

ABAXIS INC  
Form 10-Q  
August 09, 2005

---

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549  
  
**FORM 10-Q**

(Mark One)

☒ **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended June 30, 2005

OR

☐ **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
Commission File Number 000-19720

**ABAXIS, INC.**

*(Exact name of registrant as specified in its charter)*

**California**  
*(State of Incorporation)*

**77-0213001**  
*(I.R.S. Employer Identification No.)*

**3240 Whipple Road**  
**Union City, California 94587**  
*(Address of principal executive offices)*

**(510) 675-6500**

*(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 such shorter period that the registrant was required to file 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 August 4, 2005, there were 19,917,782 shares of the registrant's common stock outstanding.

---

**ABAXIS, INC.**  
**Report on Form 10-Q**  
**For the Quarter Ended June 30, 2005**

**TABLE OF CONTENTS**

**PART I. FINANCIAL INFORMATION**

|         |  |    |
|---------|--|----|
| Item 1. | <u>Condensed Financial Statements (Unaudited):</u>   |    |
|         | <u>Condensed Statements of Operations for the three months ended June 30, 2005 and 2004</u>  | 3  |
|         | <u>Condensed Balance Sheets at June 30, 2005 and March 31, 2005</u>                          | 4  |
|         | <u>Condensed Statements of Cash Flows for the three months ended June 30, 2005 and 2004</u>  | 5  |
|         | <u>Notes to Condensed Financial Statements</u>   | 6  |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 10 |
| Item 3. | <u>Quantitative and Qualitative Disclosures About Market Risk</u>                            | 27 |
| Item 4. | <u>Controls and Procedures</u>   | 27 |

**PART II. OTHER INFORMATION**

|         |  |    |
|---------|--|----|
| Item 1. | <u>Legal Proceedings</u>   | 28 |
| Item 2. | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 28 |
| Item 3. | <u>Defaults Upon Senior Securities</u>                             | 28 |
| Item 4. | <u>Submission of Matters to a Vote of Security Holders</u>         | 28 |
| Item 5. | <u>Other Information</u>   | 28 |
| Item 6. | <u>Exhibits</u>  | 28 |
|         | <u>Signatures</u>  | 29 |

**PART I: FINANCIAL INFORMATION****ITEM 1. CONDENSED FINANCIAL STATEMENTS (UNAUDITED)**

**Abaxis, Inc.**  
**Condensed Statements of Operations**  
**(Unaudited)**

|  | <b>Three Months Ended<br/>June 30,</b> |               |
|--|--|---------------|
|  | <b>2005</b>                            | <b>2004</b>   |
| Revenues:  |  |               |
| Product sales, net                                   | \$ 14,238,000                          | \$ 13,207,000 |
| Development and licensing revenue                    | 35,000                                 | 35,000        |
| Total revenues                                       | 14,273,000                             | 13,242,000    |
| Costs and operating expenses:                        |  |               |
| Cost of product sales                                | 6,446,000                              | 6,074,000     |
| Selling, general and administrative                  | 4,675,000                              | 3,641,000     |
| Research and development                             | 1,632,000                              | 1,237,000     |
| Total costs and operating expenses                   | 12,753,000                             | 10,952,000    |
| Income from operations                               | 1,520,000                              | 2,290,000     |
| Interest and other income                            | 66,000                                 | 60,000        |
| Interest and other expense                           | (13,000)                               | (6,000)       |
| Net income before income taxes                       | 1,573,000                              | 2,344,000     |
| Income tax provision                                 | 572,000                                | 910,000       |
| Net income   | \$ 1,001,000                           | \$ 1,434,000  |
| Basic net income per share                           | \$ 0.05                                | \$ 0.07       |
| Diluted net income per share                         | \$ 0.05                                | \$ 0.07       |
| Weighted average common shares outstanding - basic   | 19,897,000                             | 19,575,000    |
| Weighted average common shares outstanding - diluted | 21,120,000                             | 21,901,000    |

See notes to unaudited condensed financial statements.

**Abaxis, Inc.**  
**Condensed Balance Sheets**  
**(Unaudited)**

|   | <b>June 30,<br/>2005</b> | <b>March 31,<br/>2005</b> |
|---|--------------------------|---------------------------|
| <b>ASSETS</b>   |                          |                           |
| Current assets:   |                          |                           |
| Cash and cash equivalents   | \$ 7,174,000             | \$ 5,776,000              |
| Short-term investments  | 16,917,000               | 16,858,000                |
| Trade receivables (net of allowances of \$519,000 at June 30, 2005 and \$482,000 at March 31, 2005)   | 10,392,000               | 10,509,000                |
| Inventories   | 8,846,000                | 8,355,000                 |
| Prepaid expenses  | 228,000                  | 282,000                   |
| Net deferred tax asset - current  | 4,199,000                | 4,677,000                 |
| <b>Total current assets</b>   | <b>47,756,000</b>        | <b>46,457,000</b>         |
| Property and equipment, net   | 8,992,000                | 8,824,000                 |
| Intangible assets, net  | 581,000                  | 600,000                   |
| Deposits and other assets   | 90,000                   | 96,000                    |
| Net deferred tax asset - non-current  | 15,032,000               | 15,032,000                |
| <b>Total assets</b>   | <b>\$ 72,451,000</b>     | <b>\$ 71,009,000</b>      |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                          |                           |
| Current liabilities:  |                          |                           |
| Accounts payable  | \$ 3,573,000             | \$ 3,850,000              |
| Accrued payroll and related expenses  | 2,249,000                | 1,867,000                 |
| Other accrued liabilities   | 1,030,000                | 657,000                   |
| Warranty reserve  | 318,000                  | 245,000                   |
| Deferred revenue  | 789,000                  | 907,000                   |
| Income tax payable  | 196,000                  | 171,000                   |
| Current portion of capital lease obligations  | 11,000                   | 16,000                    |
| <b>Total current liabilities</b>  | <b>8,166,000</b>         | <b>7,713,000</b>          |
| Deferred rent   | 469,000                  | 462,000                   |
| Deferred revenue, less current portion  | 1,020,000                | 1,146,000                 |
| Commission obligation, less current portion   | 16,000                   | 21,000                    |
| <b>Total non-current liabilities</b>  | <b>1,505,000</b>         | <b>1,629,000</b>          |
| Commitments and contingencies (Note 6)  |                          |                           |
| Shareholders' equity:   |                          |                           |
| Common stock, no par value: authorized shares -35,000,000; issued and outstanding shares - 19,902,570 at June 30, 2005 and 19,891,607 at March 31, 2005 | 94,667,000               | 94,614,000                |
| Accumulated deficit   | (32,017,000)             | (33,018,000)              |
| Accumulated other comprehensive income  | 130,000                  | 71,000                    |
| <b>Total shareholders' equity</b>   | <b>62,780,000</b>        | <b>61,667,000</b>         |
| <b>Total liabilities and shareholders' equity</b>   | <b>\$ 72,451,000</b>     | <b>\$ 71,009,000</b>      |

See notes to unaudited condensed financial statements.

**Abaxis, Inc.**  
**Condensed Statements of Cash Flows**  
**(Unaudited)**

|   | <b>Three Months Ended<br/>June 30,</b> |               |
|---|--|---------------|
|   | <b>2005</b>                            | <b>2004</b>   |
| <b>Cash flows from operating activities:</b>                                      |  |               |
| Net income  | \$ 1,001,000                           | \$ 1,434,000  |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |               |
| Depreciation and amortization   | 514,000                                | 438,000       |
| Gain on disposal of equipment   |  | (2,000)       |
| Stock option income tax benefits  | 19,000                                 | 300,000       |
| Stock-based compensation, including amortization of deferred stock compensation   | (12,000)                               |               |
| Changes in operating assets and liabilities:                                      |  |               |
| Trade receivables   | 117,000                                | (821,000)     |
| Inventories   | (488,000)                              | (88,000)      |
| Prepaid expenses  | 54,000                                 | (55,000)      |
| Net deferred tax assets - current   | 478,000                                | (417,000)     |
| Deposits and other assets   | 6,000                                  | 20,000        |
| Net deferred tax assets - non-current   |  | 906,000       |
| Accounts payable  | (277,000)                              | (173,000)     |
| Accrued payroll and related expenses  | 382,000                                | (466,000)     |
| Other accrued liabilities   | 373,000                                | 158,000       |
| Warranty reserve  | 73,000                                 | (17,000)      |
| Income tax payable  | 25,000                                 | 30,000        |
| Deferred rent   | 7,000                                  | 16,000        |
| Deferred revenue  | (244,000)                              | 74,000        |
| Long-term commission obligation   | (5,000)                                | (6,000)       |
| Net cash provided by operating activities   | 2,023,000                              | 1,331,000     |
| <b>Cash flows from investing activities:</b>                                      |  |               |
| Purchase of property and equipment  | (666,000)                              | (590,000)     |
| Proceeds from disposal of equipment   |  | 7,000         |
| Net cash used in investing activities   | (666,000)                              | (583,000)     |
| <b>Cash flows from financing activities:</b>                                      |  |               |
| Repayment of capital lease obligations  | (5,000)                                | (6,000)       |
| Exercise of warrants and common stock options                                     | 46,000                                 | 604,000       |
| Net cash provided by financing activities   | 41,000                                 | 598,000       |
| Net increase in cash and cash equivalents   | 1,398,000                              | 1,346,000     |
| Cash and cash equivalents at beginning of period                                  | 5,776,000                              | 9,324,000     |
| Cash and cash equivalents at end of period  | \$ 7,174,000                           | \$ 10,670,000 |
| <b>Supplemental disclosures of cash flow information:</b>                         |  |               |
| Cash paid for interest  | \$ 1,000                               | \$ 4,000      |
| Cash paid for income taxes, net of refunds  | \$ 50,000                              | \$ 9,000      |
| <b>Supplemental disclosures of non-cash investing and financing activities:</b>   |  |               |
| Issuance of common stock for payment of dividends payable                         | \$                                     | \$ 28,000     |

## Edgar Filing: ABAXIS INC - Form 10-Q

|  |    |                   |                   |
|--|----|-------------------|-------------------|
| Unrealized gains on short-term investments | \$ | 59,000            | \$                |
|  |    | <u>          </u> | <u>          </u> |

See notes to unaudited condensed financial statements.

**ABAXIS, INC.**  
**NOTES TO CONDENSED FINANCIAL STATEMENTS**  
**(Unaudited)**

**1. Significant Accounting Policies**

***Basis of Presentation***

The condensed unaudited financial statements included herein have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. These condensed unaudited financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2005. The unaudited condensed financial statements included herein reflect all normal recurring adjustments, which are, in the opinion of management, necessary to state fairly the results of operations and financial position for the periods presented. The results for the period ended June 30, 2005 are not necessarily indicative of the results to be expected for the entire fiscal year ending March 31, 2006 or for any future period.

***Comprehensive Income*** - Comprehensive income consists of net income and other comprehensive income, which comprised of unrealized gains on investments.

For the three months ended June 30, 2005 and 2004, the components of comprehensive income consisted of the following:

|                                 | <b>Three Months Ended<br/>June 30,</b> |              |
|---------------------------------|--|--------------|
|                                 | <b>2005</b>                            | <b>2004</b>  |
| Net income                      | \$ 1,001,000                           | \$ 1,434,000 |
| Other comprehensive income:     |  |              |
| Unrealized gains on investments | 59,000                                 |              |
| Comprehensive income            | \$ 1,060,000                           | \$ 1,434,000 |

***Stock-Based Compensation*** - The Company has adopted the disclosure provisions of SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure an amendment of FASB Statement No. 123, Accounting for Stock-Based Compensation. These disclosure provisions require prominent disclosures in both annual and interim financial statements of the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company did not change to using the fair value based method of accounting for stock-based employee compensation as permitted by the voluntary transition provisions of SFAS 148; and therefore, adoption of SFAS No. 148 did not have an impact on the financial position, results of operations or cash flows of the Company.

Had compensation cost been recognized based on the fair value at the date of grant, the Company's net income and basic and diluted net income per share would have been as follows:

|   | <b>Three Months Ended<br/>June 30,</b> |              |
|---|--|--------------|
|   | <b>2005</b>                            | <b>2004</b>  |
| Net income:   |  |              |
| As reported   | \$ 1,001,000                           | \$ 1,434,000 |
| Less stock-based compensation expense determined under the fair value method for all awards, net of related tax effects | (557,000)                              | (691,000)    |
| Pro forma net income  | \$ 444,000                             | \$ 743,000   |
| Basic and diluted net income per share:   |  |              |
| As reported - basic   | \$ 0.05                                | \$ 0.07      |
| Pro forma - basic   | \$ 0.02                                | \$ 0.04      |
| As reported - diluted   | \$ 0.05                                | \$ 0.07      |

# Edgar Filing: ABAXIS INC - Form 10-Q

|                     |    |      |    |      |
|---------------------|----|------|----|------|
| Pro forma - diluted | \$ | 0.02 | \$ | 0.03 |
|---------------------|----|------|----|------|

The Company's calculations were made using the Black-Scholes option pricing model, based on a multiple option valuation approach, and forfeitures were recognized as they occurred. The following are the weighted average assumptions:

|                         | Three Months Ended<br>June 30, |         |
|-------------------------|--------------------------------|---------|
|                         | 2005                           | 2004    |
| Expected life of option | 6 years                        | 6 years |
| Risk-free interest rate | 3.76%                          | 4.19%   |
| Dividend yield          | 0.00%                          | 0.00%   |
| Volatility              | 53%                            | 59%     |



**New Accounting Pronouncements** The Company accounts for stock-based compensation awards issued to employees using the intrinsic value measurement provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (Opinion 25). Accordingly, no compensation expense has been recorded for stock options granted with exercise prices greater than or equal to the fair value of the underlying common stock at the option grant date. On December 16, 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123R). SFAS 123R eliminates the alternative of applying the intrinsic value measurement provisions of Opinion 25 to stock compensation awards issued to employees. Rather, the new standard requires enterprises to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award, known as the requisite service period (usually the vesting period).

The Company has not yet quantified the effects of the adoption of SFAS 123R, but it is expected that the new standard may result in significant stock-based compensation expense. The pro forma effects on net income and earnings per share if the Company had applied the fair value recognition provisions of the original SFAS 123 on stock compensation awards (rather than applying the intrinsic value measurement provisions of Opinion 25) are disclosed above. Although such pro forma effects of applying the original SFAS 123 may be indicative of the effects of adopting SFAS 123R, the provisions of these two statements differ in some important respects. The actual effects of adopting SFAS 123R will be dependent on numerous factors including, but not limited to, the valuation model chosen by the Company to value stock-based awards; the assumed award forfeiture rate; the accounting policies adopted concerning the method of recognizing the fair value of awards over the requisite service period; and the transition method (as described below) chosen for adopting SFAS 123R.

SFAS 123R will be effective for the Company's first quarter of fiscal 2007, which starts April 1, 2006, and requires the use of the Modified Prospective Application Method. Under this method SFAS 123R is applied to new awards and to awards modified, repurchased, or cancelled after the effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered (such as unvested options) that are outstanding as of the date of adoption shall be recognized as the remaining requisite services are rendered. The compensation cost relating to unvested awards at the date of adoption shall be based on the grant-date fair value of those awards as calculated for pro forma disclosures under the original SFAS 123. In addition, companies may use the Modified Retrospective Application Method. This method may be applied to all prior years for which the original SFAS 123 was effective or only to prior interim periods in the year of initial adoption. If the Modified Retrospective Application Method is applied, financial statements for prior periods shall be adjusted to give effect to the fair-value-based method of accounting for awards on a consistent basis with the pro forma disclosures required for those periods under the original SFAS 123.

## 2. Net Income Per Share

Basic net income per share is computed by dividing the net income attributable to common shareholders by the weighted average number of shares of common stock outstanding. Diluted net income per share is computed by dividing net income attributable to common shareholders by the weighted average number of common shares that would have been outstanding during the period assuming the issuance of common shares for all potential dilutive common shares outstanding.

The following is a reconciliation of the weighted average number of common shares outstanding used in calculating basic and diluted net income per share:

|  | Three Months Ended<br>June 30, |            |
|--|--------------------------------|------------|
|  | 2005                           | 2004       |
|  | (number of shares)             |            |
| Weighted average common shares outstanding - |                                |            |
| Denominator for basic net income per share   | 19,897,000                     | 19,575,000 |
| Effect of dilutive securities:               |                                |            |
| Stock options and warrants                   | 1,223,000                      | 2,326,000  |
| Denominator for diluted net income per share | 21,120,000                     | 21,901,000 |

## Edgar Filing: ABAXIS INC - Form 10-Q

Diluted net income per share does not include the effect of the following common equivalent shares related to outstanding stock options and warrants, using the treasury stock method, as their effect would be antidilutive for the three months ended June 30, 2005 and 2004:

|                                   | <b>Three Months Ended<br/>June 30,</b> |                  |
|-----------------------------------|--|------------------|
|                                   | <b>2005</b>                            | <b>2004</b>      |
|                                   | <b>(number of shares)</b>              |                  |
| Options to purchase common stock  | 1,654,000                              | 870,000          |
| Warrants to purchase common stock | 193,000                                | 185,000          |
|                                   | <b>1,847,000</b>                       | <b>1,055,000</b> |

### 3. Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or market and consist of the following:

|                 | <b>June 30,<br/>2005</b> | <b>March 31,<br/>2005</b> |
|-----------------|--------------------------|---------------------------|
| Raw materials   | \$ 4,573,000             | \$ 4,753,000              |
| Work-in-process | 2,283,000                | 1,677,000                 |
| Finished goods  | 1,990,000                | 1,925,000                 |
|                 | <b>\$ 8,846,000</b>      | <b>\$ 8,355,000</b>       |

### 4. Warranty Reserves

The Company provides for the estimated future costs to be incurred under the Company's standard warranty obligations of one to two years. Estimated contractual warranty obligations are recorded when related sales are recognized and any additional amounts are recorded when such costs are probable and can be reasonably estimated.

The warranty reserve activity is summarized as follows for the three month periods ended June 30, 2005 and 2004:

|                                | <b>Three Months Ended<br/>June 30,</b> |                   |
|--------------------------------|--|-------------------|
|                                | <b>2005</b>                            | <b>2004</b>       |
| Balance beginning of period    | \$ 245,000                             | \$ 181,000        |
| Provision for warranty expense | 121,000                                | 12,000            |
| Warranty costs incurred        | (48,000)                               | (29,000)          |
|                                | <b>\$ 318,000</b>                      | <b>\$ 164,000</b> |

### 5. Line of Credit

The Company has established a line of credit with Comerica Bank-California which provides for borrowings of up to \$2,000,000. The line of credit terminates upon notification by either party and the outstanding balance is payable upon demand. The line of credit bears interest at the bank's prime rate minus 0.25%, which totaled 6.00% at June 30, 2005, and is payable monthly. Of the \$2,000,000 available, \$410,000 was committed to secure a letter of credit for the Company's facilities lease at June 30, 2005. At June 30, 2005, there was no amount outstanding under the Company's line of credit. The weighted average interest rate on the line of credit during the three months ended June 30, 2005 and 2004 was 5.66% and 3.75%, respectively.

## Edgar Filing: ABAXIS INC - Form 10-Q

The line of credit agreement contains certain financial covenants, which are evaluated on a quarterly basis. Included in these financial covenants, among other stipulations, is a requirement that the Company have a minimum net income of \$25,000 before preferred stock dividends and accretion in any three quarters of a fiscal year, provided that any loss before preferred stock dividends and accretion on preferred stock incurred in the remaining quarter is not to exceed \$250,000. The Company is also required to be profitable, as defined, on a fiscal year to date basis beginning with the six month period ending September 30, 2005 and to have net income before preferred stock dividends and accretion on preferred stock of \$1,150,000 for the fiscal year ending March 31, 2006. In addition, the Company is required to have a quick ratio, as defined, of not less than 2.00 to 1.00, cash flow coverage, as defined, of not less than 1.25 to 1.00, debt to net worth ratio, as defined, not greater than 1.00 to 1.00 and to maintain a tangible effective net worth, as defined, of not less than \$25,731,000. At June 30, 2005, the Company was in compliance with these covenants.

Borrowings under the line of credit are collateralized by the Company's net book value of assets of \$62.8 million at June 30, 2005 including its intellectual property.

## 6. Commitments and Contingencies

In November 2003, the Company entered into an OEM agreement with Diatron Messtechnik GmbH (DIATRON) of Austria to purchase DIATRON hematology instruments. Under the terms of the agreement, the Company is committed to purchase a minimum number of hematology units from DIATRON once the product was qualified for sale. Qualification occurred in May 2004 and accordingly, the Company has minimum purchase commitments. As of June 30, 2005, the outstanding commitment for fiscal 2006 through 2009 was \$590,000, \$2,645,000, \$2,645,000 and \$2,645,000, respectively.

## 7. Product Category, Customer and Geographic Information

The Company operates in one segment and develops, manufactures and markets portable blood analysis systems for use in any veterinary or human patient-care setting to clinicians with rapid blood constituent measurement requirements. The following is a summary of revenues from external customers for each group of products and services provided by the Company:

|                                   | Three Months Ended<br>June 30, |               |
|-----------------------------------|--------------------------------|---------------|
|                                   | 2005                           | 2004          |
| Instruments                       | \$ 3,943,000                   | \$ 4,155,000  |
| Reagent discs and kits            | 9,444,000                      | 8,456,000     |
| Other                             | 851,000                        | 596,000       |
| Product sales, net                | 14,238,000                     | 13,207,000    |
| Development and licensing revenue | 35,000                         | 35,000        |
| Total revenues                    | \$ 14,273,000                  | \$ 13,242,000 |

The following is a summary of revenues by customer group:

|                   | Three Months Ended<br>June 30, |               |
|-------------------|--------------------------------|---------------|
|                   | 2005                           | 2004          |
| Medical Market    | \$ 1,674,000                   | \$ 2,240,000  |
| Veterinary Market | 12,006,000                     | 10,510,000    |
| Other             | 593,000                        | 492,000       |
| Total revenues    | \$ 14,273,000                  | \$ 13,242,000 |

The following is a summary of revenues by geographic region based on customer location:

|                        | Three Months Ended<br>June 30, |               |
|------------------------|--------------------------------|---------------|
|                        | 2005                           | 2004          |
| United States          | \$ 12,087,000                  | \$ 11,512,000 |
| Europe                 | 1,684,000                      | 1,296,000     |
| Asia and Latin America | 502,000                        | 434,000       |
| Total revenues         | \$ 14,273,000                  | \$ 13,242,000 |

Two distributors, DVM Resources and Henry Schein, Inc., accounted for 19% and 15%, respectively, of total revenues for the three months ended June 30, 2005. Two distributors, Vedco Inc. and DVM Resources, accounted for 26% and 16%, respectively, of total revenues for the three months ended June 30, 2004.

## Edgar Filing: ABAXIS INC - Form 10-Q

At June 30, 2005, three distributors accounted for 27%, 12% and 10%, respectively, of trade receivables. At June 30, 2004, two distributors accounted for 32% and 20%, respectively, of trade receivables.

Substantially all of the Company's long-lived assets are located in the United States.

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

*This Management's Discussion and Analysis of Financial Condition and Results of Operations includes a number of forward-looking statements which reflect Abaxis' current views with respect to future events and financial performance. In this report, the words will, anticipates, believes, expects, future, intends, plans, and similar expressions identify forward-looking statements. These forward-looking statements are subject to certain risks and uncertainties, including but not limited to those discussed below, that could cause actual results to differ materially from historical results or those anticipated. Such risks and uncertainties include the market acceptance of our products and the continuing development of our products, required United States Food and Drug Administration (FDA) clearance and other government approvals, risks associated with manufacturing and distributing our products on a commercial scale, free of defects, risks related to the introduction of new instruments manufactured by third parties, risks associated with entering the human diagnostic market on a larger scale, risks related to the protection of the Company's intellectual property or claims of infringement of intellectual property asserted by third parties, risks involved in carrying of inventory, risks associated with the ability to attract, train and retain competent sales personnel, general market conditions and competition. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Abaxis assumes no obligation to update any forward-looking statements as circumstances change.*

### Business Overview

Abaxis, Inc. ( us or we ), incorporated in California in 1989, develops, manufactures and markets portable blood analysis systems for use in any veterinary or human patient-care setting to provide clinicians with rapid blood constituent measurements. Our principal offices are located at 3240 Whipple Road, Union City, California 94587 and our telephone number is (510) 675-6500. Our Internet address is [www.abaxis.com](http://www.abaxis.com). We make available free of charge on or through our Internet website our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission. Our common stock trades on the Nasdaq National Market under the symbol ABAX.

Our primary product is a blood analysis system, consisting of a compact, 6.9 kilogram (15 pounds) portable analyzer and a series of single-use plastic discs, called reagent discs, containing all the chemicals required to perform a panel of up to 13 tests on veterinary patients and 14 tests on human patients. The system can be operated with minimal training and performs multiple routine tests on whole blood, serum or plasma samples. The system provides test results in less than 14 minutes with the precision and accuracy equivalent to a clinical laboratory analyzer. We currently market this system for veterinary use under the name VetScan® and in the human medical market under the name Piccolo®.

Through April 2004, we marketed a veterinary hematology analyzer under the name VetScan HMT, which provided a complete blood count including three-part white blood cell differential in less than 2 minutes and required only 12 µL (microliters) of whole blood. It provided results for eight selectable species, plus two user configurable programs. We marketed one type of reagent kit with this analyzer. We purchased the hematology analyzer and reagent kits from Melet Schloesing Laboratoires of France. We continue to support and service our current population of VetScan HMT hematology customers.

In May 2004, we introduced a veterinary hematology instrument ( VetScan HMII ) that offers an 18-parameter CBC (complete blood count) analysis, including a three-part white blood cell differential for the diagnostic assessment of patients by the veterinarian in their clinic. We entered into an original equipment manufacturing ( OEM ) agreement with Diatron Messtechnik GmbH (DIATRON) of Austria to purchase the DIATRON hematology instruments commencing in the fiscal quarter that the instruments were qualified, which was the first quarter of fiscal 2005. We market the combination of the VetScan and the VetScan HMII under the name VetScan DXS.

Sales for any future periods are not predictable with a significant degree of certainty. We generally operate with limited order backlog because our products typically are shipped shortly after orders are received. As a result, product sales in any quarter are generally dependent on orders booked and shipped in that quarter. Our expense levels, which are to a large extent fixed, are based in part on our expectations of future revenues. Accordingly, we may be unable to adjust spending in a timely manner to compensate for any unexpected revenue shortfall. As a result, any such shortfall would negatively affect our operating results and financial condition. Our sales may be adversely impacted by pricing pressure from competitors. Our ability to be consistently profitable will depend, in part, on our ability to increase our sales volumes of our VetScan DXS and Piccolo products and to successfully compete with other competitors. We believe that period to period comparisons of our results of operations are not necessarily meaningful indicators of future results.

**Results of Operations****Total Revenues*****Revenues by Product and Services***

The following is a summary of revenues for each group of products and services provided by the Company for the three months ended June 30, 2005 and 2004:

|                                   | <b>Three Months Ended<br/>June 30,</b> |               | <b>Increase/<br/>(Decrease)</b> | <b>Percentage<br/>Change</b> |
|-----------------------------------|--|---------------|---------------------------------|------------------------------|
|                                   | <b>2005</b>                            | <b>2004</b>   |                                 |                              |
| Instruments                       | \$ 3,943,000                           | \$ 4,155,000  | \$ (212,000)                    | (5)%                         |
| Percentage of total revenues      | 28%                                    | 31%           |                                 |                              |
| Reagent discs and kits            | 9,444,000                              | 8,456,000     | 988,000                         | 12%                          |
| Percentage of total revenues      | 66%                                    | 64%           |                                 |                              |
| Other                             | 851,000                                | 596,000       | 255,000                         | 43%                          |
| Percentage of total revenues      | 6%                                     | 5%            |                                 |                              |
| Product sales, net                | 14,238,000                             | 13,207,000    | 1,031,000                       | 8%                           |
| Development and licensing revenue | 35,000                                 | 35,000        |                                 |                              |
| Total revenues                    | \$ 14,273,000                          | \$ 13,242,000 | \$ 1,031,000                    | 8%                           |

**Instruments**

In the three months ended June 30, 2005, total revenues from instrument sales decreased 5% or \$212,000, as compared to the three months ended June 30, 2004. The decrease in instrument sales was primarily in the medical market due to a decrease in sales of our Piccolo systems to the U.S. Military of \$401,000 and a decrease in sales of our Piccolo systems in the United States market (excluding the U.S. Military) of \$123,000. These decreases were partially offset by a net increase in revenue from the sale of our VetScan systems of \$334,000. Revenue from the sale of our VetScan systems increased \$147,000 in the United States and \$215,000 in Europe. The increase in the United States market is primarily due to a marketing promotion in the first quarter of fiscal 2006 and an increase in sales personnel in the United States to promote our products. The increase in the Europe market is primarily due to an increase in sales to various distributors.

**Reagent Discs and Kits**

In the three months ended June 30, 2005, total revenues from medical and veterinary reagent discs and veterinary hematology reagent kits increased 12% or \$988,000, as compared to the three months ended June 30, 2004. The increase in revenue from reagent discs and kits was primarily due to the expanded installed base of our instruments.

**Other**

In the three months ended June 30, 2005, total revenues from other products increased 43% or \$255,000, as compared to the three months ended June 30, 2004. The increase in other products is primarily due to an increase in revenue from maintenance contracts and shipping and handling costs offset by a decrease in revenue from our supply contract with Becton Dickinson Immunocytometry Systems.

**Revenues by Customer Group**

The following is a summary of revenues by customer group for the three months ended June 30, 2005 and 2004:

|                              | Three Months Ended<br>June 30, |               | Increase/<br>(Decrease) | Percentage<br>Change |
|------------------------------|--------------------------------|---------------|-------------------------|----------------------|
|                              | 2005                           | 2004          |                         |                      |
| Medical Market               | \$ 1,674,000                   | \$ 2,240,000  | \$ (566,000)            | (25)%                |
| Percentage of total revenues | 12%                            | 17%           |                         |                      |
| Veterinary Market            | 12,006,000                     | 10,510,000    | 1,496,000               | 14%                  |
| Percentage of total revenues | 84%                            | 79%           |                         |                      |
| Other                        | 593,000                        | 492,000       | 101,000                 | 21%                  |
| Percentage of total revenues | 4%                             | 4%            |                         |                      |
| Total revenues               | \$ 14,273,000                  | \$ 13,242,000 | \$ 1,031,000            | 8%                   |

**Medical Market**

Revenues from the medical market decreased 25% or \$566,000 in the three months ended June 30, 2005, as compared to the three months ended June 30, 2004. We sold a total of 56 Piccolo systems in the three months ended June 30, 2005, a 41% decrease from the 95 Piccolo systems sold in the three months ended June 30, 2004. Revenues from the sale of our Piccolo systems decreased 45% or \$542,000 primarily due to a decrease in the sale of our Piccolo systems to the U.S. Military of 73% or \$401,000 and a decrease in the sale of our Piccolo systems in the United States market (excluding the U.S. Military) of 23% or \$123,000.

Revenues from the sale of our reagent discs in the medical market decreased slightly by 6% or \$60,000, as we sold 94,000 reagent discs in the three months ended June 30, 2005, as compared to 89,000 reagent discs sold in the three months ended June 30, 2004. The decrease in revenue from reagent discs was primarily attributed to a decrease in unit sales of reagent discs sold to the U.S. Military (total decrease in absolute dollars of 56% or \$298,000). The net decrease in reagent discs was offset by an increase in sales of 53% or \$208,000 in the United States market (excluding the U.S. Military) due to the continued expanded installed base of our Piccolo systems.

**Veterinary Market**

Revenues from the veterinary market increased 14% or \$1,496,000 in the three months ended June 30, 2005, as compared to the three months ended June 30, 2004. We sold a total of 435 VetScan and hematology systems in the three months ended June 30, 2005, an 18% increase from the 369 instruments sold in the three months ended June 30, 2004. Revenues from the sale of our VetScan and hematology systems increased 11% or \$330,000, primarily due to a marketing promotion in the United States market in the first quarter of fiscal 2006 and an increase in sales personnel in the United States to promote our products.

Revenues from the sale of our reagent discs and kits in the veterinary market increased 14% or \$1,048,000 in the three months ended June 30, 2005, as compared to the three months ended June 30, 2004. We sold 674,000 reagent discs in the three months ended June 30, 2005, as compared to 612,000 reagent discs sold in the three months ended June 30, 2004. Also, we sold 3,392 hematology reagent kits in the three months ended June 30, 2005, as compared to 2,974 hematology reagent kits in the three months ended June 30, 2004. The overall increase in unit sales of reagent discs and hematology reagent kits sold is due to a higher consumption rate of users and to the expanded installed base of our instruments.



**Revenues by Geographical Location**

The following is a summary of revenues by geographic region based on customer location for the three months ended June 30, 2005 and 2004:

|                              | <b>Three Months Ended<br/>June 30,</b> |               | <b>Increase/<br/>Decrease</b> | <b>Percentage<br/>Change</b> |
|------------------------------|--|---------------|-------------------------------|------------------------------|
|                              | <b>2005</b>                            | <b>2004</b>   |                               |                              |
| United States                | \$ 12,087,000                          | \$ 11,512,000 | \$ 575,000                    | 5%                           |
| Percentage of total revenues | 85%                                    | 87%           |                               |                              |
| Europe                       | 1,684,000                              | 1,296,000     | 388,000                       | 30%                          |
| Percentage of total revenues | 12%                                    | 10%           |                               |                              |
| Asia and Latin America       | 502,000                                | 434,000       | 68,000                        | 16%                          |
| Percentage of total revenues | 3%                                     | 3%            |                               |                              |
| Total revenues               | \$ 14,273,000                          | \$ 13,242,000 | \$ 1,031,000                  | 8%                           |

**United States**

Total revenues in the United States increased 5% or \$575,000 for the three months ended June 30, 2005, as compared to the three months ended June 30, 2004. The net increase was attributed to an increase in the sale of our veterinary reagent discs and hematology reagent kits by 13% or \$833,000 primarily due to both a higher consumption rate of institutional users and to the expanded installed base of our instruments. Medical reagent discs in the United States market (excluding the U.S. Military) increased 53% or \$208,000 due to the continued expanded installed base of our Piccolo systems while sales of medical reagent discs to the U.S. Military decreased 56% or \$298,000.

The net increase in the United States market was offset by an overall decrease in revenue from instrument sales of 12% or \$422,000. Sales of our Piccolo systems to the U.S. Military decreased 73% or \$401,000 and sales of our Piccolo systems in the United States (excluding the U.S. Military) decreased 23% or \$123,000. These decreases were offset by an increase in sales of our VetScan systems of 11% or \$147,000. The increase in sales of our VetScan systems is primarily due to a marketing promotion in the United States market in the first quarter of fiscal 2006 and an increase in sales personnel in the United States to promote our products.

Total revenues from other products increased 43% or \$254,000 for the three months ended June 30, 2005, as compared to the three months ended June 30, 2004. The increase in other products is primarily due to an increase in revenue from maintenance contracts and shipping and handling costs offset by a decrease in revenue from our supply contract with Becton Dickinson Immunocytometry Systems.

Two distributors, DVM Resources and Henry Schein, Inc., accounted for 19% and 15%, respectively, of total revenues for the three months ended June 30, 2005. Two distributors, Vedco Inc. and DVM Resources, accounted for 26% and 16%, respectively, of total revenues for the three months ended June 30, 2004.

**Europe**

Total revenues in Europe increased 30% or \$388,000 for the three months ended June 30, 2005, as compared to the three months ended June 30, 2004. Revenues from the sale of our instruments increased 45% or \$197,000, primarily due to an increase in the sale of our VetScan and hematology systems of 82% or \$271,000 resulting from an increase in sales to various distributors offset by a decrease in the sale of our Piccolo systems of 69% or \$74,000. Revenues from the sale of our reagent discs and hematology reagent kits increased 22% or \$186,000 due to the expanded installed base of our instruments in both the medical and veterinary markets.

**Asia and Latin America**

Total revenues in Asia and Latin America increased 16% or \$68,000 for the three months ended June 30, 2005, as compared to the three months ended June 30, 2004. The increase is primarily due to revenues from the sale of our reagent discs and hematology reagent kits of 23% or \$59,000 due to a higher consumption rate of institutional users.

**Cost of Product Sales**

Edgar Filing: ABAXIS INC - Form 10-Q

|                              | Three Months Ended<br>June 30, |              | Increase/<br>Decrease | Percentage<br>Change |
|------------------------------|--------------------------------|--------------|-----------------------|----------------------|
|                              | 2005                           | 2004         |                       |                      |
| Cost of product sales        | \$ 6,446,000                   | \$ 6,074,000 | \$ 372,000            | 6%                   |
| Percentage of total revenues | 45%                            | 46%          |                       |                      |

Cost of product sales includes the costs associated with manufacturing, assembly, package, warranty repairs, test and quality assurance for our instrument analyzers, reagent discs and hematology reagents and manufacturing overhead, including costs of personnel and equipment associated with manufacturing support. The increase in cost of product sales in absolute dollars during the three months ended June 30, 2005, as compared to the three months ended June 30, 2004 was due to an increase in the sales volume of instruments and reagent discs. As a percentage of total revenues, cost of product sales decreased due to the lower unit costs of hematology reagents and the lower unit costs of manufacturing reagent discs from improved manufacturing processes and absorption of fixed costs of our facilities.

#### ***Selling, General and Administrative Expense***

|  | Three Months Ended<br>June 30, |              | Increase/<br>Decrease | Percentage<br>Change |
|--|--------------------------------|--------------|-----------------------|----------------------|
|  | 2005                           | 2004         |                       |                      |
| Selling, general and administrative expenses | \$ 4,675,000                   | \$ 3,641,000 | \$ 1,034,000          | 28%                  |
| Percentage of total revenues                 | 33%                            | 27%          |                       |                      |

Selling, general and administrative expenses consist primarily of salaries and benefits, commissions and related expenses for personnel engaged in marketing, advertising, costs associated with promotional and other marketing expenses, customer service and technical service and general corporate functions, including accounting, human resources and legal. The increase in selling, general and administrative expenses in absolute dollars during the three months ended June 30, 2005 as compared to the three months ended June 30, 2004 was due to personnel-related costs resulting from an increase in headcount in various divisions such as sales and marketing, customer service and technical service, to support the growth in both our veterinary and medical markets. In addition, the increase in expenses also relates to Sarbanes-Oxley compliance.

#### ***Research and Development Expense***

|                                   | Three Months Ended<br>June 30, |              | Increase/<br>Decrease | Percentage<br>Change |
|-----------------------------------|--------------------------------|--------------|-----------------------|----------------------|
|                                   | 2005                           | 2004         |                       |                      |
| Research and development expenses | \$ 1,632,000                   | \$ 1,237,000 | \$ 395,000            | 32%                  |
| Percentage of total revenues      | 11%                            | 9%           |                       |                      |

Research and development expenses consist of salaries and benefits, related expenses associated with the development of clinical trials of new test methods and the enhancement of existing products. The increase in research and development expenses in absolute dollars during the three months ended June 30, 2005, as compared to the three months June 30, 2004 was due to new product development in both the medical and veterinary markets. The higher investments in research and development resulted in the completion of three new discs, Lipids Plus, Basic Metabolic Panel Plus, and Avian/Reptilian Plus with Bile Acids, and the submission to the FDA of ALT, AST and glucose for CLIA waived status. We anticipate the dollar amount of research and development expenses to increase in fiscal 2006 from fiscal 2005 but remain consistent as a percentage of total revenues, as we complete new products for both the medical and veterinary markets. There can be no assurance, however, that we will undertake such research and development activities in future periods or, if we do, that such activities will be successful.

#### ***Interest and Other Income (Expense), Net***

The following table sets forth our interest and other income (expense), net for the three months ended June 30, 2005 and 2004:

|                            | Three Months Ended<br>June 30, |           | Percentage<br>Change |
|----------------------------|--------------------------------|-----------|----------------------|
|                            | 2005                           | 2004      |                      |
| Interest and other income  | \$ 66,000                      | \$ 60,000 | 10%                  |
| Interest and other expense | (13,000)                       | (6,000)   | 117%                 |
|                            | \$ 53,000                      | \$ 54,000 | (2)%                 |



**Interest and Other Income**

Interest and other income primarily consists of interest earned on cash, cash equivalents and short-term investments. The increase of 10% or \$6,000 in the three months ended June 30, 2005, as compared to the three months ended June 30, 2004, was primarily due to higher average invested balances.

**Interest and Other Expense**

Interest and other expense primarily consists of interest incurred on our capital lease, co-promotion agreement with Abbott Laboratories and currency losses. The increase in interest and other expense of 117% or \$7,000 in the three months ended June 30, 2005, as compared to the three months ended June 30, 2004, was primarily due to currency losses.

**Income Tax Provision**

|                      | Three Months Ended<br>June 30, |            |
|----------------------|--------------------------------|------------|
|                      | 2005                           | 2004       |
| Income tax provision | \$ 572,000                     | \$ 910,000 |
| Effective tax rate   | 36%                            | 39%        |

For the three months ended June 30, 2005 and 2004, the effective tax rate was 36% and 39%, respectively. The decrease in our effective tax rate was primarily due to an increase in federal and state research and development tax credits and a manufacturing deduction under the American Jobs Creation Act of 2004.

**Liquidity and Capital Resources**

As of June 30, 2005, we had \$24,091,000 in cash, cash equivalents and short-term investments as compared to \$22,634,000 at March 31, 2005.

|                           | June 30,<br>2005     | March 31,<br>2005    | Increase/<br>(Decrease) |
|---------------------------|----------------------|----------------------|-------------------------|
| Cash and cash equivalents | \$ 7,174,000         | \$ 5,776,000         | \$ 1,398,000            |
| Short-term investments    | 16,917,000           | 16,858,000           | 59,000                  |
|                           | <u>\$ 24,091,000</u> | <u>\$ 22,634,000</u> | <u>\$ 1,457,000</u>     |

Cash provided (used) in the three months ended June 30, 2005 and 2004 as follows:

|   | Three Months Ended<br>June 30, |                     |
|---|--------------------------------|---------------------|
|   | 2005                           | 2004                |
| Cash provided by operating activities     | \$ 2,023,000                   | \$ 1,331,000        |
| Cash used in investing activities         | (666,000)                      | (583,000)           |
| Cash provided by financing activities     | 41,000                         | 598,000             |
| Net increase in cash and cash equivalents | <u>\$ 1,398,000</u>            | <u>\$ 1,346,000</u> |

**Operating Activities** During the three months ended June 30, 2005, we generated \$2,023,000 of cash from operating activities compared to \$1,331,000 during the three months ended June 30, 2004. This change was primarily the result of net income of \$1,001,000, adjusted for the effects of non-cash expenses including depreciation and amortization of \$514,000, stock option income tax benefits of \$19,000 and an increase in current net deferred tax assets of \$478,000.

## Edgar Filing: ABAXIS INC - Form 10-Q

Our net trade receivable balances were \$10,392,000 and \$10,509,000 as of June 30, 2005 and March 31, 2005, respectively. The decrease of \$117,000 in our receivable balance was due to an increase in collections during the first quarter of fiscal 2006 as compared to the first quarter of fiscal 2005. Inventories increased to \$8,846,000 as of June 30, 2005 from \$8,355,000 as of March 31, 2005, primarily related to purchases due to a higher projected sales volume. Current net deferred tax assets decreased to \$4,199,000 as of June 30, 2005 from \$4,677,000 as of March 31, 2005, as a result of the utilization of net operating losses on income during the first quarter of fiscal 2006.

Accounts payable decreased to \$3,573,000 as of June 30, 2005 from \$3,850,000 as of March 31, 2005, primarily related to the timing and payments of services and inventory purchases. Accrued payroll and related expenses increased to \$2,249,000 as of June 30, 2005 from \$1,867,000 as of March 31, 2005, as a result of personnel-related costs due to an increase in headcount, primarily in sales and marketing to support the growth in both our veterinary and medical businesses. Other accrued liabilities increased to \$1,030,000 as of June 30, 2005 from \$657,000 as of March 31, 2005, due primarily to marketing promotions to customers and accrued expenses related to professional services. The current portion of deferred revenue decreased to \$789,000 as of June 30, 2005 from \$907,000 as of March 31, 2005 and the non-current portion of deferred revenue decreased to \$1,020,000 as of June 30, 2005 from \$1,146,000 as of March 31, 2005, as a result of the reduction of incentives in the form of free goods given to customers.

Net cash provided by operating activities for the three months ended June 30, 2004 was \$1,331,000. This was primarily the result of net income of \$1,434,000 offset by the effects of non-cash expenses including depreciation and amortization of \$438,000, stock option income tax benefits of \$300,000, an increase in current net deferred tax assets of \$417,000 and a decrease in non-current net deferred tax assets of \$906,000. Other changes included a decrease of \$20,000 in deposits and other assets, increases totaling \$278,000 in deferred rent, deferred revenue, income tax payable and other accrued liabilities. Uses of cash from operating activities included increases in accounts receivable of \$821,000, mainly due to the timing of collections and sales during the quarter; increases in inventories and prepaid expenses totaling \$143,000; decreases in accrued payroll and related expenses of \$466,000 related to the timing of payroll-related payments; and decreases in accounts payable, warranty reserve and long-term commission obligation totaling \$196,000.

We anticipate that we will incur incremental additional costs to support our future operations, including further additional pre-clinical testing and clinical trials for our current and future products; research and design costs related to the continuing development of our current and future products; and acquisition of capital equipment for our manufacturing facility, which includes the ongoing costs related to the continuing development of our current and future products.

We anticipate that our existing capital resources, available line of credit and anticipated revenue from the sales of our products will be adequate to satisfy our currently planned operating and financial requirements through at least the next twelve months. Our future capital requirements will largely depend upon the increased market acceptance of our point-of-care blood analyzer products. However, our sales for any future periods are not predictable with a significant degree of certainty. Regardless, we may seek to raise additional funds to pursue strategic acquisition opportunities.

**Investing Activities** Net cash used in investing activities were \$666,000 and \$583,000 for the three months ended June 30, 2005 and 2004, respectively, primarily related to the purchases of property and equipment to support both our increased product demand and our goal of more efficient production lines, as well as our new product introduction.

We anticipate that we will continue to purchase property and equipment necessary in the normal course of our business.

**Financing Activities** Net cash provided by financing activities for the three months ended June 30, 2005 was \$41,000, which included net cash proceeds of \$46,000 from the exercise of common stock options and warrants offset by repayments of \$5,000 on our capital lease obligations. Net cash provided by financing activities for the three months ended June 30, 2004 was \$598,000, which included net cash proceeds of \$604,000 from the exercise of common stock options and warrants offset by repayments of \$6,000 on our capital lease obligations.

**Line of Credit** We have established a line of credit with Comerica Bank-California which provides for borrowings of up to \$2,000,000. The line of credit terminates upon notification by either party and the outstanding balance is payable upon demand. The line of credit bears interest at the bank's prime rate minus 0.25%, which totaled 6.00% at June 30, 2005, and is payable monthly. Of the \$2,000,000 available, \$410,000 was committed to secure a letter of credit for our facilities lease at June 30, 2005. At June 30, 2005, there was no amount outstanding under our line of credit. The weighted average interest rate on the line of credit during the three months ended June 30, 2005 and 2004 was 5.66% and 3.75%, respectively.

The line of credit agreement contains certain financial covenants, which are evaluated on a quarterly basis. Included in these financial covenants, among other stipulations, is a requirement that we have a minimum net income of \$25,000 before preferred stock dividends and accretion in any three quarters of a fiscal year, provided that any loss before preferred stock dividends and accretion on preferred stock incurred in the remaining quarter is not to exceed \$250,000. We are also required to be profitable, as defined, on a fiscal year to date basis beginning with the six month period ending September 30, 2005 and to have net income before preferred stock dividends and accretion on preferred stock of \$1,150,000 for the fiscal year ending March 31, 2006. In addition, we are required to have a quick ratio, as defined, of not less than 2.00 to 1.00, cash flow coverage, as defined, of not less than 1.25 to 1.00, debt to net worth ratio, as defined, not greater than 1.00 to 1.00 and to maintain a tangible effective net worth, as defined, of not less than \$25,731,000. At June 30, 2005, we were in compliance with these covenants.

Borrowings under the line of credit are collateralized by our net book value of assets of \$62.8 million at June 30, 2005 including our intellectual property.

**Critical Accounting Policies** We have identified certain accounting policies as critical to our business operations and the understanding of our results of operations. The impact and any associated risks related to the identified critical accounting policies on our business operations are discussed in our Annual Report on Form 10-K for the fiscal year ended March 31, 2005 filed with the Securities and Exchange Commission.

**Contingencies** We are involved from time to time in various litigation matters in the normal course of business. We believe that the ultimate resolution of these matters will not have a material effect on our financial position or results of operations.

**New Accounting Pronouncements** Abaxis accounts for stock-based compensation awards issued to employees using the intrinsic value measurement provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (Opinion 25). Accordingly, no compensation expense has been recorded for stock options granted with exercise prices greater than or equal to the fair value of the underlying common stock at the option grant date. On December 16, 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123R). SFAS 123R eliminates the alternative of applying the intrinsic value measurement provisions of Opinion 25 to stock compensation awards issued to employees. Rather, the new standard requires enterprises to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award, known as the requisite service period (usually the vesting period).

Abaxis has not yet quantified the effects of the adoption of SFAS 123R, but it is expected that the new standard may result in significant stock-based compensation expense. The pro forma effects on net income and earnings per share if we had applied the fair value recognition provisions of original SFAS 123 on stock compensation awards (rather than applying the intrinsic value measurement provisions of Opinion 25) are disclosed in Note 1 to the condensed, unaudited financial statements. Although such pro forma effects of applying original SFAS 123 may be indicative of the effects of adopting SFAS 123R, the provisions of these two statements differ in some important respects. The actual effects of adopting SFAS 123R will be dependent on numerous factors including, but not limited to, the valuation model we choose to value stock-based awards; the assumed award forfeiture rate; the accounting policies adopted concerning the method of recognizing the fair value of awards over the requisite service period; and the transition method (as described below) chosen for adopting SFAS 123R.

SFAS 123R will be effective for our first quarter of fiscal 2007, which begins April 1, 2006, and requires the use of the Modified Prospective Application Method. Under this method SFAS 123R is applied to new awards and to awards modified, repurchased, or cancelled after the effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered (such as unvested options) that are outstanding as of the date of adoption shall be recognized as the remaining requisite services are rendered. The compensation cost relating to unvested awards at the date of adoption shall be based on the grant-date fair value of those awards as calculated for pro forma disclosures under the original SFAS 123. In addition, companies may use the Modified Retrospective Application Method. This method may be applied to all prior years for which the original SFAS 123 was effective or only to prior interim periods in the year of initial adoption. If the Modified Retrospective Application Method is applied, financial statements for prior periods shall be adjusted to give effect to the fair-value-based method of accounting for awards on a consistent basis with the pro forma disclosures required for those periods under the original SFAS 123.

## **RISK FACTORS THAT MAY AFFECT OUR PERFORMANCE**

Our future performance is subject to a number of risks. If any of the following risks actually occur, our business could be harmed and the trading price of our common stock could decline. You should also refer to other information contained in our annual report for the fiscal year ended March 31, 2005, as filed on Form 10-K, including the financial statements included therein and the notes related thereto.

When used in these risk factors, the words anticipates, believes, expects, intends, plans, future, and similar expressions identify forward-looking statements. Our actual results could differ materially from those that we project in the forward-looking statements as a result of factors that we have set forth throughout this document as well as factors of which we are currently not aware.

### **We Have Not Been Consistently Profitable; We Must Increase Sales Of Our Piccolo And VetScan DXS Products To Maintain Consistent Profitability**

We recognized a net loss attributable to common shareholders in one of the last twelve fiscal quarters ended June 30, 2005. As of June 30, 2005, we have incurred cumulative net losses of \$32 million. Our ability to be consistently profitable will depend, in part, on our ability to increase our sales volumes of our Piccolo and VetScan DXS products. Increasing the sales volume of our products will depend upon our ability to:

- continue to develop our products;
- increase our sales and marketing activities;
- effectively manage our manufacturing activities; and
- effectively compete against current and future competitors.





We cannot assure you that we will be able to successfully increase our sales volumes of our products to achieve sustained profitability.

**We Are Not Able To Predict Sales In Future Quarters And A Number Of Factors Affect Our Periodic Results**

We are not able to accurately predict our sales in future quarters. Our revenue in the veterinary market are derived primarily by selling to distributors who resell our products to the ultimate user. In December 2004, we terminated our relationship with Vedco, Inc., a warehousing cooperative for member distributors who sold Abaxis products to their respective customers, as part of the realignment of our distribution channel. During the third and fourth quarters of fiscal 2005, we worked with other U.S. based regional and national distributors, which included American Veterinary Supply Corp., DVM Resources, Henry Schein, Inc., IVESCO, TradeWinds Trading Company and Western Medical Supply, to expand their sales and services to support the customers served by other Vedco distributors. In the third quarter of fiscal 2005, we negotiated direct distributor agreements with Vedco members Merritt Veterinary Supply and Miller Veterinary Supply.

While we are better able to predict sales of our reagent discs, as we sell these discs primarily for use with blood chemistry analyzers that we sold in prior periods, we generally are unable to predict with much certainty sales of our analyzers, as we typically sell our analyzers to new users. Accordingly, our sales in any one quarter are not indicative of our sales in any future period. In addition, we generally operate with limited order backlog, because we ship our products shortly after we receive the orders from our customers. As a result, our product sales in any quarter are generally dependent on orders that we receive and ship in that quarter. We base our expense levels, which are to a large extent fixed, in part on our expectations as to future revenues. We may be unable to reduce our spending in a timely manner to compensate for any unexpected revenue shortfall. As a result, any such shortfall would immediately materially and adversely impact our operating results and financial condition. In addition, we have historically experienced a decrease in our sales, especially in Europe, in our second and third quarters, ending in September and December of each year, which we believe is due to seasonal patterns in the decision making processes to acquire our products. Accordingly, we believe that period to period comparisons of our results of operations are not necessarily meaningful.

Our periodic operating results have varied in the past. In the future, we anticipate our periodic operating results to vary significantly depending on, but not limited to, a number of factors, including, in addition to those factors discussed elsewhere in this section:

- new product announcements made by us or our competitors;
- changes in our pricing structures or the pricing structures of our competitors;
- our ability to develop, introduce and market new products on a timely basis;
- our manufacturing capacities and our ability to increase the scale of these capacities;
- the mix of product sales between our analyzer and our reagent disc products;
- the amount we spend on research and development; and
- changes in our strategy.

**We Could Fail to Achieve Anticipated Revenue If The Market Does Not Accept Our Products**

Our core compact blood chemistry analyzer product differs substantially from current blood chemistry analyzers on the market. Our primary competition is from centralized laboratories that offer a greater number of tests than our products, but do so at a greater cost and requiring more time. We also compete with other point-of-care analyzers that cost more, require more maintenance and offer a narrower range of tests. However, these point-of-care analyzers are generally marketed by larger companies which have greater resources for sales and marketing, in addition to a recognized brand name and established distribution relationships.

Historically we have marketed our VetScan analyzer to veterinarians and we have relatively limited experience in large scale sales of our Piccolo analyzer into the human medical market. We continue to develop new animal blood tests that we cannot be assured will be accepted by the veterinary market. Although we believe that our blood analyzers offer consumers many advantages, including according to our analyses substantial cost savings, in terms of the actual product and implementation of it procedurally, these advantages involve changes to current standard practices, such as using large clinical laboratories, that will require changes in both the procedures and mindset of care providers. The human medical market in particular is highly regulated, structured, difficult to penetrate and often slow to adopt new product offerings. If we are unable to convince large numbers of medical clinics, hospitals and other point-of-care environments of the benefits of our products, we will suffer lost sales and could fail to achieve anticipated revenue.

**We Are Dependent Upon Our Profitability, And If We Cannot Remain Profitable We May Need Additional Funding In The Future And These Funds May Not Be Available To Us**

We believe that our existing capital resources, available line of credit and anticipated revenue from the sales of our products will be adequate to satisfy our currently planned operating and financial requirements through March 31, 2006, although no assurances can be given. The bank financing documents for our available line of credit contain a number of covenants concerning financial tests that we must meet that are more fully detailed in the agreements that we have filed with the SEC as exhibits to our periodic reports. We may need additional funds if we are unable to meet requirements for continuing access to bank financing or if we do not achieve anticipated revenues from the sale of our Piccolo and VetScan DXS products.

Further, we expect to incur incremental additional costs to support our future operations, including:

further commercialization of our products and development of new test methods to allow us to further penetrate the human diagnostic market and the veterinary diagnostic market;

our need to acquire capital equipment for our manufacturing facilities, which includes the ongoing costs related to the continuing development of our current and future products;

research and design costs related to the continuing development of our current and future products; and

additional pre-clinical testing and clinical trials for our current and future products.

To the extent that our existing resources and anticipated revenue from the sale of our products are insufficient to fund our activities or if we are unable to meet the financial tests contained in our bank financing documents, we may have to raise additional funds from the issuance of public or private securities. In the event that we cannot maintain compliance with the financial covenants of our bank financing agreements, we may also be subject to increased interest rate expenses. We may not be able to raise additional funding, or if we are able to, we may not be able to raise funding on acceptable terms. We may also dilute then-existing shareholders if we raise additional funds by issuing new equity securities. Alternately, we may have to relinquish rights to certain of our technologies, products and/or sales territories if we are required to obtain funds through arrangements with collaborative partners. If we are unable to raise needed funds, we may be required to curtail our operations significantly. This would materially adversely affect our operating results and financial condition.

**We Rely On Patents And Other Proprietary Information, The Loss Of Any Of Which Would Negatively Affect Our Business**

As of June 30, 2005, 34 patent applications have been filed on behalf of Abaxis with the United States Patent and Trademark Office, of which 29 have been issued. Additionally, we have filed several international patent applications covering the same subject matter as our domestic applications. The patent position of any medical device manufacturer, including Abaxis, is uncertain and may involve complex legal and factual issues. Consequently, we may not be issued any additional patents, either domestically or internationally. Furthermore, our patents may not provide significant proprietary protection because there is a chance that they will be circumvented or invalidated. We cannot be certain that we were the first creator of the inventions covered by our issued patents or pending patent applications, or that we were the first to file patent applications for these inventions, because (1) the United States Patent and Trademark Office maintains all patent applications that are not filed in any foreign jurisdictions in secrecy until it issues the patents (unless a patent application owner files a request for publication) and (2) publications of discoveries in the scientific or patent literature tend to lag behind actual discoveries by several months. We may have to participate in interference proceedings, which are proceedings in front of the U.S. Patent and Trademark Office, to determine who will be issued a patent. These proceedings could be costly and could be decided against us.

We also rely upon copyrights, trademarks and unpatented trade secrets. Others may independently develop substantially equivalent proprietary information and techniques that would undermine our proprietary technologies. Further, others may gain access to our trade secrets or disclose such technology. Although we require our employees, consultants and advisors to execute agreements that require that our corporate information be kept confidential and that any inventions by these individuals are property of Abaxis, there can be no assurance that these agreements will provide meaningful protection or adequate remedies for our trade secrets in the event of unauthorized use or disclosure of such information. The unauthorized dissemination of our confidential information would negatively impact our business.

### **We Continue to Develop Our Marketing And Distribution Experience In the Human Diagnostic Market**

Although we have gained experience marketing our VetScan DXS system products in the veterinary diagnostic market, we have much less experience in marketing the Piccolo system in the human diagnostic market. Accordingly, we have limited sales, marketing and distribution experience, especially in the human diagnostic market. We cannot assure you that:

we will be able to establish and maintain effective distribution arrangements in the human medical market;

any distribution arrangements that we are able to establish will be successful in marketing our products; or

the costs associated with marketing and distributing our products will not be excessive.

Should we fail to effectively develop our marketing and distribution efforts, our growth will be limited and our results of operations will be adversely affected.

### **We May Inadvertently Produce Defective Products, Which May Subject Us to Significant Warranty Liabilities or Product Liability Claims And We May Have Insufficient Product Liability Insurance**

Our business exposes us to potential warranty and product liability risks which are inherent in the testing, manufacturing and marketing of human and veterinary medical products. We strive to apply sophisticated methods to raw materials and produce defect-free medical test equipment. Although we have established procedures for quality control on both the raw materials that we receive from suppliers and our manufactured final products, these procedures may prove inadequate to detect a defect that either occurs in limited quantities or that we have not anticipated. We believe that our Piccolo and VetScan systems detect the vast majority of errors that occur on our reagent discs and automatically reject such tests, prompting the medical provider to retest the patient. However, our Piccolo and VetScan systems may be unable to detect errors which could result in the misdiagnosis of human or veterinary patients.

Should we inadvertently ship defective products, we may be subject to substantial claims under our warranty policy or product liability law. In addition, our policy is to credit medical providers for any defective product that we produce, including those reagent discs that are rejected by our Piccolo and VetScan systems. Therefore, even if a mass defect within a lot or lots of reagent discs were detected by our Piccolo and VetScan systems, our need to replace such reagent discs free of charge would materially harm our financial condition. Further, in the event that a product defect is not detected by our Piccolo system, our relatively recent expansion into the human medical market greatly increases the risk that the amount of damages involved with just one product defect would be material to our operations. We currently maintain limited product liability insurance that we believe is adequate for our needs, taking into account the risks involved and cost of coverage. However, our product liability insurance and cash may be insufficient to cover potential liabilities. In addition, in the future the coverage that we require may be unavailable on commercially reasonable terms, if at all. Even with our current insurance coverage, a mass product defect, product liability claim or recall would materially adversely affect our business or our financial condition.

### **Many of Our Sales Force Have Been Employed By Us For Less Than One Year And We Must Effectively Train And Integrate Our Sales Team In Order To Achieve Our Anticipated Revenue**

At June 30, 2005, we had thirty-nine full-time sales personnel involved in our sales and marketing activities, many of whom have been employed by us for a limited period of time. While these individuals work with our distribution partners both domestically and internationally to extend our market reach, the primary selling activities are often done by these individuals. If we are to increase our sales, we will need to train new salespeople and supervise them closely. We also will continue hiring additional sales personnel. If we are unable to retain our existing personnel, or attract and train additional qualified personnel, our growth may be limited due to our lack of capacity to market our products.

### **We Need to Successfully Manufacture and Market Additional Reagent Discs For The Human Diagnostic Market If We Are To Compete In That Market**

We have developed a blood analysis system that consists of a portable blood analyzer and single-use reagent discs. Each reagent disc performs a series of standard blood tests. We believe that it is necessary to develop additional series of reagent discs with various tests for use with the Piccolo and VetScan systems. Historically, we primarily developed reagent discs suitable for the veterinary diagnostic market. Prior to 2003, Abaxis had received 510(k) clearances for nineteen test methods. Since 2003, we have received additional 510(k) clearances from the U.S. Food and Drug Administration for high density lipoprotein cholesterol (HDL), triglycerides, magnesium and phosphorus for the human diagnostic market. These tests are included in standard tests for which the medical community receives reimbursements from third party payors such as HMOs and Medicare. We may not be able to successfully manufacture or market these newly developed reagent discs. Our failure to meet these challenges will materially adversely affect our operating results and financial condition.



### **We Rely On Distributors To Sell Our Products; We Rely On Sole Distributor Arrangements In A Number Of Countries**

We distribute our products primarily through distributors. As a result, we are dependent upon these distributors to sell our products and to assist us in promoting and creating a demand for our products. We have a number of distributors in the United States who distribute our VetScan products. For the three months ended June 30, 2005, two distributors, DVM Resources and Henry Schein, Inc., accounted for 19% and 15%, respectively, of total revenues. For the three months ended June 30, 2004, two distributors, Vedco Inc. and DVM Resources, accounted for 26% and 16%, respectively, of total revenues.

In December 2004, we terminated our relationship with Vedco, Inc., a warehousing cooperative for member distributors who sold Abaxis products to their respective customers, as part of the realignment of our distribution channel. During the third and fourth quarters of fiscal 2005, we worked with other U.S. based regional and national distributors, which included American Veterinary Supply Corp., DVM Resources, Henry Schein, Inc., IVESCO, TradeWinds Trading Company and Western Medical Supply, to expand their sales and services to support the customers served by other Vedco distributors. In the third quarter of fiscal 2005, we negotiated direct distributor agreements with Vedco members Merritt Veterinary Supply and Miller Veterinary Supply. We believe that our future growth depends, in part, on the efforts of these distributors.

If one of our distributors were to stop selling our products, we may not be able to replace such lost revenue. We operate on a purchase order basis with the distributors and the distributors are under no contractual obligation to continue carrying our products. Further, many of our distributors may carry our competitors' products, and may promote our competitors' products over our own products. Finally, we do not have at this time distribution partners in the United States who distribute our products for the human medical market. Internationally, we have a few distributors for our products in both the human and veterinary diagnostic markets, which includes one distributor in Japan who is in the process of obtaining the required approvals for sales of Abaxis products in the respective countries.

We currently have distributors for our products in the following countries: Australia, Austria, Bahrain, Belgium, Canada, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Korea, Kuwait, Mexico, New Zealand, Norway, Portugal, Russia, South Africa, Spain, Sweden, Switzerland, United Arab Emirates, the United Kingdom and the United States. Our distributor in each of these countries is responsible for obtaining the necessary approvals to sell our products. These distributors may not be successful in obtaining proper approvals for our products in their respective countries, and they may not be successful in marketing our products. We plan to continue to enter into additional distributor relationships to expand our international distribution base and solidify our international presence. However, we may not be successful in entering into additional distributor relationships. Our distributors may terminate their relationship with us at any time. Historically, we have experienced a high degree of turnover among our international distributors. This high degree of turnover makes it difficult for us to establish a steady distribution network overseas. Consequently, we may not be successful in marketing our Piccolo and VetScan DXS products internationally.

### **We Depend On Sole Suppliers For Several Key Components To Our Products, Many of Whom We Have Not Entered Into Contractual Relationships With**

We use several key components that are currently available from limited or sole sources as discussed below:

*Reagent Discs:* Two injection molding manufacturers, C. Brewer & Co. and Nypro Oregon, Inc., currently make the molded plastic discs which, when loaded with reagents and welded together, form our reagent disc products. We believe that only a few manufacturers are capable of producing these discs to the narrow tolerances that we require; to date, we have only qualified these two manufacturers, with Nypro Oregon, Inc. being qualified at two separate facilities, to manufacture the molded plastic discs.

*Reagent Chemicals:* We currently depend on the following single source vendors for some of the chemicals that we use to produce the dry reagent chemistry beads that are either inserted in our reagent discs or sold as a stand-alone product: Amano Enzyme USA Co., Ltd., Genzyme Corporation, Kikkoman Corporation Biochemical Division, Microgenics Corporation, Roche Molecular Biochemicals of Roche Diagnostics Corporation, a division of F. Hoffmann-La Roche, Ltd., Shinko American Inc. and Sigma Aldrich Inc.

*Blood Analyzer Components:* Our analyzer products use several technologically advanced components that we currently purchase from two single source vendors, PerkinElmer, Inc. and Electro Alliance, Inc. Our analyzers use a printer that is only made by Seiko North America Corporation. The loss of the supply of any of these components could force us to redesign our analyzers.

*Hematology Instrument and Reagents:* We purchase the HMII instruments from DIATRON of Austria. To date, we have qualified two suppliers to produce the reagents for the hematology instruments: Mallinckrodt Baker BV and Clinical Diagnostic Solutions, Inc.

For our hematology instruments purchased from Diatron, we are subject to minimum purchase requirements through fiscal 2009. We operate on a purchase order basis with all of the suppliers of our molded plastic reagent discs, reagent chemicals and blood analyzer components and thus these suppliers are under no contractual obligation to supply us with their products or to do so at specified prices. Although we believe that there are potential alternate suppliers available for these critical components, to date we have not qualified additional vendors beyond those referenced above.

Because we are dependent on a limited number of suppliers and manufacturers for critical components to our products, we are particularly susceptible to any interruption in the supply of these products or the viability of our assembly arrangements. The loss of any one of these suppliers or a disruption in our manufacturing arrangements could materially adversely affect our business and financial condition.

#### **We Compete With Larger, Better Established Entities Such As Hospitals And Commercial Laboratories**

Blood analysis is a well established field in which there are a number of competitors that have substantially greater financial resources and larger, more established marketing, sales and service organizations than we do. We compete with the following organizations:

commercial clinical laboratories;

hospitals clinical laboratories; and

manufacturers of bench top multi-test blood analyzers and other testing systems that health care providers can use on-site.

#### **We May Not Be Able To Compete With These Organizations Or Their Products Or With Future Organizations Or Future Products**

Historically, hospitals and commercial laboratories perform the most human diagnostic testing, and commercial laboratories perform the most veterinary medical testing. We have identified five principal factors that customers typically use to evaluate our products and those of our competitors. These factors are:

range of tests offered;

the immediacy of results;

cost effectiveness;

ease of use; and

reliability of results.

We believe that we compete effectively on each of these factors except for the range of tests offered. Clinical laboratories are effective at processing large panels of tests using skilled technicians and complex equipment. While our current offering of reagent discs cannot provide the same broad range of tests, we believe that in certain limited markets our products provide a sufficient breadth of test menus to compete successfully with clinical laboratories given the advantages of our products with respect to the other four factors. However, we cannot assure you that we will continue to be able to compete effectively on cost effectiveness, ease of use, immediacy of results or reliability of results. We also cannot assure you that we will ever be able to compete effectively solely on the basis of range of tests offered.

Competition in the human and veterinary diagnostic markets is intense. Our principal competitors in the human diagnostic market are Alfa Wassermann S.P.A., Elan Diagnostics, Hemagen Diagnostics, Inc., i-STAT Corporation (which was purchased by Abbott Laboratories), Johnson & Johnson (including its subsidiary, Ortho-Clinical Diagnostics, Inc.), Novitron International, Inc., Polymedco and Roche. Our principal competitors in the veterinary diagnostic market are Idexx Laboratories, Inc. and Heska Corporation. Most of our competitors have significantly greater financial and other resources than we do. In particular, many of our competitors have large sales forces and well-established distribution channels. Consequently, we must develop our distribution channels and improve our direct sales force in order to compete in these markets.

### **Changes In Third Party Payor Reimbursement Regulations Can Negatively Affect Our Business**

By regulating the maximum amount of reimbursement they will provide for blood testing services, third party payors, such as HMOs, pay-per-service insurance plans, Medicare and Medicaid, can indirectly affect the pricing or the relative attractiveness of our human testing products. For example, the Centers for Medicare and Medicaid Services ( CMS ) sets the level of reimbursement of fees for blood testing services for Medicare beneficiaries. If third party payors decrease the reimbursement amounts for blood testing services, it may decrease the amount that physicians and hospitals are able to charge patients for such services. Consequently, we will need to charge less for our products. If the government and third party payors do not provide for adequate coverage and reimbursement levels to allow health care providers to use our products, the demand for our products will decrease.

### **We Are Subject To Numerous Governmental Regulations**

#### ***Need for FDA Certification for Our Medical Device Products***

Our Piccolo products are regulated under the 1976 Medical Device Amendments to the Food, Drug and Cosmetic Act, which is administered by the Food and Drug Administration. The FDA has classified our Piccolo products as Class I and Class II devices. These classifications require us to submit to the FDA a pre-market notification form or 510(k). The FDA uses the 510(k) to substantiate product claims that are made by medical device manufacturers prior to marketing. In our 510(k) notification, we must, among other things, establish that the product we plan to market is substantially equivalent to (1) a product that was on the market prior to the adoption of the 1976 Medical Device Amendment or (2) to a product that the FDA has previously cleared under the 510(k) process. The FDA review process of a 510(k) notification can last anywhere from three to six months, and the FDA must issue a written order finding substantial equivalence before a company can market a medical device. As of June 30, 2005, we have received market clearance from the FDA for our Piccolo system and 23 reagent tests that we have on ten reagent discs, with the addition of General Chemistry 13 in the third quarter of fiscal 2005. We are currently developing additional tests that the FDA will have to clear through the 510(k) notification procedures. These new test products are crucial for our success in the human diagnostic market. If we do not receive 510(k) clearance for a particular product, we will not be able to sell that product in the United States.

#### ***Need to Comply with Manufacturing Regulations***

The 1976 Medical Device Amendment also requires us to manufacture our Piccolo products in accordance with Good Manufacturing Practices guidelines. Current Good Manufacturing Practice requirements are set forth in the 21 CFR 820 Quality System Regulation. These requirements regulate the methods used in, and the facilities and controls used for, the design, manufacture, packaging, storage, installation and servicing of our medical devices intended for human use. Our manufacturing facility is subject to periodic inspections. In addition, various state regulatory agencies may regulate the manufacture of our products. For example, we have obtained a license from the State of California to manufacture our products. In April 2001, the State of California Food and Drug Branch granted our manufacturing facility in compliance status, based on the regulations for Good Manufacturing Practices for medical devices. In May 2001, the State of California Food and Drug Branch granted licensing for our new Union City facility. The most recent inspection was in March 2003 when the U.S. FDA conducted a facility inspection and verified our compliance with the 21 CFR 820 Regulation. We cannot assure you that we will successfully pass a re-inspection by the FDA or the State of California. In addition, we cannot assure you that we can comply with all current or future government manufacturing requirements and regulations. If we are unable to comply with the regulations, or if we do not pass routine inspections, our business and results of operations will be materially adversely affected.

#### ***Effects of the Clinical Laboratory Improvement Amendments on Our Products***

Our Piccolo products are affected by the Clinical Laboratory Improvement Amendments of 1988. The Clinical Laboratory Improvement Amendments are intended to insure the quality and reliability of all medical testing in the United States regardless of where tests are performed. The current Clinical Laboratory Improvement Amendments divide laboratory tests into three categories: simple, moderately complex and highly complex. Tests performed using the Piccolo system are in the moderately complex category. This category requires that any location in which testing is performed be certified as a laboratory. Hence, we can only sell our Piccolo products to customers who meet the standards of a laboratory. To receive laboratory certification, a testing facility must be certified by the Centers for Medicare and Medicaid Services. After the testing facility receives a laboratory certification, it must then meet the Clinical Laboratory Improvement Amendments regulations. Because we can only sell our Piccolo products to testing facilities that are certified laboratories, the market for our products is correspondingly constrained.



In July 2004, the U.S. Food and Drug Administration (FDA) granted our first waived status under CLIA regulations for our lipids test panel when used in conjunction with our Piccolo point of care analyzer. Waived status permits untrained personnel to run the Piccolo using the Lipid Panel and, thus, extending the sites (doctors' offices and other point-of-care environments) that can use the Piccolo. Currently, a second petition is under evaluation by the FDA for our Lipid Panel Plus disc. This disc includes total cholesterol, HDL cholesterol, triglycerides, glucose, and the liver enzymes, ALT and AST. We cannot assure you that we will successfully receive the waived status from the FDA on this second disc or for other products. Consequently, the market for our Piccolo products may be confined to those testing facilities that are certified as laboratories and our growth will be limited accordingly.

***We Are Subject to Various Federal, State, Local, and International Regulations***

Federal and state regulations regarding the manufacture and sale of health care products and diagnostic devices may change. In addition, as we continue to sell in foreign markets, we may have to obtain additional governmental clearances in those markets. For example, in December 2003, we received certification from the British Standards Institute to the ISO 13485:1996 quality system standard for medical devices. This quality system certification, along with successful completion of product testing to current European standards and the translation of Piccolo product documentation into the required languages, enabled us to meet the compliance requirements of the CE Mark and the current European In Vitro Device Directive. We cannot predict what impact, if any, such current or future regulatory changes would have on our business. We may not be able to obtain regulatory clearances for our products in the United States or in foreign markets, and the failure to obtain these regulatory clearances will materially adversely affect our business and results of operations.

Although we believe that we will be able to comply with all applicable regulations of the Food and Drug Administration and of the State of California, including the Quality System Regulation, current regulations depend on administrative interpretations. Future interpretations made by the Food and Drug Administration, the Centers for Medicare and Medicaid Services (CMS) or other regulatory bodies may adversely affect our business.

**We Depend On Key Members Of Our Management And Scientific Staff, And We Must Retain And Recruit Qualified Individuals If We Are To Be Competitive**

We are highly dependent on the principal members of our management and scientific staff. The loss of any of these key personnel, including in particular Clinton H. Severson, our President, Chief Executive Officer and Chairman of our Board of Directors, might impede the achievement of our business objectives. Mr. Severson's amended and restated employment agreement with us has been filed with the SEC as an exhibit. We are not aware of any member of our executive management team who intends to retire within one year of the date of this filing. We currently do not maintain key man life insurance on any of our employees. Although historically we have been relatively successful both in retaining our current management and scientific staff and attracting and retaining skilled and experienced marketing, sales and manufacturing personnel, we may not be able to employ such personnel on acceptable terms in the future because numerous medical products and other high technology companies compete for the services of these qualified individuals.

**Standards For Compliance With Section 404 Of the Sarbanes-Oxley Act Of 2002 Are Complex, And If We Are Unable To Maintain An Effective Internal Control Over Our Financial Reporting, Our Business Could Be Harmed And Our Stock Price Could Decline**

Rules adopted by the Securities and Exchange Commission pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 require an annual assessment of our internal control over financial reporting by management of the Company, and attestation of our assessment by our independent registered public accountants. The standards that must be met for management to assess the internal control over financial reporting as effective are new and complex, and require significant documentation, testing and possible remediation to meet the detailed standards.

Our management assessed the effectiveness of our internal control over financial reporting as of March 31, 2005, and this assessment identified a material weakness in our internal control over financial reporting. The Company did not maintain effective controls over the determination and reporting of the provision for income taxes. There were errors in the annual tax provision for the fiscal year ended March 31, 2005 (which were corrected prior to the issuance of the financial statements) as a result of ineffective controls relating to insufficient formalized procedures to obtain and review documents with tax-related information in the determination of the provision of income taxes and the components of deferred income tax assets and liabilities. Additionally, there were insufficient formalized procedures to ensure that the provision of income taxes received adequate review to ensure that such provision is accounted for in accordance with generally accepted accounting principles.

This material weakness resulted from a design deficiency and resulted in audit adjustments to the provision for income taxes totaling \$280,000. These audit adjustments were reflected in our fiscal 2005 earnings announcement on April 28, 2005, filed on a Current Report on Form 8-K, and do not impact previously filed financial statements. Additionally, this control deficiency could result in a future material misstatement of the Company's income tax provision (and related balance sheet accounts) that would not be prevented or detected by management. Accordingly, management has determined that this control deficiency constitutes a material weakness. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal

## Edgar Filing: ABAXIS INC - Form 10-Q

Control-Integrated Framework. Because of the material weakness described above, management believes that, as of March 31, 2005, the Company's internal control over financial reporting was not effective.

Any failure to implement required new or improved controls, or difficulties encountered in our implementation could harm our operating results or prevent us from accurately reporting our financial results or cause us to fail to meet our reporting obligations in the future. If we cannot assess our internal control over financial reporting as effective, or our independent registered public accountants are unable to provide an unqualified attestation report on such assessment, investor confidence and share value may be negatively impacted.

**Legislative Actions, Higher Insurance Cost And Potential New Accounting Pronouncements Are Likely To Cause Our General And Administrative Expenses To Increase And Impact Our Future Financial Position And Results Of Operations**

In order to comply with the Sarbanes-Oxley Act of 2002, as well as changes to Nasdaq listing standards and accounting changes by the Securities and Exchange Commission, we will be required to enhance our internal controls, hire additional personnel and utilize additional outside legal, accounting and advisory services, all of which will cause our general and administrative costs to increase. Insurers are also likely to increase premiums as a result of the high claims rates incurred over the past year, and so our premiums for our various insurance policies, including our directors' and officers' insurance policies, are likely to increase.

**As a Result of New Requirements Relating to Accounting Treatment For Employee Stock Options, We May Be Forced to Change Our Business Practices**

We currently account for the issuance of stock options under APB Opinion No. 25, Accounting for Stock Issued to Employees. On December 16, 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS 123R). The new standard requires us to treat the value of the stock options granted to employees as a compensation expense. In April 2005, the Securities and Exchange Commission amended the compliance dates and, accordingly, we will be required to record an expense for our stock-based compensation plans using the fair value method beginning on April 1, 2006. As a result, we may decide to reduce the number of stock options granted to employees or to grant options to fewer employees. This could affect our ability to retain existing employees and attract qualified candidates, and increase the cash compensation we would have to pay to them. In addition, such a change would have a negative effect on our earnings.

**We Must Comply With Strict And Potentially Costly Environmental Regulations**

We are subject to stringent federal, state and local laws, rules, regulations and policies that govern the use, generation, manufacture, storage, air emission, effluent discharge, handling and disposal of certain materials and wastes. In particular, we are subject to laws, rules and regulations governing the handling and disposal of biohazardous materials used in the development and testing of our products. We handle and dispose of human and veterinary blood samples for testing (whole blood, plasma, serum) and we paid approximately \$64,000 in fiscal 2005 to comply with applicable environmental regulations. Although we believe that we have complied with applicable laws and regulations in all material respects and have not been required to take any action to correct any noncompliance, we may have to incur significant costs to comply with environmental regulations if our manufacturing to commercial levels continues to increase. In addition, if a government agency determines that we have not complied with these laws, rules and regulations, we may have to pay significant fines and/or take remedial action that would be expensive and we do not carry environmental-related insurance coverage.

**System Failures Or Delays May Harm Our Business And Our Facilities And Manufacturing Operations Are Vulnerable To Natural Disasters And Other Unexpected Losses**

Our success depends on the efficient and uninterrupted operation of our manufacturing operations, which are co-located with our corporate headquarters in Union City, California. A failure of manufacturing operations, be it in the development and manufacturing of our Piccolo or VetScan analyzers or the reagent discs used in the analyzers could result in our inability to supply customer demand.

We do not have a backup facility to provide redundant manufacturing capacity in the event of a system failure. Accordingly, if our Union City location experienced a system failure, or regulatory problem that temporarily shut-down our manufacturing facility, our manufacturing ability would become unavailable until we were able to bring an alternative facility online, a process which could take several weeks or even months. These manufacturing operations are also vulnerable to damage from earthquakes, fire, floods, power loss, telecommunications failures, break-ins and similar events. Although we carry property and business interruption insurance, our coverage may not be adequate to compensate us for all losses that may occur. Additionally, our computer servers may be vulnerable to computer viruses, physical or electronic break-ins and similar disruptions.

**Fluctuations In Foreign Exchange Rates And The Possible Lack Of Financial Stability In Foreign Countries Could Prevent Overseas Sales Growth**

Our international sales are overwhelmingly currently U.S. dollar-denominated. As a result, an increase in the value of the U.S. dollar relative to foreign currencies could make our products less competitive in international markets. For the limited amount of our sales denominated in local currencies, we are subject to fluctuations in exchange rates between the U.S. dollar and the particular local currency. Our operating results could also be adversely affected by the seasonality of international sales and the economic conditions of our overseas markets.

**Our Stock Price Is Highly Volatile And Investing In Our Stock Involves A High Degree Of Risk**

The market price of our common stock, like the securities of many other medical products companies, fluctuates over a wide range, and will continue to be highly volatile in the future. During the past two years, our stock price closed at a high of \$22.80 on January 26, 2004 and a low of \$6.40 on July 1, 2003. The following factors may affect the market price of our common stock:

fluctuation in our operating results;

announcements of technological innovations or new commercial products by us or our competitors;

changes in governmental regulation;

prospects and proposals for health care reform;

governmental or third party payors' controls on prices that our customers may pay for our products;

developments or disputes concerning patent or our other proprietary rights;

public concern as to the safety of our devices or similar devices developed by our competitors; and

general market conditions.

Because our stock price is so volatile, investing in our common stock is highly risky. A potential investor must be able to withstand the loss of his entire investment in our common stock.

**Our Shareholders Rights Plan And Our Ability To Issue Preferred Stock May Delay Or Prevent A Change Of Control Of Abaxis**

Our Shareholder Rights Plan, adopted by our Board of Directors on April 22, 2003 may make it more difficult for a third party to acquire, or discourage a third party from attempting to acquire, control of Abaxis. The Shareholder Rights Plan could limit the price that investors might be willing to pay in the future for shares of our common stock.

In addition, our Board of Directors has the authority to issue up to 5,000,000 shares of preferred stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the shareholders, except to the extent required by NASDAQ rules. The issuance of preferred stock, while providing flexibility in connection with possible financings or acquisitions or other corporate purposes, could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We are exposed to financial market risks with respect to interest rates on our line of credit, cash equivalent and short-term investments.

For our line of credit, which provides for borrowings of up to \$2,000,000, the interest rate is equal to the bank's prime rate minus 0.25%, which totaled 6.00% at June 30, 2005. Consequently, an increase in the prime rate would expose us to higher interest expenses. At June 30, 2005, there was no amount outstanding on our line of credit.

At June 30, 2005, our short-term investments totaled \$16,917,000, consisting of corporate obligations, U. S. Treasury and Agency securities and various certificate of deposits with maturities of one year or less from the date of purchase. Our short-term investment objective is to maximize yields without significantly increased risk.

As a matter of management policy, we do not currently enter into transactions involving derivative financial instruments. In the event we do enter into such transactions in the future, such items will be accounted for in accordance with Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, in which case we will formally document all relationships between hedging instruments and hedged items, as well as our risk management objective and strategy for undertaking such hedge transactions.

### **Item 4. Controls and Procedures**

#### **Evaluation of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended as of the end of the period covered by this report. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were not effective as of June 30, 2005, because of the material weakness related to controls around the determination and reporting of the provision for income taxes, as described below. As reported in our annual report on Form 10-K for the fiscal year ended March 31, 2005, we identified a material weakness in our internal control over financial reporting which we view as an integral part of our disclosure controls and procedures. As of June 30, 2005, we have not fully remediated the material weakness.

#### **Changes in Internal Control over Financial Reporting**

During the quarter ended June 30, 2005, there has been no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect our internal control over financial reporting.

As of March 31, 2005, the Company did not maintain effective controls over the determination and reporting of the provision for income taxes. There were errors in the annual tax provision for the fiscal year ended March 31, 2005 (which were corrected prior to the issuance of the financial statements) as a result of ineffective controls relating to insufficient formalized procedures to obtain and review documents with tax-related information in the determination of the provision of income taxes and the components of deferred income tax assets and liabilities. Additionally, there were insufficient formalized procedures to ensure that the provision of income taxes received adequate review to ensure that such provision is accounted for in accordance with generally accepted accounting principles. This material weakness resulted from a design deficiency and resulted in audit adjustments to the provision for income taxes totaling \$280,000. These audit adjustments were reflected in our fiscal 2005 earnings announcement on April 28, 2005, filed on a Current Report on Form 8-K, and do not impact previously filed financial statements.

We are in the process of implementing a remediation plan to address the ineffective controls related to the determination and reporting of the tax provision. We plan to implement improved controls to facilitate a comprehensive and detailed review of our tax accounting and reporting by ensuring that accounting personnel with the adequate experience, skills and knowledge are directly involved in the review and evaluation of tax accounting and reporting.

## **PART II -- OTHER INFORMATION**

### **Item 1. Legal Proceedings**

We are from time to time involved in various litigation matters in the normal course of business. We believe that the ultimate resolution of these matters will not have a material effect on our financial position or results of operations.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Not applicable.

### **Item 3. Defaults Upon Senior Securities**

Not applicable.

### **Item 4. Submission of Matters to a Vote of Security Holders**

Not applicable.

### **Item 5. Other Information**

Not applicable.

### **Item 6. Exhibits**

| <b>Exhibit No.</b> | <b>Description of Document</b>   |
|--------------------|--|
| 10.38              | <u>Distributor Agreement by and between the Veterinary Division of Henry Schein and Abaxis, Inc., dated April 5, 2004. (1)</u>           |
| 10.39              | <u>Employment Agreement with Mr. Clinton H. Severson, as amended and restated, as of August 2, 2005.</u>                                 |
| 31.1               | <u>Certification of President and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>                 |
| 31.2               | <u>Certification of Chief Financial Officer and Vice President of Finance pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| 32.1               | <u>Certification of President and Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>                 |
| 32.2               | <u>Certification of Chief Financial Officer and Vice President of Finance pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> |

---

(1) Confidential treatment of certain portions of this agreement has been requested from the Securities and Exchange Commission.

**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.

ABAXIS, INC.  
(Registrant)

Date: August 9, 2005

BY: /s/ CLINTON H. SEVERSON

---

Clinton H. Severson  
President, Chief Executive Officer and Director  
(Principal Executive Officer)

Date: August 9, 2005

BY: /s/ ALBERTO R. SANTA INES

---

Alberto R. Santa Ines  
Chief Financial Officer and Vice President of  
Finance  
(Principal Financial and Accounting Officer)