We also plan to accelerate our research and development activities in order to introduce new products which can be utilized on our LDX Analyzer. In addition, we are investing a significant amount of capital to improve the efficiency of our manufacturing operations. We also intend to seek opportunities to acquire or distribute single use test cassettes or other products which can be sold through our established distribution channels.

In addition, legislation to allow Medicare reimbursement for cholesterol was introduced on February 12, 2003 to both the Senate and House of Representatives, and diabetes screening, was introduced on March 11, 2003 in the Senate and May 22, 2003 in the House of Representatives. Both acts have passed in their respective bodies and are now in conference to resolve differences between the two bills. If this legislation is enacted, it may provide further opportunity, starting in calendar 2005, for us to capitalize on the increasing need for testing in both the physician office laboratory and health promotion markets to assess risk for heart disease and diabetes in individuals that we believe could result from passage of such legislation. Further, a major class of cholesterol lowering medications called statins may be approved by the FDA for over the counter sales in the future, which could provide pharmacies with an incentive to conduct testing of patients in the pharmacy as part of a health awareness initiative and provide us with additional opportunities to market our products.

Results of Operations

In the following discussion of our results of operations, results related to the WellCheck segment have been reclassified to Discontinued Operations for both the current fiscal year and fiscal year 2003.

Table of Contents

The following table sets forth our results of operations expressed as a percentage of total revenue. Our historical operating results are not necessarily indicative of the results for any future period.

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	Sept. 26, 2003	Sept. 27, 2002	Sept. 26, 2003	Sept. 27, 2002
Revenue	100%	100%	100%	100%
Cost of goods sold	42	44	41	40
Gross profit	58	56	59	60
Operating expenses				
Sales and marketing	23	23	23	25
Research and development	6	5	6	5
General and administrative	17	14	17	14
Other operating costs	2	0	1	0
Total operating expenses	48	42	47	44
Income from operations	10	14	12	16
Interest and other income	0	1	1	1
Provision for income taxes	3	1	5	1
Income from continuing operations	7	14	8	16
Loss from discontinued operations	0	(5)	0	(5)
Net income	7%	9%	8%	11%

**Thirteen weeks ended September 26, 2003 and September 27, 2002
and**

Twenty Six weeks ended September 26, 2003 and September 27, 2002

Revenue. For the thirteen weeks ended September 26, 2003, revenue increased \$1.5 million, or 12%, to \$13.4 million from \$11.9 million for the thirteen weeks ended September 27, 2002. Sales of single use test cassettes increased \$1.4 million, or 16%, from \$9.3 million for the thirteen weeks ended September 27, 2002 to \$10.7 million for the thirteen weeks ended September 26, 2003. Revenue for our LDX analyzer increased \$54,000, or 6%, to \$969,000 for the thirteen weeks ended September 26, 2003 from \$915,000 for the thirteen weeks ended September 27, 2002. Revenue for our GDx analyzer and related single use test cartridges decreased \$204,000, or 21%, to \$760,000 for the thirteen weeks ended September 26, 2003, from \$964,000 for the thirteen weeks ended September 27, 2002. Our GDx sales during the prior year period were primarily attributable to a single marketing program with one company. Sales of accessories increased \$143,000, or 19%, to \$907,000 for the thirteen weeks ended September 26, 2003 from \$764,000 for the thirteen weeks ended September 27, 2002.

For the thirteen weeks ended September 26, 2003, domestic revenue increased \$1.1 million, or 10%, to \$11.6 million from \$10.5 million for the thirteen weeks ended September 27, 2002. In addition to the seasonal revenue increase relating to September being designated Cholesterol month, the increase in revenue was attributable to the continued adoption by physicians of the ATP III guidelines for treatment of high cholesterol, the increased number of CLIA waived laboratories and increased growth in the use of statin drugs, all of which resulted in higher demand for our LDX and single use test cassettes. This resulted in a 20% revenue increase in sales to the physician office laboratory market, which increased \$1.2 million to \$7.1 million during the thirteen weeks ended September 26, 2003, from \$5.9 million for the thirteen weeks ended September 27, 2002. Most of the increase related to revenue from single use

Table of Contents

test cassettes which increased 14%, while unit volume of single use test cassettes increased 20% from the prior year period. Additionally, domestic revenue for our GDX analyzer and related single use test cartridges decreased \$285,000, or 31%, to \$645,000 for the thirteen weeks ended September 26, 2003, from \$930,000 for the thirteen weeks ended September 27, 2002. Our GDX sales during the prior year period were primarily attributable to a single marketing program with one company.

International revenue increased \$367,000, or 27%, to \$1.7 million for the thirteen weeks ended September 26, 2003 from \$1.4 million for the thirteen weeks ended September 27, 2002. The increase primarily related to the continued impact of the launch by AstraZeneca PLC of the statin Crestor in the United Kingdom, and the preparation for its launch in Germany, Spain and Italy. Additionally, AstraZeneca's competitors increased promotional spending to counter the impact of Crestor's launch, which also contributed to the increased international sales of our LDX and single use cassettes. The increase in international revenue related primarily to the sale of single use test cassettes which increased \$189,000, or 19%, to \$1.2 million for the thirteen weeks ended September 26, 2003 from \$1.0 million for the thirteen weeks ended September 27, 2002. Additionally, international revenue for our GDX and related products, which we began shipping in July 2002, increased \$81,000, or 240%, to \$115,000 for the thirteen weeks ended September 26, 2003, from \$34,000 for the thirteen weeks ended September 27, 2002.

For the twenty-six weeks ended September 26, 2003, revenue increased \$4.0 million, or 18%, to \$27.1 million from \$23.1 million for the twenty-six weeks ended September 27, 2002. Sales of single use test cassettes increased \$2.6 million, or 14%, from \$19.0 million for the twenty-six weeks ended September 27, 2002 to \$21.6 million for the twenty-six weeks ended September 26, 2003. Revenue for our LDX analyzer increased \$333,000, or 20%, to \$2.0 million for the twenty-six weeks ended September 26, 2003 from \$1.7 million for the twenty-six weeks ended September 27, 2002. Revenue for our GDX analyzer and related single use test cartridges increased \$676,000, or 70%, to \$1.6 million for the twenty-six weeks ended September 26, 2003, from \$965,000 for the twenty-six weeks ended September 27, 2002. Our GDX sales during the prior year period were primarily due to a single marketing program with one company. Accessories sales increased \$420,000, or 30%, to \$1.8 million for the twenty-six weeks ended September 26, 2003 from \$1.4 million for the twenty-six weeks ended September 27, 2002.

For the twenty-six weeks ended September 26, 2003, domestic revenue increased \$3.1 million, or 15.3%, to \$23.4 million from \$20.3 million for the twenty-six weeks ended September 27, 2002. The increase in revenue was attributable to the continued adoption by physicians of the ATP III guidelines for treatment of high cholesterol, the increased number of CLIA waived laboratories and increased growth in the use of statin drugs, all of which resulted in higher demand for our LDX and single use test cassettes. This resulted in a 31% revenue increase in the physician office laboratory market, which increased \$3.5 million to \$14.8 million during the twenty-six weeks ended September 26, 2003, from \$11.3 million for the twenty-six weeks ended September 27, 2002. Most of the increase related to revenue from single use test cassettes which increased 13%, while single use test cassettes unit volume increased 16% from the prior year period. Additionally, domestic revenue for our GDX analyzer and related single use test cartridges, which we began shipping in July 2002, increased \$444,000, or 48%, to \$1.4 million for the twenty-six weeks ended September 26, 2003, from \$930,000 for the twenty-six weeks ended September 27, 2002.

International revenue increased \$919,000, or 33%, to \$3.7 million for the twenty-six weeks ended September 26, 2003 from \$2.8 million for the twenty-six weeks ended September 27, 2002. The

Table of Contents

increase primarily related to the continued impact of the launch by AstraZeneca PLC of the statin Crestor in the United Kingdom and Mexico, and the preparation for its launch in Germany, Spain and Italy. Most of the increase related to the sale of single use test cassettes which increased \$472,000, or 23%, to \$2.5 million for the twenty-six weeks ended September 26, 2003 from \$2.1 million for the twenty-six weeks ended September 27, 2002. Additionally, international revenue for our GDX and related products, which we began shipping in July 2002, increased \$231,000, or 687%, to \$265,000 for the twenty-six weeks ended September 26, 2003, from \$34,000 for the twenty-six weeks ended September 27, 2002.

Cost of Goods Sold. Cost of goods sold includes direct labor, direct material, overhead and royalties. Cost of goods sold increased \$372,000, or 7%, to \$5.6 million for the thirteen weeks ended September 26, 2003 from \$5.2 million for the thirteen weeks ended September 27, 2002. Most of the increase related to higher unit volume of products sold. Gross margins were 58% and 56% for the thirteen weeks ended September 26, 2003 and September 27, 2002, respectively. As a percent of sales, cost of goods sold decreased, primarily due to both a 20% increase in the production of single use cassettes and a 7% decrease in factory spending.

For the twenty-six weeks ended September 26, 2003, cost of goods sold increased \$1.9 million, or 20%, to \$11.2 million from \$9.3 million for the twenty-six weeks ended September 27, 2002. The increase in cost of goods sold primarily related to a 17% higher unit volume for single use test cassettes. Gross margins were 59% and 60% for the twenty-six weeks ended September 26, 2003 and September 27, 2002, respectively. As a percentage of sales, the cost of goods sold increased, which was primarily attributable to a 3% decline in the average sale price of single use test cassettes. Production increased 16% while factory spending increased only 10%, reducing the average cost of products manufactured for the twenty-six weeks ended September 26, 2003, compared to the twenty-six weeks ended September 27, 2002.

Sales and Marketing Expenses. Sales and marketing expenses include salaries, commissions, bonuses, travel and expenses for outside services related to marketing programs. Sales and marketing expenses increased \$291,000, or 10%, to \$3.1 million for the thirteen weeks ended September 26, 2003 from \$2.8 million for the thirteen weeks ended September 27, 2002. The increase was attributable to higher spending for travel, wages and related expenses due to an increased number of field staff. As a percent of total revenue, sales and marketing expenses remained constant at 23% for both the thirteen weeks ended September 26, 2003 and the thirteen weeks ended September 27, 2002. Over the balance of the fiscal year, we expect sales and marketing expenses to increase as our involvement in trade shows and distributor relations activity increases.

For the twenty-six weeks ended September 26, 2003 sales and marketing expenses increased \$255,000, or 4%, to \$6.1 million from \$5.8 million for the twenty-six weeks ended September 27, 2002. An increase in wages, benefits and travel related expenses, due to an enlarged number of field staff, hired to increase product penetration into the market, was the primary cause of the increase in sales and marketing expenses. These increases were offset by a lower effective commission accrual rate during the twenty-six weeks ended September 26, 2003. As a percent of total revenue, sales and marketing expenses decreased to 23% for the twenty-six weeks ended September 26, 2003 from 25% for the twenty-six weeks ended September 27, 2002.

Research and Development Expenses. Research and development expenses include salaries, bonuses, expenses for professional consulting services, supplies and depreciation of capital equipment.

Table of Contents

Research and development expenses increased \$137,000, or 22%, to \$765,000, for the thirteen weeks ended September 26, 2003 from \$628,000 for the thirteen weeks ended September 27, 2002. The increase was mainly attributable to increases of \$41,000 for material used in new product development, \$20,000 for wage and related costs, and \$37,000 for outside professional services. All of these increases related to accelerated activities in new product development. As a percent of total revenue, research and development expenses increased to 6% for the thirteen weeks ended September 26, 2003 from 5% for the thirteen weeks ended September 27, 2002.

For the twenty-six weeks ended September 26, 2003, research and development expenses increased \$353,000, or 28%, to \$1.6 million from \$1.3 million for the twenty-six weeks ended September 27, 2002. The increased spending related primarily to higher consumption of material used in new product development, outside consultants and increased wages and related expenses. All of these increases related to accelerated efforts in new product development. As a percent of total revenue, research and development expenses increased to 6% for the twenty-six weeks ended September 26, 2003 from 5% for the twenty-six weeks ended September 27, 2002.

General and Administrative Expenses. General and administrative expenses include compensation, benefits and expenses for outside professional services, including information services, legal and accounting. General and administrative expenses increased \$750,000, or 47%, to \$2.3 million for the thirteen weeks ended September 26, 2003 from \$1.6 million for the thirteen weeks ended September 27, 2002. The increase related to \$248,000 in higher fees for outside professional services and consulting, including legal and accounting, \$119,000 for staffing related costs, attributable to training and recruiting new employees, and an \$88,000 increase in directors and officers liability insurance premiums. We expect expenses related to outside professional services to remain constant or increase over the balance of the fiscal year. As a percent of total revenue, general and administrative expenses increased to 17% for the thirteen weeks ended September 26, 2003 from 14% for the thirteen weeks ended September 27, 2002.

For the twenty-six weeks ended September 26, 2003, general and administrative expenses increased \$1.5 million, or 51%, to \$4.6 million from \$3.1 million for the twenty-six weeks ended September 27, 2002. This increase was primarily attributable to an increase in costs associated with outside professional services and consulting, including legal services and accounting support, which increased \$626,000. Additionally, staffing related costs, attributable to training and recruiting new employees and directors and officers liability insurance premiums increased. As a percent of total revenue, general and administrative expenses increased to 17% for the twenty-six weeks ended September 26, 2003 from 14% for the twenty-six weeks ended September 27, 2002.

Other operating costs. For the thirteen weeks and twenty-six weeks ended September 26, 2003, other operating costs were \$250,000, with no corresponding costs for the thirteen weeks or twenty-six weeks ended September 27, 2002. The cost related to the write-off of an option to purchase a patent which the Company determined no longer had an economic value.

Interest and other income, net. Interest and other income, net, reflects income from the investment of cash balances and marketable securities, less the fees charged by financial institutions. Interest income decreased \$87,000, or 66%, to \$44,000 for the thirteen weeks ended September 26, 2003 from \$131,000 for the thirteen weeks ended September 27, 2002. The decrease was primarily attributable to lower yields on securities investments. We expect income from securities investments will continue at the current rate unless there is an increase on the market yield on corporate bonds.

Table of Contents

For the twenty-six weeks ended September 26, 2003, interest and other income decreased \$8,000, or 4%, to \$209,000 from \$217,000 for the twenty-six weeks ended September 27, 2002. The decrease related to lower yields on securities investments.

Income Taxes. For the twenty-six weeks ended September 26, 2003, the provision for income taxes increased \$1.2 million, or 801%, to \$1.4 million from \$155,000 for the twenty-six weeks ended September 27, 2002. The increase is attributable to an effective tax rate increase from 4% to 39%.

Based on our continued positive operating results, in the fourth quarter of fiscal 2003 we determined that it was increasingly likely that we would be able to realize a portion of our net operating loss carryforwards in future periods, thereby reducing taxes to be paid in those periods. A valuation allowance of \$4.2 million for deferred tax assets was released for the amount of net operating loss carry forwards expected to be utilized in fiscal 2004 and fiscal 2005. Beginning with the thirteen weeks ended June 27, 2003, we recognized deferred tax expense for the value of net operating losses utilized based on an estimated effective tax rate for the year of 39%. Based on future results, we may recognize additional deferred tax benefits to be realized in future periods. Since we have significant federal net operating losses and both federal and California tax credit carryforwards, the provision for income taxes for the thirteen weeks ended September 27, 2002 primarily represented the estimated alternative minimum tax.

Discontinued Operations. Discontinued operations include all revenue, cost of goods sold, compensation, benefits, travel and expenses for outside professional services, including information services and legal consulting, related to the operations of the WellCheck segment, which we sold on December 23, 2002. The gain of \$9,000 for the thirteen weeks ended September 26, 2003 was primarily attributable to royalties related to TEAMS software, compared to the net loss from discontinued operations of \$595,000 for the thirteen weeks ended September 27, 2002, which related to conducting WellCheck operations for the full fiscal quarter.

For the twenty-six weeks ended September 27, 2003, the net gain on discontinued operations was \$24,000, compared to a net loss of \$1.2 million for the twenty six weeks ended September 27, 2002. The net gain relates to royalty revenue for utilization of TEAMS software and adjustments to the previously recognized loss.

Future contingent sales proceeds, including TEAMS royalties and performance remuneration, will be recognized as earned as a component of discontinued operations.

Liquidity and Capital Resources

We have financed our operations primarily through the sale of equity securities and from positive cash flows from operations. From inception to September 26, 2003, we have raised \$83.7 million in net proceeds from equity financings. As of September 26, 2003, we had \$27.3 million of cash, cash equivalents and short and long-term marketable securities. In addition to these amounts, we have available a \$4.0 million revolving bank line of credit with Wells Fargo Bank, N.A. While the line of credit is in effect, we are required to deposit assets with a collective value, as defined in the line of credit agreement, equivalent to no less than 100% of the outstanding principal balance. Amounts outstanding under the line of credit bear interest at either our choice of 0.5% below the bank's prime rate or 1.75% above the LIBOR rate, depending on the payment schedule. The line of credit agreement expires on September 1, 2004. As of September 26, 2003, we had no borrowings outstanding under this line of credit.

Table of Contents

Cash, cash equivalents and total investments were \$27.3 million at September 26, 2003, an increase of \$1.2 million, or 5%, from March 28, 2003. Cash provided by operations during the twenty-six weeks ended September 26, 2003 was \$1.8 million, which was \$142,000, or 7%, lower than the twenty-six weeks ended September 27, 2002. The decrease related mainly to lower pre-tax income. For the six months ended September 26, 2003, accounts receivable increased \$2.3 million due to a significant increase in sales during September 2003. Additionally, accounts payable and accrued expenses decreased \$582,000 due to payment timing of trade payables, and accrued payroll and benefits decreased \$535,000.

Additions to plant and equipment were \$2.1 million and \$1.0 million for the first twenty-six weeks of fiscal 2004 and fiscal 2003, respectively. The capital spending for both the current and prior year was related to tenant improvements, expansion of our manufacturing capacity, and development and expansion of our information technology systems. As of September 26, 2003, we had committed to approximately \$50,000 of additional expenditures to complete the expansion of our Hayward facility.

Sales of common stock through the employee stock option program and employee stock purchase program were \$1.4 million for the twenty-six weeks ended September 26, 2003, which represented a decrease of \$1.2 million, or 46%, from the twenty-six weeks ended September 27, 2002. The decline related to decreased exercises of stock options due to a decrease in the value of shares of our common stock on the open market.

Based on current plans and business conditions, we believe that our existing cash, cash equivalents, marketable securities, cash flows anticipated to be generated by future operations and available bank borrowings under our existing line of credit will be sufficient to meet our anticipated operating requirements for at least the next 12 months. We expect legal expenses to increase over the balance of the fiscal year. We believe that our existing cash, cash equivalents, and marketable securities will be an adequate source of funds for our legal defense. We cannot be certain, however, that our underlying assumed levels of revenue and expenses will be accurate. We may be required to expend greater than anticipated funds if unforeseen difficulties arise relating to modifying or expanding facilities, obtaining necessary product regulatory approvals, scaling up manufacturing for new tests, litigating disputes or other matters.

Our future liquidity and capital requirements will depend upon numerous additional factors, including the cost and timing of expanding our manufacturing capacity, the number and type of new tests we seek to develop, the success of these development efforts, the cost and timing of acquiring new products or technologies, the cost and timing of expansion of sales and marketing activities, the extent to which our existing and new products gain market acceptance, competing technological and market developments, the progress of commercialization efforts of our distributors, the cost involved in preparing, filing, prosecuting, maintaining and enforcing patent claims and other intellectual property rights, developments related to regulatory and third-party reimbursement matters, a significant shortfall in operating results and other factors.

In the event that additional financing is needed, we may seek to raise additional funds through debt, public or private financing, collaborative relationships or arrangements. However, we may not be successful in obtaining necessary funds. Even if we do raise funds, any additional equity financing may be dilutive to shareholders, and debt financing may involve restrictive covenants that limit the manner in which we operate. Collaborative arrangements, if necessary to raise additional funds, may require us to relinquish our rights to certain products or marketing territories. Our failure to raise capital on

Table of Contents

acceptable terms when needed could have a material adverse effect on our business, financial condition and results of operations. See Factors Affecting Future Operating Results.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenue and expenses and disclosures at the date of the financial statements. On an ongoing basis, we evaluate our estimates, including those related to accounts receivable, inventories and income taxes. We use authoritative pronouncements, historical experience and other assumptions as the basis for making estimates. Actual results could differ from these estimates.

We have made no changes to our critical accounting policies from those described in our most recent Annual Report on Form 10-K. For a description of critical accounting policies, please refer to the Annual Report on Form 10-K for the fiscal year ended March 28, 2003.

Recent Accounting Pronouncements

In May 2003, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. This standard is effective for financial instruments entered into or modified after May 31, 2003. We adopted this standard and the adoption of this standard had no material impact on our financial statements.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 of Derivative Instruments and Hedging Activities*. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts. This standard is effective for contracts entered into or modified after June 30, 2003. We adopted this standard and the adoption of this standard had no material impact on our financial statements.

Factors Affecting Future Operating Results

We have a history of operating losses and fluctuating operating results, which may result in the market price of our common stock declining

Our revenue and operating results have varied significantly from quarter to quarter in the past and may continue to fluctuate in the future. As of September 26, 2003, we had an accumulated deficit of \$35.4 million. Our first profitable quarter was the third quarter of fiscal 1998, and our first profitable year was fiscal 1998. We recorded a net loss of \$2.6 million for fiscal 2001, a net profit of \$5.6 million for fiscal 2002 and a net profit of \$4.9 million for fiscal 2003. The following are among the factors that could cause our revenue, operating results and margins to fluctuate significantly from quarter to quarter:

the timing and level of market acceptance of the LDX System and the GDX System;

variations in manufacturing efficiencies;

Table of Contents

the timing of the introduction, availability and market acceptance of new tests and products;

the timing and level of expenditures associated with research and development activities;

the timing and establishment of strategic distribution arrangements and the success of the activities conducted under such arrangements;

changes in demand for our products based on changes in third-party reimbursement, competition, changes in government regulation and other factors;

the timing of significant orders from, and shipments, to customers;

product pricing and discounts;

additional cost of expanded leased facilities;

promotional program spending by European pharmaceutical companies;

variations in the mix of products sold; and

general economic conditions.

These and other factors are difficult to predict and could have a material adverse effect on our business, financial condition and operating results. Fluctuations in quarterly demand for our products may cause our manufacturing operations to fluctuate in volume, increase uncertainty in operational planning and/or affect cash flows from operations. We commit to many of our expenses in advance, based on our expectations of future business needs. These costs are largely fixed in the short-term. As a result, when business levels do not meet expectations, our fixed costs will not be recovered and we will experience losses. This situation is likely to result in the future because of the variability and unpredictability of our revenue. This also means that our results will likely not meet the expectations of public market security analysts or investors at one time or another, which may result in the market price of our common stock declining.

Our business depends on our ability to protect our proprietary technology through patents and other means and to operate without infringing the proprietary rights of others

Our success depends in part on our ability to develop and maintain the proprietary aspects of our technology and operate without infringing the proprietary rights of others. We have nine United States patents, one German patent and have filed patent applications relating to our technology internationally under the Patent Cooperation Treaty and individual foreign patent applications. The risks of relying on the proprietary nature of our technology include:

our pending patent applications may not result in the issuance of any patents, or, if issued, such patents may not offer protection against competitors with similar technology;

our patents may be challenged, invalidated or circumvented in the future, and the rights created under our patents may not provide a competitive advantage;

competitors, many of whom have substantially greater resources than us and have made substantial investments in competing technologies, may seek to apply for and obtain patents covering technologies that are more effective than ours. This could render our technologies or products obsolete or uncompetitive or could prevent, limit or interfere with our ability to make, use or sell our products either in the United States or in international markets;

the medical products industry has been characterized by extensive litigation regarding patents and other intellectual property rights; and

Table of Contents

an adverse determination in litigation or interference proceedings to which we may become a party could subject us to significant liabilities to third parties or require us to seek licenses from third parties, which may not be available on commercially reasonable terms or at all.

We may in the future become subject to patent infringement claims and litigation or interference proceedings conducted in the United States Patent and Trademark Office to determine the priority of inventions. Litigation may also be necessary to enforce any patents issued to us, to protect our trade secrets or know-how or to determine the enforceability, scope and validity of the proprietary rights of others. The defense and prosecution of intellectual property suits, patent interference proceedings and related legal and administrative proceedings are both costly and time consuming and will likely result in substantially diverting the attention of technical and management personnel from our business operations. We may also be subject to significant damages or equitable remedies regarding the development and sale of our products and operation of our business. For information concerning current legal proceedings see *Legal Proceedings* in this Quarterly Report on Form 10-Q.

We rely on trade secrets, technical know-how and continuing invention to develop and maintain our competitive position. Others may independently develop substantially equivalent proprietary information and techniques or otherwise gain access to our trade secrets or disclose such technology. We may also be unable to adequately protect our right to our trade secrets.

Our stock price is likely to continue to be volatile, which could result in substantial losses for investors

The market price of our common stock has in the past been, and in the future is likely to be, highly volatile. These fluctuations could result in substantial losses for investors. Our stock price may fluctuate for a number of reasons including:

quarterly variations in our operating results;

developments in or disputes regarding patent or other proprietary rights;

announcements of technological or competitive developments by us and our competitors;

regulatory developments regarding us or our competitors;

changes in the current structure of the healthcare financing and payment systems;

stock market price and volume fluctuations, which have particularly affected the market prices for medical products and high technology companies and which are often been unrelated to the operating performance of such companies; and

general economic, political and market conditions.

With the advent of the internet, new avenues have been created for the dissemination of information. We do not have control over the information that is distributed and discussed on electronic bulletin boards and investment chat rooms. The motives of the people or organizations that distribute such information may not be in our best interest or in the interest of our shareholders. This, in addition to other forms of investment information, including newsletters and research publications, could result in a significant decline in the market price of our common stock.

In addition, stock markets have from time to time experienced extreme price and volume fluctuations. The market prices for diagnostic product companies have been affected by these market fluctuations and such effects have often been unrelated to the operating performance of such companies. These broad market fluctuations may cause a decline in the market price of our common stock.

Table of Contents

Securities class action litigation is often brought against a company after a period of volatility in the market price of its stock. This type of litigation has been brought against us in the past and could be brought against us in the future, which could result in substantial expense and damage awards and divert management's attention from running our business.

We depend on technology that we license from others, which may not be available to us in the future and would prevent us from introducing new products and harm our business

Our current products incorporate technologies that are the subject of patents issued to, and patent applications filed by, others. We have obtained licenses for certain of these technologies. We may in the future be required to obtain licenses for new products. We may be unable to obtain licenses for technology patented by others on commercially reasonable terms, or at all. We also may be unable to develop alternative approaches if we are unable to obtain licenses. Our future licenses may also not be adequate for the operation of our business. Failure to obtain adequate licenses on commercially reasonable terms could prevent us from introducing our products and severely harm our business.

If third-party reimbursement for use of our products is eliminated or reduced, our sales will be greatly reduced and our business may fail

In the United States, healthcare providers that purchase products such as the LDX System and the GDX System generally rely on their patients' healthcare insurers, including private health insurance plans, federal Medicare, state Medicaid and managed care organizations, to reimburse all or part of the cost of the procedure in which the product is being used. We will be unable to successfully market our products if their purchase and use is not subject to reimbursement from government health authorities, private health insurers and other third-party payors. If this reimbursement is not available or is limited, healthcare providers will be much less likely to use our products, our sales will be greatly reduced and our business may fail.

There are current conditions in the healthcare industry that increase the possibility that third-party payors may reduce or eliminate reimbursement for tests using our products in certain settings. These conditions include:

third-party payors are increasingly scrutinizing and challenging the prices charged for medical products and services;

healthcare providers are moving toward a managed care system in which they provide comprehensive healthcare for a fixed cost per patient and authorize fewer elective procedures, such as the use of our products for diagnostic screening;

general uncertainty regarding what changes will be made in the reimbursement methods used by third-party payors and how that will affect the use of products such as ours, which may deter healthcare providers from adopting the use of our products; and

an overall escalating cost of medical products and services has led to and will continue to lead to increased pressures on the healthcare industry, both domestic and international, to reduce the cost of products and services, including products offered by us.

Market acceptance of our products in international markets is also dependent, in part, on the availability of reimbursement or funding, as the case may be, within prevailing healthcare systems. Reimbursement, funding and healthcare payment systems in international markets vary significantly by country and include both government sponsored healthcare and private insurance. Third-party reimbursement and coverage may not be available or adequate in either the United States or

Table of Contents

international markets, and current reimbursement or funding amounts may be decreased in the future. Also, future legislation, regulation or reimbursement policies of third-party payors may adversely affect demand for our products or our ability to sell our products on a profitable basis. Any of these events could materially harm our business.

We may be unable to effectively compete against other providers of diagnostic products, which could cause our sales to decline

The market for diagnostic products in which we operate is intensely competitive. Our business is based on the sale of diagnostic products that physicians and other healthcare providers can administer in their own facilities without sending samples to laboratories. Thus, our competition consists primarily of clinical reference laboratories and hospital-based laboratories, as well as manufacturers of bench top analyzers. To achieve and maintain market acceptance for the LDX System and the GDX System, we must demonstrate that the LDX System and the GDX System are attractive alternatives to bench top analyzers as well as to clinical and hospital laboratories. Even if we can demonstrate that our products are more cost effective and save time, physicians and other healthcare providers may resist changing their established source of such tests. The LDX System and the GDX System may be unable to compete with these other testing services and analyzers. In addition, companies with a significant presence in the market for clinical diagnostics, such as Abbott Laboratories, Bayer Diagnostics, Beckman Coulter, Inc. and Roche Diagnostics (a subsidiary of Roche Holdings, Ltd.) have developed or are developing analyzers designed for point of care testing. These competitors have substantially greater financial, technical, research and other resources and larger, more established marketing, sales, distribution and service organizations than us. These competitors also offer broader product lines than us, have greater name recognition than us and offer discounts as a competitive tactic. In addition, several smaller companies are currently making or developing products that compete or will compete with ours. We may not have the financial resources, technical expertise or marketing, distribution or support capabilities to compete successfully in the future. Even if we do have such resources and capabilities, we may not employ them successfully.

Our LDX System and GDX System have not yet achieved broad market acceptance in all of our target markets and if broad market acceptance does not occur, our operating results will be harmed

Our LDX System, including the LDX Analyzer and single use test cassettes, currently accounts for substantially all of the revenue of our business. If this revenue does not grow, our overall business will be severely harmed. In addition, we have limited experience marketing and distributing the GDX System, and it is uncertain whether this product will achieve broad market acceptance in our target markets and generate significant revenue in the future. For us to increase revenue, sustain profitability and maintain positive cash flows from operations, the LDX System and the GDX System must continue to and begin to gain market acceptance among healthcare providers, particularly physician office laboratories. We have made only limited sales of the LDX System to physician office laboratories to date relative to the size of the available market. Factors that could prevent broad market acceptance of the LDX System and the GDX System include:

low levels of awareness of the availability of our technology in both the physician and other customer groups;

the availability and pricing of other testing alternatives;

many managed care organizations have contracts with laboratories, which require participating or employed physicians to send patient specimens to contracted laboratories;

Table of Contents

physicians are under growing pressure by Medicare and other third-party payors to limit their testing to medically necessary tests; and a decrease in the amount of reimbursement for performing tests on the LDX System and the GDX System.

If our LDX System does not achieve broader market acceptance and our GDX System does not achieve favorable market acceptance, our business will not grow. Even if we are successful in continuing to place our LDX Analyzer at physician office laboratories and other near-patient testing sites and marketing our GDX System, there can be no assurance that placement of these products will result in sustained demand for our single use test cassettes and single use test cartridges.

In addition, we must leverage our installed base of systems in order to increase the sales of our single use test cassettes and single use test cartridges. If we are unable to increase the usage of cassettes on our current installed base, we will have to identify new customers and induce them to purchase an analyzer, which requires more time and effort and has a significantly larger purchase price than the single use test cassettes.

As a result of these many hurdles to achieving broad market acceptance for the LDX System and the GDX System, demand may not be sufficient to sustain revenue and profits from operations. Because the LDX System currently contributes the vast majority of our revenue, and we expect the GDX System to contribute a material portion of our revenue in the future, we could be required to cease operations if the LDX System and the GDX System do not achieve and maintain a significant level of market acceptance.

If we do not successfully develop, acquire or form alliances to introduce and market new tests and products, our future business will be harmed

We believe our business will not grow significantly if we do not develop, acquire or form alliances for new tests and products to use in conjunction with the LDX System and the GDX System. If new tests and products are not developed and accepted in the market, our business will not grow significantly and will be harmed. Developing new tests involves many significant problems and risks, including:

research and development is a very expensive process;

research and development takes a very long time to result in a marketable product;

significant costs (including diversion of resources) may be incurred in development before knowing if the development will result in a test that is commercially viable;

a new test will not be successful unless it is effectively marketed to its target market;

the manufacturing process for a new test must be reliable, cost efficient and high volume and must be developed and implemented in a timely manner to produce the test for sale;

new tests must meet a significant market need to be successful; and

new tests must obtain proper regulatory approvals to be marketed.

We could experience difficulties that delay or prevent the successful development, introduction and marketing of new tests and products. For example, regulatory clearance or approval of any new tests or products may not be granted on a timely basis, or at all. We have experienced difficulties obtaining regulatory approval for tests in the past. Because the evaluation of applications by the FDA for CLIA waived status is not based on precisely defined, objectively measurable criteria, we cannot predict the likelihood of obtaining CLIA waived status for future products.

Table of Contents

We face risks from failures in our manufacturing processes

We manufacture all of the single use test cassettes that are used with the LDX Analyzer. The manufacture of single use test cassettes is a highly complex and precise process that is sensitive to a wide variety of factors. Significant additional resources, implementation of additional manufacturing equipment or changes in our manufacturing processes have been, and may continue to be, required for the scaling-up of each new product prior to commercialization or in order to meet increasing customer demand once commercialization begins, and this work may not be completed successfully or efficiently. In the past, we have experienced lower than expected manufacturing yields that have adversely affected gross margins and delayed product shipments. If we do not maintain acceptable manufacturing yields of test cassettes or experience product shipment delays, our business, financial condition and operating results could be materially adversely affected. We may reject or be unable to sell a substantial percentage of test cassettes because of:

raw materials variations or impurities;

manufacturing process variances and impurities; and

decreased manufacturing equipment performance.

Our LDX and cassette manufacturing lines would be costly and time consuming to repair or replace if their operation were interrupted. The interruption of our manufacturing operations or the loss of associates dedicated to the manufacturing facility could severely harm our business. The risks involving our manufacturing lines include:

as our production levels have increased, we have been required to use our machinery more hours per day and the down time resulting from equipment failure has increased;

the custom nature of much of our manufacturing equipment increases the time required to remedy equipment failures and replace equipment;

we have a limited number of associates dedicated to the operation and maintenance of our manufacturing equipment, the loss of whom could impact our ability to effectively operate and service such equipment;

we manufacture all cassettes at our Hayward, California manufacturing facility, so manufacturing operations are at risk to interruption from earthquake, fire, power outages or other events affecting this one location; and

we have recently completed the process of scaling up a new manufacturing line to production capability. Our failure to maintain production levels and operate this line at production capability for an extended period would impact our ability to increase our manufacturing capacity.

Our operating results may suffer if we do not reduce our manufacturing costs

We believe we will be required to reduce manufacturing costs for new and existing test cassettes to achieve sustained profitability. We currently operate two manufacturing lines for dry chemistry cassettes. A third manufacturing line is currently used primarily for research and development purposes. The complexity and custom nature of our manufacturing process increases the amount of time and money required to add an additional manufacturing line. In addition, we may need to implement additional cassette manufacturing cost reduction programs. Failure to maintain full production levels for our new manufacturing line could prevent us from satisfying customer orders in a timely manner, which

Table of Contents

could lead to customer dissatisfaction and loss of business and a failure to reduce manufacturing costs for dry chemistry tests, which could prevent us from achieving sustained profitability.

Our future results could be harmed by economic, political, regulatory and other risks associated with international sales

Historically, a significant portion of our total revenue has been generated outside of the United States. International revenue as a percentage of our total revenue was approximately 14% in fiscal 2003 and 19% in fiscal 2002. We anticipate that international revenue will continue to represent a significant portion of our total revenue in the future. Our revenue is generally denominated in United States dollars; however, a strengthening of the dollar could make our products less competitive in foreign markets and, as a result, our future revenue from international operations may be unpredictable. We make foreign currency denominated purchases related to our GDX System in the United Kingdom. This exposes us to risks associated with currency exchange fluctuations. To minimize this risk, we have undertaken certain foreign currency hedging transactions; however, weakening of the dollar could make the cost of the GDX System less competitive in the domestic market, resulting in less predictable domestic revenue.

In addition to foreign currency risks, our international sales and operations may also be subject to the following risks:

our dependency on pharmaceutical companies promotional programs as a primary source of international revenue;

unexpected changes in regulatory requirements;

the impact of recessions in economies outside the United States;

changes in a specific country's or region's political or economic conditions, particularly in emerging nations;

less effective protection of intellectual property rights in some countries;

changes in tariffs and other trade protection measures;

difficulties in managing international operations; and

potential insolvency of international distributors and difficulty in collecting accounts receivable and longer collection periods.

If we are unable to minimize the foregoing risks, they may harm our current and future international sales and, consequently, our business.

We depend on single source suppliers for certain materials used in our manufacturing process and failure of our suppliers to provide materials to us could harm our business

We currently depend on single source vendors to provide certain subassemblies, components and raw materials used in the manufacture of our products. We also depend on a third-party manufacturer for the GDX System. Any supply interruption in a single sourced material or product could restrict our ability to manufacture and distribute products until a new source of supply is identified and qualified. We may not be successful in qualifying additional sources of supply on a timely basis, or at all. Failure to obtain a usable alternative source or product could prevent us from manufacturing and distributing our products, resulting in inability to fill orders, customer dissatisfaction and loss of business.

Table of Contents

This would likely severely harm our business. In addition, an uncorrected impurity or supplier's variation in material, either unknown to us or incompatible with our manufacturing process, could interfere with our ability to manufacture and distribute products. Because we are a small customer of many of our suppliers and we purchase their subassemblies, components and materials with purchase orders instead of long-term commitments, our suppliers may not devote adequate resources to supplying our needs. Any interruption or reduction in the future supply of any materials currently obtained from single or limited sources could severely harm our business.

We depend on distributors to sell our products and failure to maintain and expand these relationships could adversely affect our ability to generate revenue

To increase revenue and achieve sustained profitability, we will have to maintain and expand our existing distribution relationships and develop new distribution relationships. We are dependent on our distributors to assist us in promoting market acceptance of the LDX System and the GDx System. However, we may be unable to enter into and maintain new arrangements on a timely basis, or at all. Even if we do enter into additional distributor relationships, those distributors may not devote the resources necessary to provide effective sales and marketing support to our products. In addition, our distributors sell products offered by our competitors. If our competitors offer our distributors more favorable terms or have more products available to meet their needs or utilize the leverage of broader product lines sold through the distributor, those distributors may de-emphasize or decline to carry our products. In addition, our distributors' order decision-making process is complex and involves several factors, including end-user demand, warehouse allocation and marketing resources, which can make it difficult to accurately predict total sales for the quarter until late in the quarter. In order to keep our products included in distributors' marketing programs, in the past we have provided promotional goods or made short-term pricing concessions. Our distributors could also modify their business practices, such as payment terms or inventory levels. If we are unable to maintain successful relationships with distributors or expand our distribution channels or we experience unexpected changes in payment terms, inventory levels or other practices by our distributors, our business will suffer.

We rely on a limited number of customers for a substantial part of our revenue

Sales to a limited number of customers have accounted for a significant portion of our revenue in each fiscal period. We expect that sales to a limited number of customers will continue to account for a substantial portion of our total revenue in future periods. Our top ten customers comprised 63% of our revenue in fiscal 2003. In fiscal 2003, PSS accounted for approximately 22% of our total revenue and McKesson accounted for 9% of our total revenue. In fiscal 2002, PSS accounted for approximately 20% of our total revenue. We have experienced periods in which sales to some of our major customers, as a percentage of total revenue, have fluctuated due to delays or failures to place expected orders. We do not have long-term agreements with any of our customers, who generally purchase our products pursuant to cancelable short-term purchase orders. If we were to lose a major customer or if orders by or shipments to a major customer were to otherwise decrease or be delayed, our operating results would be harmed.

Recently enacted and proposed changes in securities laws and regulations are likely to increase our costs.

The Sarbanes-Oxley Act of 2002 along with other recent and proposed rules from the Securities and Exchange Commission and Nasdaq require changes in our corporate governance, public disclosure and compliance practices. Many of these new requirements will increase our legal and financial compliance costs, and make some corporate actions more difficult, such as proposing new or amendments to stock

Table of Contents

option plans, which now requires shareholder approval. These developments could make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. These developments also could make it more difficult for us to attract and retain qualified executive officers and qualified members of our board of directors, particularly to serve on our audit committee.

Our products are subject to multiple levels of government regulation and any regulatory changes are difficult to predict and may be damaging to our business

The manufacture and sale of our diagnostic products, including the LDX System and the GDX System, is subject to extensive regulation by numerous governmental authorities, principally the FDA and corresponding state and foreign regulatory agencies. We are unable to commence marketing or commercial sales in the United States of any of the new tests we develop until we receive the required clearances and approvals. The process of obtaining required regulatory clearances and approvals is lengthy, expensive and uncertain. As a result, our new tests under development, even if successfully developed, may never obtain such clearance or approval. Additionally, certain material changes to products that have already been cleared or approved are subject to further review and clearance or approval. Medical devices are subject to continual review, and later discovery of previously unknown problems with a cleared product may result in restrictions on the product's marketing or withdrawal of the product from the market. If we lose previously obtained clearances, or fail to comply with existing or future regulatory requirements, we may be unable to market the affected products, which would depress our revenue and severely harm our business.

In addition, any future amendment or addition to regulations impacting our products could prevent us from marketing the LDX System and the GDX System. Regulatory changes could hurt our business by increasing burdens on our products or by reducing or eliminating certain competitive advantages of the LDX System's and the GDX System's waived status. Food and Drug Administration clearance or approval of products such as ours can be obtained by either of two processes:

the 510(k) clearance process, which generally takes from four to 12 months but may take longer; and

the pre-market approval process, which is a longer and more costly process than a 510(k) clearance process, involves the submission of extensive supporting data and clinical information and generally takes one to three years but may take significantly longer.

If our future products are required to obtain a pre-market approval, this would significantly delay our ability to market those tests and significantly increase the costs of development.

The use of our products and those of our competitors is also affected by federal and state regulations, which provide for regulation of laboratory testing, as well as by the laws and regulations of foreign countries. The scope of these regulations includes quality control, proficiency testing, personnel standards and inspections. In the United States, clinical laboratory testing is regulated under the Clinical Laboratory Improvement Act of 1976.

The LDX Analyzer, our total cholesterol, high density lipoproteins, triglycerides and glucose tests in any combination, our ALT test cassette, the GDX Analyzer and A1C test cartridges have been classified as waived from the application of many of the requirements under the CLIA. We believe this waived classification is critical for our products to be successful in their domestic markets. Any failure of our new tests to obtain waived status under the CLIA will severely limit our ability to commercialize such

Table of Contents

tests. Loss of waived status for existing diagnostic products or failure to obtain waived status for new products could limit our revenue, which would severely harm our business.

We may not be able to use some or all of our deferred tax asset, which may adversely affect our financial results.

During fiscal 2003 we determined, based on eight consecutive quarters of income from continuing operations, it would be prudent to reduce our tax valuation allowance by \$4.2 million reflecting the economic benefits of our enterprise. Changes in existing tax law or adoption of new governmental tax laws or policies could limit, prevent or delay the use of our tax asset. Additionally, changes in the general domestic or world economic condition could result in significant reduction, or elimination of taxable income precluding us from using or eliminating our deferred tax asset.

In addition, United States income tax law imposes limitations on the ability of corporations to use net operating loss carryforwards if the corporation experiences a more than 50% change in ownership during any three-year period. We cannot assure you that we will not take actions, such as the issuance of additional stock, that would cause an ownership change to occur. Accordingly, we may be limited to the amount we can use in any given year, so even if we have substantial net income, we may not be able to use our net operating loss carryforwards before they expire. In addition, the net operating loss carryforwards are subject to examination by the Internal Revenue Service, or IRS, and are thus subject to adjustment or disallowance resulting from any such IRS examination.

If we have taxable income in the future, and we are unable to fully utilize our net operating loss carryforwards, our future tax payments could be higher and our financial results may suffer.

We may face fines or our manufacturing facilities could be closed if we fail to comply with manufacturing and environmental regulations

Our manufacturing processes and, in certain instances, those of our contract manufacturers, are subject to stringent federal, state and local regulations governing the use, generation, manufacture, storage, handling and disposal of certain materials and wastes. Failure to comply with present or future regulations could result in many things, including warning letters, fines, injunctions, civil penalties, recall or seizure of products, total or partial suspension of production, refusal of the government to grant pre-market clearance or pre-market approval for devices, withdrawal of approvals and criminal prosecution. Any of these developments could harm our business. We and our contract manufacturers are also subject to federal, state and foreign regulations regarding the manufacture of healthcare products and diagnostic devices, including:

Quality System Regulations, which requires manufacturers to be in compliance with Food and Drug Administration regulations;

ISO9001/EN46001 requirements, which is an industry standard for maintaining and assuring conformance to quality standards; and

other foreign regulations and state and local health, safety and environmental regulations, which include testing, control and documentation requirements.

Changes in existing regulations or adoption of new governmental regulations or policies could prevent or delay regulatory approval of our products or require us to incur significant costs to comply with manufacturing and environmental regulations, which could harm our business.

Table of Contents

A continuation of the general economic downturn in the United States or abroad may reduce our revenue and harm our business

The primary customers for our products are physician office laboratories and entities conducting health promotion programs. Any significant downturn in domestic or global economic conditions which results in the reduction of the capital spending budgets of our customers or a delay in capital equipment purchases would likely result in a decline in demand for our products and could be detrimental to our business. Economic growth in the United States and other countries has slowed significantly and many commentators believe that the United States economy is experiencing a recession. Overall, customer spending is getting tighter and spending decisions are being more closely scrutinized. These conditions have negatively impacted our business and may continue to do so if they persist.

We may pursue strategic acquisitions which could have an adverse impact on our business if they are unsuccessful

We continue to evaluate strategic opportunities available to us and we may pursue product, technology or business acquisitions. These acquisitions could be very costly, could result in dilution to existing investors and could result in integration problems that harm our business as a whole. Any acquisition could result in expending significant amounts of cash, issuing potentially dilutive equity securities or incurring debt or unknown liabilities associated with the acquired business. In addition, our acquisitions may not be successful in achieving our desired strategic objectives, which could materially harm our operating results and business. Acquisitions may also result in difficulties in assimilating the operations, technologies, products, services and personnel of the acquired company or business or in achieving the cost savings or other financial benefits we anticipated. These difficulties could result in additional expenses, diversion of management attention and an inability to respond quickly to market issues. Any of these results could harm us financially.

If we are successful in growing sales, our business will be harmed if we cannot effectively manage the operational and management challenges of growth

If we are successful in achieving and maintaining market acceptance for the LDX System and the GDX System, we will be required to expand our operations, particularly in the areas of sales, marketing and manufacturing. As we expand our operations, this expansion will likely result in new and increased responsibilities for management personnel and place significant strain on our management, operating and financial systems and resources. To accommodate any such growth and compete effectively, we will be required to implement and improve our information systems, procedures and controls, and to expand, train, motivate and manage our work force. Our personnel, systems, procedures and controls may not be adequate to support our future operations. Any failure to implement and improve operational, financial and management systems or to manage our work force as required by future growth, if any, could harm our business and prevent us from improving our financial condition as a result of increased sales.

We depend upon key employees in a competitive market for skilled personnel, and, without additional qualified associates, we cannot grow our business

Our success depends in significant part on the continued service of certain key scientific, technical, regulatory and managerial personnel. Our success will also require us to continue to identify, attract, hire and retain additional highly qualified personnel in those areas. Competition for qualified personnel in our industry is very competitive due to the limited number of people available with the necessary technical skills and understanding of our industry. We may be unable to retain our key personnel or

Table of Contents

attract or retain other necessary highly qualified personnel in the future, which would harm the development of our business.

Product liability and professional liability suits against us could result in expensive and time consuming litigation, payment of substantial damages and an increase in our insurance rates

Sale and use of our products and the past performance of testing services by our formerly wholly owned subsidiary could lead to the filing of a product liability or professional liability claim. If any of these claims are brought, we may have to expend significant resources defending against them. If we are found liable for any of these claims, we may have to pay damages that could severely hurt our financial position. Loss of these claims could also hurt our reputation, resulting in our losing business and market share. The medical testing industry has historically been litigious, and we face financial exposure to these liability claims if use of our products results in personal injury or improper diagnosis. We also face the possibility that defects in the design or manufacture of our products might necessitate a product recall.

We currently maintain product liability insurance and professional liability insurance for claims relating to the past performance of testing services, but there can be no assurance that the coverage limits of our insurance policies will be adequate. Insurance is expensive and difficult to obtain, and we may be unable to maintain product liability insurance in the future on acceptable terms or in sufficient amounts to protect us against losses due to product liability. Inability to maintain insurance at an acceptable cost or to otherwise protect against potential product liability could prevent or inhibit the continued commercialization of our products. In addition, a product liability or professional liability claim in excess of relevant insurance coverage or a product recall could severely hurt our financial condition.

If the healthcare system in the United States undergoes fundamental change, these changes may harm our business

We believe that the healthcare industry in the United States is likely to undergo fundamental changes due to current political, economic and regulatory influences. We anticipate that Congress, state legislatures and the private sector will continue to review and assess alternative healthcare delivery and payment systems. Potential alternatives include mandated basic healthcare benefits, controls on healthcare spending through limitations on the growth of private health insurance premiums and Medicare and Medicaid spending, the creation of large insurance purchasing groups, price controls and other fundamental changes to the healthcare delivery system. We expect legislative debate to continue in the future and for market forces to demand reduced costs. We cannot predict what impact the adoption of any federal or state healthcare reform measures, future private sector reform or market forces may have on our business. Any changes in the healthcare system could potentially have extremely negative effects on our business.

We may need additional capital in the future to support our growth, and such additional funds may not be available to us

We intend to expend substantial funds for capital expenditures and working capital related to research and development, expansion of sales and marketing activities and other working capital and general corporate purposes. Although we believe our cash, cash equivalents, marketable securities, cash flow anticipated to be generated by future operations and available bank borrowings under an existing line of credit will be sufficient to meet our operating requirements for the foreseeable future, we may

Table of Contents

still require additional financing. For example, we may be required to expend greater than anticipated funds if unforeseen difficulties arise in expanding manufacturing capacity for existing cassettes or in the course of completing required additional development, obtaining necessary regulatory approvals, obtaining waived status under CLIA or introducing or scaling up manufacturing for new tests.

If we need additional capital in the future, we may seek to raise additional funds through public or private financing, collaborative relationships or other arrangements. Any additional equity financing may be dilutive to our existing shareholders or have rights, preferences and privileges senior to those of our existing shareholders. If we raise additional capital through borrowings, the terms of such borrowings may impose limitations on how our management may operate the business in the future. Collaborative arrangements, if necessary to raise additional funds, may require us to relinquish our rights to technologies, products or marketing territories. Our failure to raise capital on acceptable terms when needed could prevent us from developing our products and our business.

We have made use of a device to limit the possibility that we are acquired, which may mean that a transaction that shareholders are in favor of or are benefited by may be prevented

Our Board of Directors has the authority to issue up to 5,000,000 shares of preferred stock and to determine the rights, preferences, privileges and restrictions of such shares without any further vote or action by our shareholders. To date, our Board of Directors has designated 25,000 shares as Series A participating preferred stock in connection with our poison pill antitakeover plan. The issuance of preferred stock under certain circumstances could have the effect of delaying or preventing an acquisition of our company or otherwise adversely affecting the rights of the holders of our stock. The poison pill may have the effect of rendering more difficult or discouraging an acquisition of our company which is deemed undesirable by our board of directors. The poison pill may cause substantial dilution to a person or group attempting to acquire us on terms or in a manner not approved by our board of directors, except pursuant to an offer conditioned on the negation, purchase or redemption of the rights issued under the poison pill.

Table of Contents**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****Quantitative Disclosures**

Our exposure to market risks is inherent in our operations, primarily to interest rates relating to our investment portfolio.

We are subject to interest rate risks on cash and cash equivalents, available for sale marketable securities and any future financing requirements. Interest rate risks related to marketable securities are managed by managing maturities in our marketable securities portfolio.

We have concluded that the fair market value of our investment portfolio or related income would not be significantly impacted by short term changes in interest rates due to the nature of our marketable securities, which have maturity dates that do not exceed fiscal 2007 and have primarily fixed interest rates.

We enter into forward exchange contracts to manage foreign currency exposures arising from inventory purchases and accounts payable denominated in foreign currencies. Our policy is to hedge 100% of all committed purchase contracts and a lesser percentage for forecasted purchases. At September 26, 2003, we had outstanding forward contracts to purchase £795,000 for approximately \$1.3 million. The open contracts mature at various dates through February 13 2004 and hedge certain forecasted inventory purchases denominated in the British Pound Sterling. The unrealized gain on the forward contracts at September 26, 2003 was \$68,000, all of which is expected to be reclassified to earnings within the next 12 months. There was no gain or loss recorded in the period from hedge ineffectiveness or from forecasted transactions no longer expected to occur. We do not enter into foreign exchange forward contracts for trading purposes. We do not expect gains or losses on these contracts to have a material impact on our financial results.

The following table presents the future principal cash flows or amount and related weighted average interest rates expected by year for our existing cash and cash equivalents, marketable securities and long-term investments.

	Fiscal Year				Total	Fair Value
	2004	2005	2006	2007		
	(in thousands)					
Cash, cash equivalents	\$7,361	\$	\$	\$	\$ 7,361	\$ 7,361
Short-term marketable securities	\$2,227	\$6,283	\$	\$	\$ 8,510	\$ 8,510
Weighted average interest rate	2.36%	4.08%			2.78%	
Long-term marketable securities	\$	\$6,503	\$4,636	\$ 320	\$11,459	\$11,459
Weighted average interest rate		2.74%	3.28%	4.42%	3.01%	

Table of Contents

Qualitative Disclosures

Our primary interest rate risk exposures relate to:

the available for sale securities will fall in value if market interest rates increase; and

the impact of interest rate movements on our ability to obtain adequate debt financing to fund future operations.

We have the ability to hold at least a portion of the fixed income investments until maturity and therefore would not expect the operating results or cash flows to be affected to a significant degree by a sudden change in market interest rates on our short and long term marketable securities portfolio.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures. Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act of 1934, as amended) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Changes in internal control over financial reporting. There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On August 2, 2002, N.V. Euromedix (Euromedix) filed suit against us in the Commercial Court in Leuven Belgium (No. F5700-02), seeking damages for the wrongful termination of an implied distribution agreement with our company for Europe and parts of the Middle East. On November 7, 2002, the court dismissed the suit. On December 31, 2002, Euromedix filed suit against us in the Commercial Court in Leuven Belgium (No. F8756-02), seeking damages in the amount of approximately 3.5 million for the wrongful termination of an implied distribution agreement with our company for Europe and parts of the Middle East. A hearing was held on April 29, 2003 regarding certain procedural issues. In a judgment rendered on May 27, 2003, the court referred the complaint to the Constitutional Court before rendering a final decision. The court asked the Constitutional Court to render an opinion regarding certain constitutional issues related to the trademark infringement arguments we raised at the hearing. Hearings in the Constitutional Court were held on July 8, 2003 and September 9, 2003. The court has not yet rendered its opinion. We believe these claims are without merit and intend to continue to defend the claims vigorously.

On December 23, 1999, Roche Diagnostics GmbH (Roche) filed suit against us and two of our distributors, Health Care Solutions AG and Euromedix N.V./SA, in the Canton Court of the Canton Zug

Table of Contents

in Zug, Switzerland (No. ES580/1999), seeking a cease and desist order barring us from selling HDL assay single use test cassettes in Switzerland. The complaint alleges that we violated a Roche European patent for HDL. On July 11, 2000, the court denied Roche's request for an injunction and ordered it to pay a portion of our legal fees. On May 2, 2002, in response to our motion, the court ruled that it did not have local jurisdiction over the matter and ordered Roche to pay our legal fees. Roche subsequently appealed the May 2, 2002 decision by the Canton Court of the Canton Zug. On October 7, 2002, the Swiss Federal Tribunal referred the matter back to the Canton Court but rejected the jurisdiction aspect of Roche's appeal. At this point in time, no schedule has been set regarding additional court activity. We believe the claim is without merit and intend to continue to defend the claim vigorously.

In January 2000, Roche filed suit against us and two of our distributors, Micro-Medical GmbH and Euromedix N.V./SA, in the District Court in Dusseldorf, Germany (No. 4aO4/00), seeking a cease and desist order barring us from selling HDL single use test cassettes in Germany. The complaint alleges we violated a Roche German priority patent for HDL by selling our single use test cassette containing a HDL assay in Germany. On December 4, 2001, a hearing was held in Dusseldorf, Germany at which witnesses for Roche and our company testified. On October 29, 2002, the District Court held a hearing on the merits of the case. The court rendered its decision on December 19, 2002, ruling that (i) we are not allowed to further distribute HDL test cassettes which correspond to the German Roche patent, (ii) our distributors must destroy HDL products in their possession, (iii) we and our distributors are subject to unspecified damages based on all sales which occurred in Germany since December 8, 1995 and (iv) we and our distributors must pay the legal fees of the litigation. However, the decision is not enforceable until Roche posts a bond of security in the amount of 2.5 million, approximately \$2.7 million. Roche has not yet posted the bond, nor has it notified the Company of an intention to post the bond. On January 10, 2003, we appealed this ruling with the Appeal Court in Dusseldorf. The appeal court has set a date of July 1, 2004 for oral arguments. We believe the claim is without merit and intend to continue to defend the claim vigorously.

On August 2, 2000, we filed suit against Roche in the Federal Patent Court in Munich, Germany (No. 3 Ni 40/00), seeking the nullification of Roche's German patent for measurement of HDL cholesterol. On December 6, 2001, a hearing was held on the merits of the nullification complaint. The court partially voided the Roche German patent while clarifying the remaining claim with additional restrictions. On February 20, 2002, we filed an appeal with the Federal Supreme Court.

In September 2000, Roche filed suit against us and one of our distributors in the Commercial Court in Vienna, Austria (No. Ei/Ti ROCH 04002), seeking a cease and desist order barring us from distributing HDL assay single use test cassettes in Austria. The complaint alleges that we violated a Roche European patent for HDL. On August 9, 2002, the court ruled in our favor and dismissed the patent infringement claim. There can be no assurance as to whether Roche will take any additional action.

On March 3, 2003, Roche Diagnostics Corporation and Roche Diagnostics GmbH filed suit against us in the United States District Court for the Southern District of Indiana (Indianapolis) (No. 03-CV-0303-LJM-WTL), seeking a preliminary and permanent injunction, damages and attorneys fees for patent infringement. We were served with the suit on June 30, 2003. The complaint alleges that we are violating three Roche U.S. patents for HDL. On July 21, 2003, we filed an answer and counter claim with the U.S. District Court for the Southern District of Indiana. We believe the claim is without merit and intend to defend the claim vigorously.

Table of Contents

Based upon consultation with outside counsel handling our defense in these matters and a discussion of potential results, we do not consider a negative litigation outcome to be probable and have not accrued any amounts for potential losses related to these proceedings. Because of uncertainties related to both the amount and range of loss on the pending litigation, management is unable to make a reasonable estimate of the liability that could result from an unfavorable outcome. As additional information becomes available, we will assess the potential liability related to our pending litigation. We will record accruals for losses if and when we determine the negative outcome of such matters to be probable and reasonably estimable. Our estimates regarding such losses could differ from actual results. Revisions in our estimates of the potential liability could materially impact our results of operations and financial position. We are also subject to various additional legal claims and assessments in the ordinary course of business, none of which are expected by management to result in a material adverse effect on the financial statements.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On August 14, 2003, we held our 2003 Annual Meeting of Shareholders in Hayward, California. The following is a brief description of each matter voted upon at the meeting and a statement of the number of votes cast for, against or withheld and the number of abstentions and the number of broker non-votes with respect to each matter.

1. The shareholders elected the following directors:

Nominee	In Favor	Withheld
John H. Landon	12,607,197	528,735
Michael D. Casey	12,640,395	495,537
John L. Castello	12,165,685	970,247
Stuart Heap	12,604,747	531,185
Warren E. Pinckert II	12,599,607	536,325
Larry Y. Wilson	12,640,945	494,987

2. The shareholders ratified the appointment of PricewaterhouseCoopers LLP as our independent accountants for the fiscal year ending March 28, 2004.

For	Against	Abstain	Broker Non-Vote
12,936,463	97,335	102,134	0

Table of Contents

3. The shareholders approved an amendment to our 2000 Stock Incentive Program to increase the aggregate number of shares of common stock that may be issued under such program by 650,000 to a total of 1,845,000.

For	Against	Abstain	Broker Non-Vote
11,074,879	1,938,243	122,810	0

4. The shareholders approved an amendment to our 2000 Stock Incentive Program to amend the formula grant mechanism for non-employee directors.

For	Against	Abstain	Broker Non-Vote
11,618,767	1,383,301	133,864	0

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

- (a) Exhibits.

- 10.29 2000 Stock Incentive Program, as amended, and form of agreement thereto
- 31 Certification of Chief Executive Officer and Chief Financial Officer under Rule 13a-14(a)
- 32 Certification of Chief Executive Officer and Chief Financial Officer under Rule 13a-14(b)

- (b) Reports on Form 8-K.

On July 23, 2003, we furnished a Current Report on Form 8-K reporting under Item 9 of Form 8-K that on July 23, 2003, we were issuing a press release and holding a conference call regarding our financial results for the fiscal quarter ended June 27, 2003.

Table of Contents

SIGNATURES

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

CHOLESTECH CORPORATION

Date: November 6, 2003

/s/ Warren E. Pinckert II

Warren E. Pinckert II
President and Chief Executive Officer
(Principal Executive Officer)

Date: November 6, 2003

/s/ William W. Burke

William W. Burke
Vice President of Finance and Chief
Financial Officer
(Principal Financial and Accounting Officer)

Table of Contents

INDEX TO EXHIBITS

Exhibit No.	Description
10.29	2000 Stock Incentive Program, as amended, and form of agreement thereto
31	Certification of Chief Executive Officer and Chief Financial Officer under Rule 13a-14(a)
32	Certification of Chief Executive Officer and Chief Financial Officer under Rule 13a-14(b)