

ABAXIS INC  
Form 10-Q  
February 09, 2009

Table of Contents

**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 December 31, 2008**

**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 such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

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

Large accelerated filer ☐ Accelerated filer ☒ Non-accelerated filer ☐ Smaller reporting company ☐  
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

As of February 5, 2009, there were 21,899,000 shares of the Registrant's common stock outstanding.

**ABAXIS, INC.**  
**Form 10-Q**

**For the Quarter Ended December 31, 2008**  
**TABLE OF CONTENTS**

	Page
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<b><u>Item 1. Condensed Consolidated Financial Statements (Unaudited):</u></b>	
<u>Condensed Consolidated Statements of Operations for the Three and Nine Months Ended December 31, 2008 and 2007</u>	3
<u>Condensed Consolidated Balance Sheets as of December 31, 2008 and March 31, 2008</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended December 31, 2008 and 2007</u>	5
<u>Notes to the Condensed Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	33
<u>Item 4. Controls and Procedures</u>	34
<u>Item 4T. Controls and Procedures</u>	34
<b><u>PART II. OTHER INFORMATION</u></b>	
<u>Item 1. Legal Proceedings</u>	34
<u>Item 1A. Risk Factors</u>	34
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	44
<u>Item 3. Defaults Upon Senior Securities</u>	44
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	44
<u>Item 5. Other Information</u>	44
<u>Item 6. Exhibits</u>	45
<b><u>SIGNATURES</u></b>	46

Exhibit 10.2

Exhibit 31.1

Exhibit 31.2

Exhibit 32.1

Exhibit 32.2

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements (Unaudited)****ABAXIS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)****(In thousands, except share and per share data)**

	<b>Three Months Ended December 31,</b>		<b>Nine Months Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Revenues	\$ 26,964	\$ 25,690	\$ 79,224	\$ 73,813
Cost of revenues	11,859	12,081	35,274	33,331
Gross profit	15,105	13,609	43,950	40,482
Operating expenses:				
Research and development	2,037	1,629	6,116	5,104
Sales and marketing	6,061	6,056	18,382	17,666
General and administrative	2,241	1,571	5,855	4,760
Total operating expenses	10,339	9,256	30,353	27,530
Income from operations	4,766	4,353	13,597	12,952
Interest and other income (expense), net	352	552	1,140	1,580
Income before income taxes	5,118	4,905	14,737	14,532
Income tax provision	1,762	1,700	5,308	5,341
Net income	\$ 3,356	\$ 3,205	\$ 9,429	\$ 9,191
Net income per share:				
Basic net income per share	\$ 0.15	\$ 0.15	\$ 0.43	\$ 0.43
Diluted net income per share	\$ 0.15	\$ 0.14	\$ 0.42	\$ 0.41
Shares used in the calculation of net income per share:				
Weighted average common shares outstanding basic	21,879,000	21,561,000	21,798,000	21,441,000
Weighted average common shares outstanding diluted	22,264,000	22,359,000	22,325,000	22,208,000

Edgar Filing: ABAXIS INC - Form 10-Q

Share-based compensation expense by function:

Cost of revenues	\$	33	\$	33	\$	108	\$	88
Research and development		64		39		178		110
Sales and marketing		143		91		401		259
General and administrative		225		122		613		374

Total share-based compensation expense	\$	465	\$	285	\$	1,300	\$	831
--	----	-----	----	-----	----	-------	----	-----

See accompanying Notes to the Condensed Consolidated Financial Statements.

**Table of Contents**

**ABAXIS, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(Unaudited)**  
**(In thousands, except share data)**

	<b>December 31, 2008</b>	<b>March 31, 2008</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 60,158	\$ 17,219
Short-term investments	14,489	6,991
Trade receivables (net of allowances of \$356 at December 31, 2008 and \$272 at March 31, 2008)	21,557	20,873
Inventories, net	17,104	18,657
Prepaid expenses	1,241	427
Net deferred tax asset    current	3,481	2,426
Total current assets	118,030	66,593
Long-term investments		35,463
Property and equipment, net	15,130	14,599
Intangible assets, net	319	375
Other assets	29	5
Net deferred tax asset    non-current	3,874	3,868
Total assets	\$ 137,382	\$ 120,903
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 5,920	\$ 6,421
Accrued payroll and related expenses	2,822	4,277
Other accrued liabilities	1,472	1,369
Deferred revenue	922	807
Warranty reserve	1,637	1,219
Total current liabilities	12,773	14,093
Non-current liabilities:		
Deferred rent	183	286
Deferred revenue	1,516	1,146
Warranty reserve	748	729
Total non-current liabilities	2,447	2,161

Commitments and contingencies (Note 8)

Shareholders' equity:

Preferred stock, no par value; 5,000,000 shares authorized; no shares issued and outstanding

Common stock, no par value; 35,000,000 shares authorized; 21,895,000 and 21,706,000 shares issued and outstanding at December 31, 2008 and at

March 31, 2008, respectively	115,700	109,031
Retained earnings (accumulated deficit)	6,462	(2,967)
Accumulated other comprehensive loss		(1,415)

Total shareholders' equity	122,162	104,649
----------------------------	---------	---------

Total liabilities and shareholders' equity	\$ 137,382	\$ 120,903
--	------------	------------

See accompanying Notes to the Condensed Consolidated Financial Statements.



Table of Contents

**ABAXIS, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**  
**(In thousands)**

	<b>Nine Months Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 9,429	\$ 9,191
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,179	2,563
(Gain) loss on disposal of property and equipment	(8)	2
(Gain) loss on foreign exchange translation	81	
Share-based compensation expense	1,300	831
Excess tax benefits from share-based awards	(5,120)	(270)
Deferred income taxes	4,051	4,906
Changes in assets and liabilities:		
Trade receivables, net	(753)	(3,933)
Inventories, net	(114)	(4,501)
Prepaid expenses	(814)	644
Other assets	(24)	19
Accounts payable	(487)	542
Accrued payroll and related expenses	(1,455)	(243)
Other accrued liabilities	25	306
Deferred rent	(103)	(71)
Deferred revenue	485	(171)
Warranty reserve	437	806
Net cash provided by operating activities	10,109	10,621
<b>Cash flows from investing activities:</b>		
Purchases of available-for-sale investments		(20,575)
Purchases of held-to-maturity investments	(21,579)	(21,167)
Proceeds from redemptions of available-for-sale investments	36,975	
Proceeds from maturities of held-to-maturity investments	14,081	32,804
Purchases of property and equipment	(1,992)	(2,522)
Proceeds from disposal of property and equipment	20	
Net cash provided by (used in) investing activities	27,505	(11,460)
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock under stock plans, net	242	2,178
Excess tax benefits from share-based awards	5,120	270

Edgar Filing: ABAXIS INC - Form 10-Q

Net cash provided by financing activities	5,362	2,448
Effect of exchange rate changes on cash and cash equivalents	(37)	
Net increase in cash and cash equivalents	42,939	1,609
Cash and cash equivalents at beginning of period	17,219	10,183
Cash and cash equivalents at end of period	\$ 60,158	\$ 11,792
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid for interest	\$ 6	\$ 4
Cash paid for income taxes, net of refunds	\$ 1,147	\$ 340
<b>Supplemental disclosure of non-cash flow information:</b>		
Change in unrealized gain (loss) on investments, net of tax	\$ 1,415	\$
Transfers of equipment between inventory and property and equipment, net	\$ 1,674	\$ 1,307
Capitalized share-based compensation	\$ 7	\$ 13
Common stock withheld for employee taxes in connection with share-based compensation	\$ 280	\$ 110

See accompanying Notes to the Condensed Consolidated Financial Statements.

**Table of Contents**

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

**NOTE 1. DESCRIPTION OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES**

**Description of Business.** Abaxis, Inc. (the Company), incorporated in California in 1989, develops, manufactures, markets and sells portable blood analysis systems for use in the human or veterinary patient-care setting to provide clinicians with rapid blood constituent measurements.

On July 1, 2008, the Company's sales office in Darmstadt, Germany was incorporated as Abaxis Europe GmbH to market, promote and distribute diagnostic systems for medical and veterinary uses. As a result, Abaxis Europe GmbH became a wholly-owned subsidiary of the Company. The subsidiary was formed to provide customer support in a timely manner in response to the growing and increasingly diverse services needs of customers in the European market. The accompanying unaudited condensed consolidated financial statements as of and for the three and nine month periods ended December 31, 2008 include the accounts of the Company and its wholly-owned subsidiary, Abaxis Europe GmbH. All intercompany transactions and balances have been eliminated in consolidation.

**Basis of Presentation.** The unaudited condensed consolidated financial statements included herein have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim periods. The unaudited condensed consolidated 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 three and nine month periods ended December 31, 2008 are not necessarily indicative of the results to be expected for the entire fiscal year ending March 31, 2009 or for any future period.

These unaudited condensed consolidated financial statements should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and 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, 2008.

**Reclassifications.** Certain reclassifications have been made to prior periods' financial statements to conform to the current period presentation. These reclassifications had no material impact on previously reported results of operations or financial position.

**Use of Estimates in Preparation of Financial Statements.** The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such management estimates include allowance for doubtful accounts, fair value of investments, sales and other allowances, inventory reserves, income taxes, valuation allowance for deferred tax assets, share-based compensation and warranty reserves. Actual results may differ from these estimates.

**NOTE 2. RECENT ACCOUNTING PRONOUNCEMENTS**

In March 2008, the Financial Accounting Standards Board (the FASB) issued Statement of Financial Accounting Standards (SFAS) SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS No. 161), which is intended to enable investors to better understand how derivative instruments and hedging activities affect an entity's financial position, financial performance and cash flows through enhanced disclosure requirements. SFAS No. 161 will be effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. SFAS No. 161 will become effective for the Company on April 1, 2009. The Company is currently evaluating the impact of adopting SFAS No. 161 on its financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS No. 141(R)). SFAS No. 141(R) will change how business acquisitions are accounted for and will impact financial statements both on the acquisition date and in subsequent periods. SFAS No. 141(R) will become effective for the Company on April 1, 2009. The Company is currently evaluating the impact of adopting SFAS No. 141(R) on its financial statements.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 (SFAS No. 160), which establishes new accounting and reporting standards for

minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity. SFAS No. 160 will become effective for the Company on April 1, 2009. The Company is currently evaluating the impact of adopting SFAS No. 160 on its financial statements.

**Table of Contents**

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS No. 159). SFAS No. 159 permits entities to choose, at specified election dates, to measure eligible items at fair value (the fair value option). Unrealized gains and losses on instruments for which the fair value option has been elected are reported in earnings at each subsequent reporting period. SFAS No. 159 is applied prospectively upon adoption. The Company adopted SFAS No. 159 effective April 1, 2008. To date, the Company has not elected the fair value option for any of its financial assets or financial liabilities.

**NOTE 3. FAIR VALUE MEASUREMENTS**

On April 1, 2008, the Company adopted SFAS No. 157, Fair Value Measurements (SFAS No. 157) to measure the fair value of its financial assets and financial liabilities. In February 2008, the FASB issued FSP FAS 157-2 Effective Date of FASB Statement No. 157 which delayed the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008. The adoption of SFAS No. 157 for financial assets and liabilities did not have a material impact on the Company's financial position, cash flows or results of operations.

SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 establishes a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) an entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The fair value hierarchy consists of three broad levels, which gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy under SFAS No. 157 are described below:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2: Directly or indirectly observable market based inputs used in models or other valuation methodologies.

Level 3: Unobservable inputs that are supported by little or no market data and require the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management's estimates of market participant assumptions.

The following table summarizes financial assets, measured at fair value on a recurring basis, by level within the fair value hierarchy as of December 31, 2008 (in thousands):

	Quoted Prices in Active Markets for Identical Assets Level 1	As of December 31, 2008		Total
		Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	
<b>Assets</b>				
Cash and cash equivalents(1)	\$ 60,158	\$	\$	\$ 60,158
Short-term investments:				
Certificates of deposits	14,489			14,489
Total assets at fair value	\$ 74,647	\$	\$	\$ 74,647

(1)

Cash and cash equivalents as of December 31, 2008 consisted of \$20.3 million in cash and \$39.9 million in cash equivalents, consisting of money market mutual funds.

The fair value of the Company's Level 1 financial assets is based on quoted market prices of the underlying security. As of December 31, 2008, the Company did not have any Level 2 or 3 financial assets or liabilities. At September 30, 2008, the par value of the Company's investments in auction rate securities totaled \$28.4 million and the fair value of these auction rate securities was \$28.0 million. In September 2008, the Company's bank where its auction rate securities were held, reached agreements with the Financial Industry Regulatory Authority, the State of Michigan Attorney General and the Michigan Office of Financial and Insurance Regulation regarding the repurchase of auction rate securities. In October 2008, the Company received a commitment from its bank to repurchase all of its remaining auction rate securities, which repurchases were completed in the third quarter of fiscal 2009. During the three and nine months ended December 31, 2008, the Company redeemed \$28.4 million and \$37.0 million, respectively, of its auction rate securities at 100% of par value by the issuer of the auction rate securities.

**Table of Contents**

The following table summarizes the changes in the beginning and ending balances in the carrying value associated with Level 3 financial assets for the nine months ended December 31, 2008 (in thousands):

	<b>Auction Rate Securities</b>
Balance at March 31, 2008	\$ 35,463
Redemptions during the period	(4,000)
Transfers	
Total gain or loss (realized or unrealized)	
Included in earnings (loss)	
Included in other comprehensive loss	96
Balance at June 30, 2008	\$ 31,559
Redemptions during the period	(4,550)
Transfers	
Total gain or loss (realized or unrealized)	
Included in earnings (loss)	
Included in other comprehensive loss	998
Balance at September 30, 2008	\$ 28,007
Redemptions during the period	(28,425)
Transfers	
Total gain or loss (realized or unrealized)	
Included in earnings (loss)	
Included in other comprehensive loss	418
Balance at December 31, 2008	\$

**NOTE 4. INVESTMENTS**

The following table summarizes, by major security type, the cost and fair value of investments (in thousands):

	<b>December 31, 2008</b>		
	<b>Cost</b>	<b>Unrealized Gain (Loss)</b>	<b>Fair Value</b>
Short-term investments			
Held-to-maturity:			
Certificates of deposits	\$ 14,489	\$	\$ 14,489
Total short-term investments in held-to-maturity	\$ 14,489	\$	\$ 14,489
	<b>March 31, 2008</b>		
	<b>Cost</b>	<b>Unrealized Gain (Loss)</b>	<b>Fair Value</b>
Short-term investments			
Held-to-maturity:			
Certificates of deposits	\$ 2,974	\$	\$ 2,974
Municipal bonds	4,017		4,017

Edgar Filing: ABAXIS INC - Form 10-Q

Total short-term investments in held-to-maturity	\$	6,991	\$		\$	6,991
Long-term investments						
Available-for-sale:						
Auction rate securities	\$	36,975	\$	(1,512)	\$	35,463
Total long-term investments in available-for-sale	\$	36,975	\$	(1,512)	\$	35,463

As of December 31, 2008 and March 31, 2008, unrealized loss on investments, net of related income taxes, was \$0 and \$1.4 million, respectively.

At December 31, 2008, the contractual maturities for certificates of deposits were one year or less from the date of purchase. At March 31, 2008, the Company determined that its auction rate securities were not liquid since several auctions related to its auction rate securities failed beginning in February 2008 and accordingly, the Company's auction rate securities were classified as long-term investments at March 31, 2008. In September 2008, the Company's bank where its auction rate securities were held, reached agreements with the Financial Industry Regulatory Authority, the State of Michigan Attorney General and the Michigan Office of Financial and Insurance Regulation regarding the repurchase of auction rate securities. In October 2008, the Company received a commitment from its bank to repurchase all of its remaining auction rate securities, which repurchases were completed in the third quarter of fiscal 2009. During the three and nine months ended December 31, 2008, the Company redeemed \$28.4 million and \$37.0 million, respectively, of its auction rate securities at 100% of par value by the issuer of the auction rate securities.



**Table of Contents****NOTE 5. INVENTORIES, NET**

Inventories, net, include material, labor and overhead, and are stated at the lower of cost (first-in, first-out method) or market. Components of inventories, net, were as follows (in thousands):

	<b>December 31, 2008</b>	<b>March 31, 2008</b>
Raw materials	\$ 9,552	\$ 9,067
Work-in-process	2,667	4,315
Finished goods	4,885	5,275
Inventories, net	\$ 17,104	\$ 18,657

**NOTE 6. WARRANTY RESERVES**

The Company provides for the estimated future costs to be incurred under the Company's standard warranty obligation on its instruments. Starting on July 1, 2007, the Company provides for the estimated future costs to be incurred under the Company's warranty obligation on its reagent discs as part of warranty reserves. Prior to July 1, 2007, the Company maintained a provision for defective reagent discs as part of sales allowances.

**Instruments.** Since the beginning of fiscal 2006, the Company's standard warranty obligation on instruments is two years. The estimated contractual warranty obligation is recorded when the related revenue is recognized and any additional amount is recorded when such cost is probable and can be reasonably estimated. The estimated accrual for warranty exposure is based on historical experience, estimated product failure rates, material usage, freight incurred in repairing the instrument after failure and known design changes.

**Reagent Discs.** Beginning on July 1, 2007, the Company records a provision for defective reagent discs when the related sale is recognized and any additional amount is recorded when such cost is probable and can be reasonably estimated. The warranty cost includes the replacement costs and freight of a defective reagent disc. Prior to July 1, 2007, the Company recorded a provision for defective reagent discs as part of sales allowances since the Company primarily issued a credit to customers for defective reagent discs. Starting on July 1, 2007, the provision for defective reagent discs is recorded as part of warranty reserves, since the Company replaces defective reagent discs rather than issue a credit to customers. The change did not have a material impact on the Company's financial statements. During the three and nine months ended December 31, 2008, the provision for warranty expense related to replacement of defective reagent discs was \$81,000 and \$291,000, respectively. The balance of accrued warranty reserve related to replacement of defective reagent discs at December 31, 2008 and 2007 was \$392,000 and \$270,000, respectively, which was classified as current liability on the balance sheet.

The Company evaluates its estimates for warranty reserves on an ongoing basis and believes it has the ability to reasonably estimate warranty costs. However, unforeseeable changes in factors may impact the estimate for warranty and such changes could cause a material change in the Company's warranty reserve accrual in the period in which the change was identified.

The change in the Company's accrued warranty reserve during the three and nine months ended December 31, 2008 and 2007 is summarized as follows (in thousands):

	<b>Three Months Ended December 31, 2008</b>		<b>Nine Months Ended December 31, 2008</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Balance at beginning of period	\$ 2,242	\$ 1,294	\$ 1,948	\$ 847
Provision for warranty expense	387	625	1,406	1,499
Warranty costs incurred	(244)	(266)	(969)	(693)
Balance at end of period	2,385	1,653	2,385	1,653
Non-current portion of warranty reserve	748	496	748	496

Current portion of warranty reserve	\$	1,637	\$	1,157	\$	1,637	\$	1,157
-------------------------------------	----	-------	----	-------	----	-------	----	-------

**NOTE 7. LINE OF CREDIT**

The Company has a line of credit with Comerica Bank-California which provides for borrowings of up to \$2.0 million. The line of credit may be terminated upon notification by either party and any outstanding balance is payable upon demand. The line of credit bears interest at the bank's prime rate minus 0.25%, which totaled 3.00% at December 31, 2008, and is payable monthly. At December 31, 2008, of the \$2.0 million available, \$97,000 was committed to secure a letter of credit for the Company's facilities lease. At December 31, 2008, there was no amount outstanding under the Company's line of credit. The weighted average interest rates on the line of credit during the three months ended December 31, 2008 and 2007 were 3.81% and 7.27%, respectively.

## **Table of Contents**

The line of credit agreement contains certain financial covenants, which are evaluated on a quarterly basis. At December 31, 2008, the Company was in compliance with each of these covenants. Included in these financial covenants, among other stipulations, are the following requirements:

The Company must have a minimum net income of \$25,000 before preferred stock dividends and accretion on preferred stock 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 required to be profitable, as defined, on a fiscal year to date basis beginning, with respect to the current fiscal year, with the six month period ended September 30, 2008 and to have net income before preferred stock dividends and accretion on preferred stock of at least \$1.2 million for the fiscal year ending March 31, 2009.

The Company is required to comply with certain financial covenants as follows:

<b>Financial Covenants</b>	<b>Requirements</b>
Quick ratio, as defined	Not less than 2.00 to 1.00
Cash flow coverage, as defined	Not less than 1.25 to 1.00
Debt to net worth ratio, as defined	Not greater than 1.00 to 1.00
Tangible effective net worth, as defined	Not less than \$25.7 million
Borrowings under the line of credit are collateralized by the Company's net book value of assets of \$122.2 million at December 31, 2008, including its intellectual property.	

## **NOTE 8. COMMITMENTS AND CONTINGENCIES**

**Purchase Commitments.** In November 2003, the Company entered into an original equipment manufacturing ( OEM ) agreement with Diatron Messtechnik GmbH ( Diatron ) of Austria to purchase Diatron hematology instruments. The Diatron hematology instruments are currently supplied by Diatron Medical Instruments PLC. Under the terms of the OEM agreement, the Company became committed to purchase a minimum number of hematology instruments from Diatron once the product was qualified for sale, which occurred in May 2004. In September 2006, the terms of the OEM agreement, with respect to the purchase commitments, were revised and the Company completed its purchase commitments in the quarter ended December 31, 2007. In February 2008, the terms of the OEM agreement, with respect to the purchase commitments, were again revised. Under the amended OEM agreement currently in effect, the Company is committed to purchase a minimum number of hematology instruments through fiscal 2009. In August 2008, the Company entered into a purchase order with scheduled shipping terms through January 2009 for the remaining number of hematology instruments to be purchased under the amended OEM agreement.

Effective January 5, 2009, the Company entered into a license agreement with Inverness Medical Switzerland GmbH ( Inverness ), pursuant to which the Company licensed co-exclusively certain worldwide patent rights related to lateral flow immunoassay technology in the field of animal health diagnostics in the professional marketplace. The license agreement provides that Inverness shall not grant any future rights to any third parties under its current lateral flow patent rights in the animal health diagnostics field in the professional marketplace. The license agreement enables the Company to develop and market products under rights from Inverness to address animal health and laboratory animal research markets.

The Company paid a \$5.0 million up-front license fee to Inverness in January 2009 and is required to pay royalties, including annual minimum royalties of \$500,000 to \$1.0 million per year over the term of the agreement, starting in fiscal 2011 through the date of the expiration of the last patent licensed under the agreement. Royalties are based on sales of products covered by claims under the licensed Inverness patent rights.

**Litigation.** The Company is involved from time to time in various litigation matters in the normal course of business. The Company believes that the ultimate resolution of these matters will not have a material effect on its financial position or results of operations.

## **NOTE 9. SHARE-BASED COMPENSATION**

Effective April 1, 2006, the Company adopted SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS No. 123(R) ) using the modified prospective method. SFAS No. 123(R) requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including stock options and restricted stock units based on their fair values, in the Company's results of operations. The share-based compensation expense includes expense for unvested awards at March 31, 2006 and all awards granted subsequent to March 31, 2006. Share-based compensation expense for the unvested awards outstanding at March 31, 2006 is based on the grant-date fair value as used in calculating the pro forma disclosures in prior period financial statements in accordance with the provisions of SFAS No. 123, Accounting for Stock-Based Compensation.

Share-based compensation has been classified in the income statement or capitalized on the balance sheet in the same manner as cash compensation paid to employees. Non-cash compensation expense recognized for share-based awards during the three months ended December 31, 2008 and 2007 was \$465,000 and \$285,000, respectively, and during the nine months ended December 31, 2008 and 2007 was \$1.3 million and \$831,000, respectively.

## **Table of Contents**

Capitalized share-based compensation cost at December 31, 2008 and 2007 was \$34,000 and \$26,000, respectively, which was included in inventory on the balance sheet.

### *Cash Flow Impact*

SFAS No. 123(R) requires cash flows resulting from excess tax benefits to be classified as a part of cash flows from financing activities. Excess tax benefits are realized tax benefits from tax deductions for exercised stock options and vested restricted stock units in excess of the deferred tax asset attributable to share-based compensation expense for such share-based awards. Excess tax benefits classified as a financing cash inflow for the three months ended December 31, 2008 and 2007 were \$2.0 million and \$132,000, respectively, and for the nine months ended December 31, 2008 and 2007 were \$5.1 million and \$270,000, respectively.

### **Equity Compensation Plans**

The Company's share-based compensation plans are described below.

**2005 Equity Incentive Plan.** The Company's 2005 Equity Incentive Plan (the "Equity Incentive Plan") restated and amended the Company's 1998 Stock Option Plan. The Equity Incentive Plan allows for the awards of stock options, stock appreciation rights, restricted stock awards, restricted stock units, performance shares, performance units, deferred compensation awards or other share-based awards to employees, directors and consultants. On October 28, 2008, the Company's shareholders approved an amendment to the Equity Incentive Plan to increase the shares reserved for issuance under the Equity Incentive Plan by 500,000 shares. As of December 31, 2008, the Equity Incentive Plan provides for the issuance of a maximum of 5,386,000 shares, of which 706,000 shares of common stock were then available for future issuance.

Options granted to employees and directors generally expire ten years from the grant date. Options granted to employees generally become exercisable over a period of four years based on cliff-vesting terms and continuous employment. Options granted to non-employee directors generally become exercisable over a period of one year based on monthly vesting terms and continuous service. See the "Stock Options" section in this Note 9 for additional information.

Restricted stock units awarded to employees generally vest over a period of four years and the awards may also be subject to accelerated vesting upon achieving certain performance-based milestones and continuous employment during the vesting period. Restricted stock units awarded to non-employee directors generally vest in full one year after the grant date based on continuous service. See the "Restricted Stock Units" section in this Note 9 for additional information.

**1992 Outside Directors' Stock Option Plan.** Under the Company's 1992 Outside Directors' Stock Option Plan (the "Directors Plan"), options to purchase shares of common stock were automatically granted, annually, to non-employee directors. Options under the Directors Plan were nonqualified stock options and were granted at the fair market value on the date of grant and expired ten years from the date of grant. Options granted to non-employee directors generally become exercisable over a period of one year based on monthly vesting terms and continuous service. The Directors Plan provided for the issuance of a maximum of 250,000 shares. As of December 31, 2008, all outstanding options under the Directors Plan were fully vested and fully exercisable and no shares of common stock were available for future issuance because the time period for granting options expired in accordance with the terms of the Directors Plan in June 2002.

The Company's current practice is to issue new shares of common stock from its authorized shares for share-based awards upon the exercise of stock options or vesting of restricted stock units.

### **Stock Options**

Prior to April 1, 2006, the Company granted stock options to employees, with an exercise price equal to the closing market price of the Company's common stock on the date of grant and with cliff-vesting terms over four years, conditional on continuous employment with the Company. In addition, prior to April 1, 2006, the Company granted stock options to non-employee directors with an exercise price equal to the closing market price of the Company's common stock on the date of grant and became exercisable over a period of one year based on monthly vesting terms, conditional on continuous service to the Company. There were no stock options granted during fiscal 2007 or 2008 or during the nine months ended December 31, 2008.



**Table of Contents**

The Company used the Black-Scholes option pricing model to determine the fair value of stock options granted prior to March 31, 2006. The fair value of each stock option granted was estimated on the date of the grant using the Black-Scholes option pricing model, based on a multiple option valuation approach, and forfeitures were recognized as they occurred. As of December 31, 2008, the total unrecognized compensation expense related to stock options granted amounted to \$4,000, which is expected to be recognized over a weighted average period of 0.12 years.

***Stock Option Activity***

The following table summarizes information regarding options outstanding and options exercisable at December 31, 2008 and the changes during the nine-month period then ended:

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (In thousands)
Outstanding at March 31, 2008	1,044,000	\$ 7.82		
Granted				
Exercised	(156,000)	3.35		
Canceled or forfeited	(1,000)	11.85		
Outstanding at December 31, 2008	887,000	\$ 8.60	3.38	\$ 7,527
Vested and expected to vest at December 31, 2008	887,000	\$ 8.60	3.38	\$ 7,525
Exercisable at December 31, 2008	884,000	\$ 8.59	3.38	\$ 7,513

The aggregate intrinsic value in the table above represents the pre-tax intrinsic value, based on the Company's closing stock price as of December 31, 2008, that would have been received by the option holders had all option holders exercised their stock options as of that date. Total intrinsic value of stock options exercised during the three months ended December 31, 2008 and 2007 was \$1.3 million and \$4.3 million, respectively, and during the nine months ended December 31, 2008 and 2007 was \$2.4 million and \$8.3 million, respectively. Cash proceeds from stock options exercised during the three months ended December 31, 2008 and 2007 were \$181,000 and \$663,000, respectively, and during the nine months ended December 31, 2008 and 2007 were \$522,000 and \$2.3 million, respectively.

**Restricted Stock Units**

The Company grants restricted stock unit awards to employees and directors as part of its share-based compensation program which began in fiscal 2007. The restricted stock unit awards entitle holders to receive shares of common stock at the end of a specified period of time. Vesting for restricted stock unit awards is based on continuous employment or service of the holder. Upon vesting, the equivalent number of common shares are typically issued net of tax withholdings. If the vesting conditions are not met, unvested restricted stock unit awards will be forfeited. Generally, the restricted stock unit awards vest according to one of the following time-based vesting schedules:

*Restricted stock unit awards to employees:* Four year time-based vesting as follows: five percent vesting after the first year; additional 10 percent after the second year; additional 15 percent after the third year; and the remaining 70 percent after the fourth year of continuous employment with the Company.

*Restricted stock unit awards to non-employee directors:* 100 percent vesting after one year of continuous service to the Company.

Certain restricted stock unit awards to employees in fiscal 2007 may also be subject to accelerated vesting upon achieving certain performance-based milestones. Additionally, the Compensation Committee of the Company's Board of Directors (the "Compensation Committee"), in its discretion, may provide in the event of a change in control for the acceleration of vesting and/or settlement of the restricted stock unit held by a participant upon such conditions and to such extent as determined by the Compensation Committee. The Company's Board of Directors has adopted an executive change in control severance plan, which it may terminate or amend at any time, that provides that awards granted to executive officers will accelerate fully on a change of control. The vesting of non-employee director awards granted under the Equity Incentive Plan automatically will also accelerate in full upon a change in control.

The fair value of restricted stock unit awards used in the Company's expense recognition method is measured based on the number of shares granted and the closing market price of the Company's common stock on the date of grant. Such value is recognized as an expense over the corresponding requisite service period. The Company's policy is to recognize the expense based on the vested portions of the awards. The share-based compensation expense is reduced for an estimate of the restricted stock unit awards that are expected to be forfeited. The forfeiture estimate is based on historical data and other factors, and compensation expense is adjusted for actual results. As of December 31, 2008, the total unrecognized compensation expense related to restricted stock unit awards granted amounted to \$13.1 million, which is expected to be recognized over a weighted average period of 2.39 years.



**Table of Contents***Restricted Stock Unit Activity*

The following table summarizes restricted stock unit activity for the nine months ended December 31, 2008:

	<b>Number of Shares</b>	<b>Weighted Average Grant Date Fair Value(1)</b>
Unvested at March 31, 2008	494,000	\$ 23.21
Granted	247,000	23.81
Vested	(44,000)	23.32
Canceled or forfeited	(10,000)	20.68
Unvested at December 31, 2008	687,000	\$ 23.46

(1) The weighted average grant date fair value of restricted stock units is based on the number of shares and the closing market price of the Company's common stock on the date of grant.

Total intrinsic value of restricted stock units vested during the three months ended December 31, 2008 and 2007 was \$14,000 and \$4,000, respectively, and during the nine months ended December 31, 2008 and 2007 was \$1.1 million and \$481,000, respectively. The total grant date fair value of restricted stock units vested during the three months ended December 31, 2008 and 2007 was \$30,000 and \$3,000, respectively, and during the nine months ended December 31, 2008 and 2007 was \$1.0 million and \$544,000, respectively.

**NOTE 10. 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 common shares outstanding during the period. Diluted net income per share is computed by dividing the 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 using the treasury stock method. Dilutive potential common shares outstanding include outstanding stock options, restricted stock units and warrants.

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

	<b>Three Months Ended December 31,</b>		<b>Nine Months Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Numerator:				

Edgar Filing: ABAXIS INC - Form 10-Q

Net income	\$	3,356	\$	3,205	\$	9,429	\$	9,191
Denominator:								
Weighted average common shares outstanding basic		21,879,000		21,561,000		21,798,000		21,441,000
Weighted average effect of dilutive securities:								
Stock options		381,000		707,000		493,000		720,000
Restricted stock units		4,000		91,000		34,000		43,000
Warrants								4,000
Weighted average common shares outstanding diluted		22,264,000		22,359,000		22,325,000		22,208,000
Net income per share:								
Basic net income per share	\$	0.15	\$	0.15	\$	0.43	\$	0.43
Diluted net income per share	\$	0.15	\$	0.14	\$	0.42	\$	0.41

The Company excluded the following stock options and warrants from the computation of diluted weighted average shares outstanding because the exercise price of the stock options and warrants is greater than the average market price of the Company's common stock during the period and, therefore, the inclusion of these stock options and warrants would be antidilutive to net income per share:

	<b>Three Months Ended December 31, 2008</b>		<b>2007</b>		<b>Nine Months Ended December 31, 2008</b>		<b>2007</b>	
Weighted average number of shares underlying antidilutive stock options and warrants		185,000				159,000		
Weighted average exercise price per share underlying antidilutive stock options and warrants	\$	21.02	\$		\$	21.65	\$	

**Table of Contents**

The Company excluded the following restricted stock units from the computation of diluted weighted average shares outstanding because the inclusion of these awards would be antidilutive to net income per share:

	<b>Three Months Ended December 31,</b>		<b>Nine Months Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Weighted average number of shares underlying antidilutive restricted stock units	679,000		190,000	4,000

**NOTE 11. INCOME TAXES**

The Company's effective tax rate for the three months ended December 31, 2008 and 2007 was 34% and 35%, respectively, and for the nine months ended December 31, 2008 and 2007 was 36% and 37%, respectively. During the three and nine months ended December 31, 2008 and 2007, the effective tax rate included a tax benefit for tax-exempt investments and included a tax benefit for the federal research and development tax credit. During the three and nine months ended December 31, 2008, the effective tax rate also included a benefit for federal qualified production activities. The decrease in the effective tax rate for the three and nine months ended December 31, 2008, as compared to the three and nine months ended December 31, 2007, was due to the recording of a tax benefit for federal and California research and development tax credits relating to the prior year which have been recorded in the three months ended December 31, 2008 as a discrete item.

The Company did not have any unrecognized tax benefits as of December 31, 2008 or December 31, 2007. During the three and nine months ended December 31, 2008 and 2007, the Company did not recognize any interest or penalties related to unrecognized tax benefits.

**NOTE 12. COMPREHENSIVE INCOME**

The following is a summary of comprehensive income for the three and nine months ended December 31, 2008 and 2007 (in thousands):

	<b>Three Months Ended December 31,</b>		<b>Nine Months Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Net income	\$ 3,356	\$ 3,205	\$ 9,429	\$ 9,191
Other comprehensive income:				
Change in unrealized gain (loss) on investments, net of tax	393		1,415	
Comprehensive income	\$ 3,749	\$ 3,205	\$ 10,844	\$ 9,191

**NOTE 13. SEGMENT REPORTING INFORMATION**

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the Company's chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance.

The Company develops, manufactures, markets and sells portable blood analysis systems for use in the human or veterinary patient-care setting to provide clinicians with rapid blood constituent measurements. The Company identifies its reportable segments as those customer groups that represent more than 10% of the combined revenue or gross profit or loss of all reported operating segments. The Company manages its business on the basis of the following two reportable segments: (i) the medical market and (ii) the veterinary market, which are based on the products sold by market and customer group. Each reportable segment has similar manufacturing processes, technology and shared infrastructures. The accounting policies for segment reporting are the same as for the Company as a whole. Assets are not segregated by segments since the Company's chief operating decision maker does not use assets as a basis to evaluate a particular segment's performance.

**Medical Market**

In the medical market reportable segment, the Company serves a worldwide customer group consisting of military installations (ships, field hospitals and mobile care units), physicians office practices across all specialties, urgent care and walk-in clinics (free-standing or hospital-connected), home care providers (national, regional or local), nursing homes, ambulance companies, oncology treatment clinics, hospital labs and draw stations. The products manufactured and sold in this segment primarily consist of Piccolo chemistry analyzers and medical reagent discs.

**Table of Contents****Veterinary Market**

In the veterinary market reportable segment, the Company serves a worldwide customer group consisting of companion animal hospitals, animal clinics with mixed practices of small animals, birds and reptiles, equine and bovine practitioners, veterinary emergency clinics, veterinary referral hospitals, universities, government, pharmaceutical companies, biotechnology companies and private research laboratories. The products manufactured and sold in this segment primarily consist of VetScan chemistry analyzers and veterinary reagent discs. The Company also sells OEM-supplied products in this segment, consisting primarily of hematology analyzers and hematology reagent kits.

The table below summarizes revenues, cost of revenues and gross profit from the Company's two operating segments and from certain unallocated items for the three and nine months ended December 31, 2008 and 2007 (in thousands):

	<b>Three Months Ended December 31,</b>		<b>Nine Months Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
<b>Revenues:</b>				
Medical Market	\$ 7,175	\$ 6,005	\$ 19,719	\$ 16,455
Veterinary Market	17,907	18,073	54,465	52,498
Other(1)	1,882	1,612	5,040	4,860
 Total revenues	 26,964	 25,690	 79,224	 73,813
<b>Cost of revenues:</b>				
Medical Market	3,548	2,946	9,772	8,194
Veterinary Market	7,389	8,677	22,672	23,525
Other(1)	922	458	2,830	1,612
 Total cost of revenues	 11,859	 12,081	 35,274	 33,331
<b>Gross profit:</b>				
Medical Market	3,627	3,059	9,947	8,261
Veterinary Market	10,518	9,396	31,793	28,973
Other(1)	960	1,154	2,210	3,248
 Gross profit	 \$ 15,105	 \$ 13,609	 \$ 43,950	 \$ 40,482

(1) Represents unallocated items, not specifically identified to any particular business segment.

**NOTE 14. REVENUES BY PRODUCT CATEGORY AND GEOGRAPHIC REGION AND SIGNIFICANT CONCENTRATIONS****Revenue Information**

The following is a summary of revenues for each group of products provided by the Company (in thousands):

<b>Revenues by Product Category</b>	<b>Three Months Ended December 31,</b>		<b>Nine Months Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Instruments	\$ 7,976	\$ 8,393	\$ 22,670	\$ 22,319
Reagent discs and kits	16,751	15,305	50,378	45,244
Other products	1,340	1,462	3,767	4,797
Product sales, net	26,067	25,160	76,815	72,360
Development and licensing revenue	897	530	2,409	1,453
Total revenues	\$ 26,964	\$ 25,690	\$ 79,224	\$ 73,813

The following is a summary of revenues by geographic region based on customer location (in thousands):

<b>Revenues by Geographic Region</b>	<b>Three Months Ended December 31,</b>		<b>Nine Months Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
North America	\$ 22,852	\$ 21,628	\$ 65,629	\$ 61,868
Europe	3,040	3,397	10,766	9,629
Asia Pacific and rest of the world	1,072	665	2,829	2,316
Total revenues	\$ 26,964	\$ 25,690	\$ 79,224	\$ 73,813

**Table of Contents****Significant Concentrations**

Revenues from significant customers as a percentage of total revenues were as follows:

<b>Distributor</b>	<b>Geographical Location</b>	<b>Three Months Ended December 31,</b>		<b>Nine Months Ended December 31,</b>	
		<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Walco International, Inc., d/b/a					
DVM Resources	United States	<10%	12%	<10%	13%

During the three and nine months ended December 31, 2008, there were no distributors or direct customers that accounted for more than 10% of total worldwide revenues.

At December 31, 2008, one distributor in the United States accounted for 14% of the Company's trade receivables. At December 31, 2007, one distributor in the United States accounted for 16% of the Company's trade receivables.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****FORWARD-LOOKING STATEMENTS**

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, intends, plans, future, project, would, may, could, should, might, 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, in Part II, Item 1A of this report and in Part I, Item 1A of our most recent Annual Report on Form 10-K filed with the Securities and Exchange Commission (the SEC), that could cause actual results to differ materially from historical results or those anticipated. Such risks and uncertainties include, but are not limited to, 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 Abaxis' 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. (Abaxis, us or we) was incorporated in California in 1989. Our principal offices are located at 3240 Whipple Road, Union City, California 94587. Our telephone number is (510) 675-6500 and 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 SEC. Our common stock trades on the NASDAQ Global Market under the symbol ABAX.

We develop, manufacture, market and sell portable blood analysis systems for use in the human or veterinary patient-care setting to provide clinicians with rapid blood constituent measurements. Our primary product is a blood analysis system, consisting of a compact 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 14 tests on human patients and 13 tests on veterinary patients. We manufacture the system in our manufacturing facilities in Union City, California and we market our blood chemistry analyzers in both the medical market and in the veterinary market, as described below.

**Medical Market:** We currently market the blood analysis system in the medical market under the name Piccolo xpress®. Through October 2006, we marketed the blood analysis system in the medical market as the Piccolo®, now referred to as the Piccolo Classic. We continue to support and service our current population of Piccolo xpress and Piccolo Classic chemistry analyzers.

Veterinary Market: We currently market the blood analysis system in the veterinary market under the name VetScan VS2®. Through March 2006, we marketed the blood analysis system in the veterinary market as the VetScan®, now referred to as the VetScan Classic. We continue to support and service our current population of VetScan VS2 and VetScan Classic chemistry analyzers.



## **Table of Contents**

In September 2007, we introduced a veterinary hematology instrument under the name VetScan HM5. The VetScan HM5 offers a 22-parameter complete blood count (CBC) analysis, including a five-part differential cell counter specifically designed for veterinary applications. In May 2004, we introduced a veterinary hematology instrument that offers an 18-parameter CBC analysis, including a three-part white blood cell differential, marketed originally as the VetScan HMII, and is now referred to as the VetScan HM2. We currently purchase the hematology instruments from Diatron Medical Instruments PLC. of Budapest, Hungary. Through April 2004, we marketed a veterinary hematology instrument under the name VetScan HMT. We continue to support and service our current population of VetScan HM5, VetScan HM2, VetScan HMII and VetScan HMT hematology instruments. We also market reagent kits to be used with our hematology instruments which we currently purchase from three suppliers: Clinical Diagnostic Solutions, Inc., Diatron and Mallinckrodt Baker BV.

On July 1, 2008, our sales office in Darmstadt, Germany was incorporated as Abaxis Europe GmbH to market, promote and distribute diagnostic systems for medical and veterinary uses. As a result, Abaxis Europe GmbH became a wholly-owned subsidiary of Abaxis. The subsidiary was formed to provide customer support in a timely manner in response to the growing and increasingly diverse services needs of customers in the European market.

Our sales for any future periods are not predictable with a significant degree of certainty, and may depend on a number of factors outside of our control, including but not limited to inventory or timing considerations by our distributors. We generally operate with a limited order backlog because our products are typically 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. In addition, 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 the sales volumes of our Piccolo and VetScan 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.

## **CRITICAL ACCOUNTING POLICIES, ESTIMATES AND JUDGMENTS**

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. On an on-going basis, we evaluate our estimates and the sensitivity of these estimates to deviations in the assumptions used in making them. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. However, there can be no assurance that our actual results will not differ from these estimates.

We have identified the policies below as critical because they are not only important to understanding our financial condition and results of operations, but also because application and interpretation of these policies requires both judgment and estimates of matters that are inherently uncertain and unknown. Accordingly, actual results may differ materially from our estimates. The impact and any associated risks related to these policies on our business operations are discussed below. A more detailed discussion on the application of these and other accounting policies are included in our Annual Report on Form 10-K for the fiscal year ended March 31, 2008.

**Revenue Recognition and Deferred Revenue.** Our primary customers are distributors and direct customers in both the medical and veterinary markets. Revenues from product sales, net of estimated sales allowances and rebates, are recognized when (i) evidence of an arrangement exists, (ii) upon shipment of the products to the customer, (iii) the sales price is fixed or determinable and (iv) collection of the resulting receivable is reasonably assured. Rights of return are not provided.

We recognize revenue associated with extended maintenance agreements ratably over the life of the contract. Amounts collected in advance of revenue recognition are recorded as a current or non-current liability based on the time from the balance sheet date to the future date of revenue recognition. We provide incentives in the form of free goods or extended maintenance agreements to customers in connection with the sale of our instruments. Revenues from such sales is allocated separately to the instruments and incentives based on the relative fair value of each element. Revenues allocated to incentives is deferred until the goods are shipped to the customer or is recognized

ratably over the life of the maintenance contract.

We periodically offer trade-in programs to customers for trading in an existing instrument to purchase a new instrument and we will either provide incentives in the form of free goods or reduce the sales price of the instrument. These incentives in the form of free goods are recorded according to the policies described above.

**Distributor and Customer Rebates.** We offer distributor pricing rebates and customer incentives from time to time. The distributor pricing rebates are offered to distributors upon meeting the sales volume requirements during a qualifying period. The distributor pricing rebates are recorded as a reduction to gross revenues during the qualifying period. Cash rebates are offered to customers who purchase specific instruments during a promotional period. Cash rebates are recorded as a reduction to gross revenues.

**Table of Contents**

**Sales and Other Allowances.** We estimate a provision for defective reagent discs as part of sales allowances when we issue credits to customers for defective reagent discs. We also establish, upon shipment of our products to distributors, a provision for potentially defective reagent discs, based on estimates derived from historical experience. The provision for potentially defective reagent discs was recorded in sales allowances, using internal data available to estimate the level of inventory in the distribution channel, the lag time for customers to report defective reagent discs and the historical rates of defective reagent discs. Starting on July 1, 2007, the provision for potentially defective reagent discs is recorded as part of warranty reserves, instead of sales allowances, since we replace defective reagent discs rather than issue a credit to customers. Changes in our estimates for accruals related to provisions for defective reagent discs have not been material to our financial position or results of operations. In the future, the actual defective reagent discs may exceed our estimates, which could adversely affect our financial results.

**Allowance for Doubtful Accounts.** We maintain an allowance for doubtful accounts based on our assessment of the collectibility of the amounts owed to us by our customers. In determining the amount of the allowance, we make judgments about the creditworthiness of customers which is mostly determined by the customer's payment history and the outstanding period of accounts. We specifically identify amounts that we believe to be uncollectible and the allowance for doubtful accounts is adjusted accordingly. An additional allowance is recorded based on certain percentages of our aged receivables, using historical experience to estimate the potential uncollectible and our assessment of the general financial condition of our customer base. If our actual collections experience changes, revisions to our allowances may be required, which could adversely affect our operating income.

**Warranty Reserves.** We provide for the estimated future costs to be incurred under our standard warranty obligation on our instruments. Our standard warranty obligation on instruments is two years. The estimated contractual warranty obligation is recorded when the related revenue is recognized and any additional amount is recorded when such cost is probable and can be reasonably estimated. While we engage in product quality programs and processes, including monitoring and evaluating the quality of our suppliers, our estimated accrual for warranty exposure is based on historical experience, estimated product failure rates, material usage and freight incurred in repairing the instrument after failure and known design changes.

A provision for defective reagent discs is recorded when related sales are recognized and any additional amounts are recorded when such costs are probable and can be reasonably estimated, at which time they are included in cost of revenues. Prior to July 1, 2007, we primarily issued a credit to customers for defective reagent discs and, therefore, the provision for estimated costs for defective reagent discs, which includes the replacement costs and freight of a defective reagent disc, was recorded as part of sales and other allowances. Starting on July 1, 2007, the provision for defective reagent discs is recorded as part of warranty reserves, since we replace defective reagent discs rather than issue a credit to customers.

We analyze the adequacy of the ending accrual balance of warranty reserves each quarter. The determination of warranty reserves requires us to make estimates of the expected costs to repair or replace the instruments and to replace defective reagent discs under warranty. If actual repair or replacement costs of instruments or replacement costs of reagent discs differ significantly from our estimates, adjustments to cost of revenues may be required.

**Inventories.** We state inventories at the lower of cost or market, cost being determined using standard costs which approximates the first-in, first-out (FIFO) method. Inventories include material, labor and overhead. We establish provisions for excess, obsolete and unusable inventories after evaluation of future demand and market conditions. If future demand or actual market conditions are less favorable than those estimated by management or if a significant amount of the material were to become unusable, additional inventory write-downs may be required, which would have a negative effect on our operating income.

**Long-Lived Assets.** The carrying value of our long-lived assets is reviewed for impairment, in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We look to current and future profitability, as well as current and future undiscounted cash flows, excluding financing costs, as primary indicators of recoverability. An impairment loss would be recognized when the sum of the undiscounted future net cash flows expected to result from the use of the asset and its eventual disposal is less than the carrying amount. If impairment is determined to exist, any related impairment loss is calculated based on

fair value.

**Income Taxes.** We account for income taxes using the liability method under which deferred tax assets and liabilities are determined based on the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amounts to be recovered.

Effective April 1, 2007, we adopted the provisions of Financial Accounting Standards Board Interpretation 48,

Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with SFAS No. 109 and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Our policy to include interest and penalties related to gross unrecognized tax benefits within our provision for income taxes did not change despite the adoption of FIN 48.

## **Table of Contents**

**Share-Based Compensation Expense.** Effective April 1, 2006, we adopted SFAS No. 123 (revised 2004),

Share-Based Payment ( SFAS No. 123(R) ) using the modified prospective method. Under the fair value provisions of SFAS No. 123(R), we recognize share-based compensation expense, net of an estimated forfeiture rate, for those shares expected to vest over the requisite service period of the award to employees and directors.

We use the Black-Scholes option pricing model to determine the fair value of stock options granted prior to March 31, 2006. Determining the appropriate fair value model and calculating the fair value of share-based awards requires highly subjective assumptions, as described below.

**Risk-free interest rate:** The risk-free interest rate is based on U.S. Treasury yields in effect at the time of grant for the expected term of the option.

**Expected stock price volatility:** We estimate the volatility of our common stock at the date of grant based on the historical volatility of our common stock.

**Expected term:** We estimate the expected term of stock options granted based on historical exercise and post-vesting termination patterns, which we believe are representative of future behavior.

**Expected dividends:** We have not paid cash dividends on our common stock and we do not anticipate paying cash dividends in the foreseeable future; consequently, we use an expected dividend yield of zero.

For restricted stock units, the assumptions to calculate compensation expense is based on the fair value of our stock at the grant date. As a result, if factors change and we use different assumptions, our share-based compensation expense could be materially different in the future.

As required by SFAS No. 123(R), employee share-based compensation expense recognized is calculated based on the awards expected to vest and reduced for estimated forfeitures. The forfeiture rate is estimated based on historical data of our share-based awards that are granted and cancelled prior to vesting and upon historical experience of employee turnover. Changes in estimated forfeiture rates and differences between estimated forfeiture rates and actual experience may result in significant, unanticipated increases or decreases in share-based compensation expense from period to period. To the extent we revise our estimate of the forfeiture rate in the future, our share-based compensation expense could be materially impacted in the quarter of revision, as well as in following quarters.

**Fair Value Measurements.** Effective April 1, 2008, we adopted SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ) to measure the fair value of our financial assets and financial liabilities. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS No. 157 establishes a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) an entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The fair value hierarchy consists of three broad levels, which gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy under SFAS No. 157 are described below:

**Level 1:** Quoted prices (unadjusted) in active markets for identical assets or liabilities. We used Level 1 assumptions for our cash, cash equivalents and certificates of deposits, which are traded in an active market. The valuations are based on quoted prices of the underlying security that are readily and regularly available in an active market, and accordingly, a significant degree of judgment is not required. As of December 31, 2008, we had Level 1 financial assets or liabilities consisting of cash, cash equivalents and certificates of deposits.

**Level 2:** Directly or indirectly observable market based inputs used in models or other valuation methodologies. As of December 31, 2008, we did not have any Level 2 financial assets or liabilities.

**Level 3:** Unobservable inputs that are supported by little or no market data and require the use of significant management judgment. As of December 31, 2008, we did not have any Level 3 financial assets or liabilities.



**Table of Contents****RESULTS OF OPERATIONS**

We develop, manufacture, market and sell portable blood analysis systems for use in the human or veterinary patient-care setting to provide clinicians with rapid blood constituent measurements. We operate in two segments: (i) the medical market and (ii) the veterinary market. See Segment Results in this section for a detailed discussion.

**Total Revenues**

**Revenues by Geographic Region and by Product Category.** Revenues by geographic region based on customer location and revenues by product category during the three and nine months ended December 31, 2008 and 2007 were as follows (in thousands, except percentages):

Revenues by Geographic Region	Three Months Ended December 31,		Change Increase/Decrease		Percent		Nine Months Ended December 31,		Change Increase/Decrease		Percent	
	2008	2007	(Decrease)	Change			2008	2007	(Decrease)	Change		
North America	\$ 22,852	\$ 21,628	\$ 1,224		6%		\$ 65,629	\$ 61,868	\$ 3,761		6%	
Percentage of total revenues	85%	84%					83%	84%				
Europe	3,040	3,397	(357)		(11%)		10,766	9,629	1,137		12%	
Percentage of total revenues	11%	13%					14%	13%				
Asia Pacific and rest of the world	1,072	665	407		61%		2,829	2,316	513		22%	
Percentage of total revenues	4%	3%					3%	3%				
Total revenues	\$ 26,964	\$ 25,690	\$ 1,274		5%		\$ 79,224	\$ 73,813	\$ 5,411		7%	

Revenues by Product Category	Three Months Ended December 31,		Change Increase/Decrease		Percent		Nine Months Ended December 31,		Change Increase/Decrease		Percent	
	2008	2007	(Decrease)	Change			2008	2007	(Decrease)	Change		
Instruments	\$ 7,976	\$ 8,393	\$ (417)		(5%)		\$ 22,670	\$ 22,319	\$ 351		2%	
Percentage of total revenues	30%	33%					29%	30%				
Reagent discs and kits	16,751	15,305	1,446		9%		50,378	45,244	5,134		11%	
Percentage of total revenues	62%	59%					63%	61%				
Other products	1,340	1,462	(122)		(8%)		3,767	4,797	(1,030)		(21%)	
Percentage of total revenues	5%	6%					5%	7%				
Product sales, net	26,067	25,160	907		4%		76,815	72,360	4,455		6%	
Percentage of total revenues	97%	98%					97%	98%				
Development and licensing revenue	897	530	367		69%		2,409	1,453	956		66%	
Percentage of total revenues	3%	2%					3%	2%				
Total revenues	\$ 26,964	\$ 25,690	\$ 1,274		5%		\$ 79,224	\$ 73,813	\$ 5,411		7%	

***Three Months Ended December 31, 2008 Compared to Three Months Ended December 31, 2007***

**North America.** During the three months ended December 31, 2008, total revenues in North America increased 6%, or \$1.2 million, as compared to the three months ended December 31, 2007. Components of the change in North America were as follows:

**Instruments.** During the three months ended December 31, 2008, total revenues from instruments sold in North America decreased 6%, or \$378,000, as compared to the three months ended December 31, 2007. The primary factors of the change were as follows:

- (i) Sales of our Piccolo chemistry analyzers in North America (excluding the U.S. government) decreased 30%, or \$602,000, primarily due to economic conditions and the resulting impact of reduced capital spending at the physician office level and lower average selling prices due to sales of reconditioned Piccolo chemistry analyzers. The decrease was partially offset by an increase in sales of our Piccolo chemistry analyzers to the U.S. government of 142%, or \$451,000, primarily due to an increase in the U.S. Military's needs for these products, which were not predictable.
- (ii) Sales of our VetScan chemistry analyzers in North America increased 17%, or \$328,000, primarily due to (a) quality and reliability improvements on our VetScan chemistry analyzers and (b) a shift in our sales and marketing focus to our VetScan chemistry analyzers and reagent discs during the second and third quarters of fiscal 2009.
- (iii) Sales of our hematology instruments in North America decreased 22%, or \$555,000, primarily due to a shift in our sales and marketing focus to our VetScan chemistry analyzers and reagent discs during the second and third quarters of fiscal 2009.



## **Table of Contents**

**Reagent discs and kits.** During the three months ended December 31, 2008, total revenues from reagent discs and kits sold in North America increased 11%, or \$1.4 million, as compared to the three months ended December 31, 2007.

The primary factors of the change were as follows:

- (i) Medical reagent discs sales in North America (excluding the U.S. government) increased 51%, or \$1.0 million, primarily due to the expanded installed base of our Piccolo chemistry analyzers. The increase was partially offset by a decrease in medical reagent discs sold to the U.S. government of 42%, or \$229,000, primarily due to the U.S. Military's decreased needs for these products, which were not predictable.
- (ii) Veterinary reagent discs sales in North America increased 6%, or \$556,000, primarily due to the expanded installed base of our VetScan chemistry analyzers and higher average selling prices.
- (iii) Sales of our hematology reagent kits in North America increased 9%, or \$85,000, primarily due to an expanded installed base of our hematology instruments.

**Other products.** During the three months ended December 31, 2008, total revenues from other products sold in North America decreased 14%, or \$206,000, as compared to the three months ended December 31, 2007. The net decrease in other products was primarily due to a decrease in demand from Becton, Dickinson and Company for products using the Orbos Discrete Lyophilization Process, which is seasonal.

**Development and licensing.** During the three months ended December 31, 2008, total revenues from development and licensing in North America increased 69%, or \$367,000, as compared to the three months ended December 31, 2007. The increase from development and licensing revenue is primarily due to a licensing agreement with Cepheid, related to our proprietary technology, the Orbos® Discrete Lyophilization Process.

**Significant concentration.** There were no distributors or direct customers that accounted for more than 10% of our total worldwide revenues for the three months ended December 31, 2008. One distributor in the United States, DVM Resources, accounted for 12% of our total worldwide revenues for the three months ended December 31, 2007.

**Europe.** During the three months ended December 31, 2008, total revenues in Europe decreased 11%, or \$357,000, as compared to the three months ended December 31, 2007. Components of the change in Europe were as follows:

**Instruments.** During the three months ended December 31, 2008, total revenues from instruments sold in Europe decreased 8%, or \$110,000, as compared to the three months ended December 31, 2007. The primary factors of the change were as follows:

- (i) Sales of our Piccolo chemistry analyzers in Europe decreased 11%, or \$58,000.
- (ii) Sales of our VetScan chemistry analyzers in Europe increased 4%, or \$25,000.
- (iii) Sales of our hematology instruments in Europe decreased 44%, or \$77,000.

**Reagent discs and kits.** During the three months ended December 31, 2008, total revenues from reagent discs and kits sold in Europe decreased 16%, or \$330,000, as compared to the three months ended December 31, 2007. The primary factors of the change were as follows:

- (i) Medical reagent discs sales in Europe increased 159%, or \$495,000, primarily due to sales to a new distributor in Europe to supply medical reagent discs into local government hospitals.
- (ii) Veterinary reagent discs sales in Europe decreased 49%, or \$840,000, primarily due to (a) the timing of purchases by a distributor during the third quarter of fiscal 2009 and (b) the impact of the global economic downturn, which lowered the average consumption rate of veterinary reagent discs.
- (iii) Sales of our hematology reagent kits in Europe increased 31%, or \$15,000, as compared to the three months ended December 31, 2007.

**Other products.** During the three months ended December 31, 2008, total revenues from other products sold in Europe increased 1037%, or \$83,000.

## **Table of Contents**

**Asia Pacific and rest of the world.** During the three months ended December 31, 2008, total revenues in Asia Pacific and rest of the world increased 61%, or \$407,000, as compared to the three months ended December 31, 2007.

Components of the change in Asia Pacific and rest of the world were as follows:

***Instruments.*** During the three months ended December 31, 2008, total revenues from instruments sold in Asia Pacific and rest of the world increased 21%, or \$71,000, as compared to the three months ended December 31, 2007. The primary factors of the change were as follows:

- (i) Sales of our Piccolo chemistry analyzers in Asia Pacific and rest of the world increased 96%, or \$43,000.
- (ii) Sales of our VetScan chemistry analyzers in Asia Pacific and rest of the world increased 121%, or \$108,000.
- (iii) Sales of our hematology instruments in Asia Pacific and rest of the world decreased 40%, or \$80,000.

***Reagent discs and kits.*** During the three months ended December 31, 2008, total revenues from reagent discs and kits sold in Asia Pacific and rest of the world increased 102%, or \$335,000, as compared to the three months ended December 31, 2007. The primary factors of the change were as follows:

- (i) Medical reagent discs sales in Asia Pacific and rest of the world increased 163%, or \$31,000.
- (ii) Veterinary reagent discs sales in Asia Pacific and rest of the world increased 93%, or \$264,000, primarily due to the expanded installed base of our VetScan chemistry analyzers.
- (iii) Sales of our hematology reagent kits in Asia Pacific and rest of the world increased 148%, or \$40,000.

***Other products.*** During the three months ended December 31, 2008, total revenues from other products sold in Asia Pacific and rest of the world were substantially the same as in the three months ended December 31, 2007.

### ***Nine Months Ended December 31, 2008 Compared to Nine Months Ended December 31, 2007***

**North America.** During the nine months ended December 31, 2008, total revenues in North America increased 6%, or \$3.8 million, as compared to the nine months ended December 31, 2007. Components of the change in North America were as follows:

***Instruments.*** During the nine months ended December 31, 2008, total revenues from instruments sold in North America increased 2%, or \$290,000, as compared to the nine months ended December 31, 2007. The primary factors of the change were as follows:

- (i) Sales of our Piccolo chemistry analyzers to the U.S. government increased 180%, or \$1.2 million, primarily due to an increase in the U.S. Military's needs for these products during the first and third quarters of fiscal 2009, which were not predictable. Sales of our Piccolo chemistry analyzers in North America (excluding the U.S. government) decreased 17%, or \$928,000, primarily due to economic conditions and the resulting impact of reduced capital spending at the physician office level.
- (ii) Sales of our VetScan chemistry analyzers in North America increased 30%, or \$1.6 million, primarily due to (a) quality and reliability improvements on our VetScan chemistry analyzers and (b) a shift in our sales and marketing focus to our VetScan chemistry analyzers and reagent discs during the second and third quarters of fiscal 2009.
- (iii) Sales of our hematology instruments in North America decreased 24%, or \$1.6 million, primarily due to a shift in our sales and marketing focus to our VetScan chemistry analyzers and reagent discs during the second and third quarters of fiscal 2009.

***Reagent discs and kits.*** During the nine months ended December 31, 2008, total revenues from reagent discs and kits sold in North America increased 10%, or \$3.6 million, as compared to the nine months ended December 31, 2007.

The primary factors of the change were as follows:

- (i) Medical reagent discs sales in North America (excluding the U.S. government) increased 46%, or \$2.7 million, primarily due to the expanded installed base of our Piccolo chemistry analyzers. Medical reagent discs sold to the U.S. government decreased 13%, or \$216,000, primarily due to the U.S. Military's decreased needs for these products, which were not predictable.
- (ii) Veterinary reagent discs sales in North America increased 2%, or \$589,000, primarily due to higher average selling prices, partially offset by a decrease in units sold to our distributors.
- (iii) Sales of our hematology reagent kits in North America increased 19%, or \$489,000, primarily due to an expanded installed base of our hematology instruments and a higher average selling price on reagents kits for our VetScan HM5, a 5-part differential hematology instrument.

***Other products.*** During the nine months ended December 31, 2008, total revenues from other products sold in North America decreased 23%, or \$1.1 million, as compared to the nine months ended December 31, 2007. The net decrease in other products was primarily due to (i) an increase in maintenance contracts offered to customers from time to time as incentives in the form of free goods in connection with the sale of our products and (ii) a decrease in demand from Becton, Dickinson and Company for products using the Orbos Discrete Lyophilization Process, which is seasonal.

**Table of Contents**

***Development and licensing.*** During the nine months ended December 31, 2008, total revenues from development and licensing in North America increased 66%, or \$956,000, as compared to the nine months ended December 31, 2007. The increase from development and licensing revenue is primarily due to a licensing agreement with Cepheid, related to our proprietary technology, the Orbos® Discrete Lyophilization Process.

***Significant concentration.*** There were no distributors or direct customers that accounted for more than 10% of our total worldwide revenues for the nine months ended December 31, 2008. One distributor in the United States, DVM Resources, accounted for 13% of our total worldwide revenues for the nine months ended December 31, 2007.

***Europe.*** During the nine months ended December 31, 2008, total revenues in Europe increased 12%, or \$1.1 million, as compared to the nine months ended December 31, 2007. Components of the change in Europe were as follows:

***Instruments.*** During the nine months ended December 31, 2008, total revenues from instruments sold in Europe decreased 4%, or \$136,000, as compared to the nine months ended December 31, 2007. The primary factors of the change were as follows:

- (i) Sales of our Piccolo chemistry analyzers in Europe decreased 7%, or \$81,000.
- (ii) Sales of our VetScan chemistry analyzers in Europe decreased 2%, or \$48,000.
- (iii) Sales of our hematology instruments in Europe were substantially the same as in the nine months ended December 31, 2007.

***Reagent discs and kits.*** During the nine months ended December 31, 2008, total revenues from reagent discs and kits sold in Europe increased 20%, or \$1.2 million, as compared to the nine months ended December 31, 2007. The primary factors of the change were as follows:

- (i) Medical reagent discs sales in Europe increased 74%, or \$623,000, due to sales to a new distributor in Europe to supply medical reagent discs into local government hospitals, primarily in the third quarter of fiscal 2009.
- (ii) Veterinary reagent discs sales in Europe increased 12%, or \$593,000, primarily due to (a) the expanded installed base of our VetScan chemistry analyzers and (b) higher average selling prices.
- (iii) Sales of our hematology reagent kits in Europe increased 12%, or \$19,000.

***Other products.*** During the nine months ended December 31, 2008, total revenues from other products sold in Europe increased 57%, or \$38,000, as compared to the nine months ended December 31, 2007.

***Asia Pacific and rest of the world.*** During the nine months ended December 31, 2008, total revenues in Asia Pacific and rest of the world increased 22%, or \$513,000, as compared to the nine months ended December 31, 2007.

Components of the change in Asia Pacific and rest of the world were as follows:

***Instruments.*** During the nine months ended December 31, 2008, total revenues from instruments sold in Asia Pacific and rest of the world increased 22%, or \$197,000, as compared to the nine months ended December 31, 2007. The primary factors of the change were as follows:

- (i) Sales of our Piccolo chemistry analyzers in Asia Pacific and rest of the world increased 58%, or \$69,000.
- (ii) Sales of our VetScan chemistry analyzers in Asia Pacific and rest of the world increased 44%, or \$158,000, primarily due to renewed distributor sales in Japan.
- (iii) Sales of our hematology instruments in Asia Pacific and rest of the world decreased 7%, or \$30,000.

***Reagent discs and kits.*** During the nine months ended December 31, 2008, total revenues from reagent discs and kits sold in Asia Pacific and rest of the world increased 22%, or \$314,000, as compared to the nine months ended December 31, 2007. The primary factors of the change were as follows:

- (i) Medical reagent discs sales in Asia Pacific and rest of the world were substantially the same as in the nine months ended December 31, 2007.
- (ii) Veterinary reagent discs sales in Asia Pacific and rest of the world increased 21%, or \$251,000, primarily due to the expanded installed base of our VetScan chemistry analyzers.
- (iii) Sales of our hematology reagent kits in Asia Pacific and rest of the world increased 70%, or \$63,000.

**Table of Contents**

**Other products.** During the nine months ended December 31, 2008, total revenues from other products sold in Asia Pacific and rest of the world were substantially the same as in the nine months ended December 31, 2007.

**Segment Results*****Three Months Ended December 31, 2008 Compared to Three Months Ended December 31, 2007***

The following table presents revenues, cost of revenues, gross profit and percent of revenues by operating segments for the three months ended December 31, 2008 and 2007 (in thousands, except percentages):

	<b>Three Months Ended December 31,</b>		<b>Change</b>			
	<b>2008</b>	<b>Percent of Revenues(1)</b>	<b>2007</b>	<b>Percent of Revenues(1)</b>	<b>Increase/ (Decrease)</b>	<b>Percent Change</b>
<b>Revenues:</b>						
Medical Market	\$ 7,175	100%	\$ 6,005	100%	\$ 1,170	19%
Percentage of total revenues	27%		23%			
Veterinary Market	17,907	100%	18,073	100%	(166)	(1%)
Percentage of total revenues	66%		70%			
Other(2)	1,882		1,612		270	17%
Percentage of total revenues	7%		7%			
Total revenues	26,964		25,690		1,274	5%
<b>Cost of revenues:</b>						
Medical Market	3,548	49%	2,946	49%	602	20%
Veterinary Market	7,389	41%	8,677	48%	(1,288)	(15%)
Other(2)	922		458		464	101%
Total cost of revenues	11,859		12,081		(222)	(2%)
<b>Gross profit:</b>						
Medical Market	3,627	51%	3,059	51%	568	19%
Veterinary Market	10,518	59%	9,396	52%	1,122	12%
Other(2)	960		1,154		(194)	(17%)
Gross profit	\$ 15,105		\$ 13,609		\$ 1,496	11%

(1) The percentages reported are based on revenues by operating segment.

(2) Represents unallocated

items, not  
specifically  
identified to any  
particular  
business  
segment.

## Medical Market

### Revenues for Medical Market Segment

During the three months ended December 31, 2008, total revenues in the medical market increased 19%, or \$1.2 million, as compared to the three months ended December 31, 2007. Components of the change were as follows:

**Instruments.** Total revenues from sales of our Piccolo chemistry analyzers decreased 6%, or \$166,000, during the three months ended December 31, 2008, as compared to the three months ended December 31, 2007. We sold a total of 242 Piccolo chemistry analyzers during the three months ended December 31, 2008, as compared to 238 Piccolo chemistry analyzers sold during the three months ended December 31, 2007. The changes in revenues were attributed to (a) a decrease in revenues in North America (excluding the U.S. government) of 30%, or \$602,000, primarily due to economic conditions and the resulting impact of reduced capital spending at the physician office level and lower average selling prices due to sales of reconditioned Piccolo chemistry analyzers, and (b) a decrease in revenues in Europe of 11%, or \$58,000. The decrease was partially offset by (c) an increase in Piccolo chemistry analyzers sold to the U.S. government of 142%, or \$451,000, primarily due to an increase in the U.S. Military's needs for these products, which were not predictable, and (d) an increase in revenues in Asia Pacific and rest of the world of 96%, or \$43,000.

**Reagent discs.** Total revenues from reagent discs sold in the medical market increased 46%, or \$1.3 million, during the three months ended December 31, 2008, as compared to the three months ended December 31, 2007. We sold 467,000 medical reagent discs during the three months ended December 31, 2008, as compared to 316,000 medical reagent discs sold during the three months ended December 31, 2007. The increase in revenues from medical reagent discs was primarily attributed to the expanded installed base of our Piccolo chemistry analyzers and included (a) an increase in revenues in North America (excluding the U.S. government) of 51%, or \$1.0 million, (b) an increase in revenues in Europe of 159%, or \$495,000, primarily due to sales to a new distributor in Europe to supply medical reagent discs into local government hospitals, and (c) an increase in revenues in Asia Pacific and rest of the world of 163%, or \$31,000. This increase was partially offset by a decrease in medical reagent discs sold to the U.S. government of 42%, or \$229,000, primarily due to the U.S. Military's decreased needs for these products, which were not predictable.

**Table of Contents****Gross Profit for Medical Market Segment**

Gross profit for the medical market segment increased 19%, or \$568,000, during the three months ended December 31, 2008, as compared to the three months ended December 31, 2007. Gross profit percentages for the medical market segment during each of the three months ended December 31, 2008 and 2007 was 51%. In absolute dollars, the increase in gross profit for the medical market segment was due to an increase in medical reagent discs sold during the three months ended December 31, 2008.

**Veterinary Market****Revenues for Veterinary Market Segment**

During the three months ended December 31, 2008, total revenues in the veterinary market decreased 1%, or \$166,000, as compared to the three months ended December 31, 2007. Components of the change were as follows:

**Instruments.** Total revenues from our veterinary instruments sold decreased 5%, or \$251,000, during the three months ended December 31, 2008, as compared to the three months ended December 31, 2007. We sold a total of 644 VetScan chemistry analyzers and hematology instruments during the three months ended December 31, 2008, as compared to an aggregate of 642 veterinary instruments sold during the three months ended December 31, 2007. The primary factors of the change were as follows:

(i) Sales of our VetScan chemistry analyzers increased 18%, or \$461,000, comprised of (a) an increase in revenues in North America of 17%, or \$328,000, primarily due to quality and reliability improvements on our VetScan chemistry analyzers and a shift in our sales and marketing focus to our VetScan chemistry analyzers and reagent discs during the second and third quarters of fiscal 2009, (b) an increase in revenues in Europe of 4%, or \$25,000, and (c) an increase in revenues in Asia Pacific and rest of the world of 121%, or \$108,000.

(ii) Sales of our hematology instruments decreased 25%, or \$712,000, comprised of (a) a decrease in revenues in North America of 22%, or \$555,000, primarily due to a shift in our sales and marketing focus to our VetScan chemistry analyzers and reagent discs during the second and third quarters of fiscal 2009, (b) a decrease in revenues in Europe of 44%, or \$77,000, and (c) a decrease in revenues in Asia Pacific and rest of the world of 40%, or \$80,000.

**Reagent discs and kits.** Total revenues from reagent discs and hematology reagent kits sold in the veterinary market increased 1%, or \$120,000, during the three months ended December 31, 2008, as compared to the three months ended December 31, 2007. The primary factors of the change were as follows:

(i) Total revenues from reagent discs sold in the veterinary market decreased 1%, or \$20,000, during the three months ended December 31, 2008, as compared to the three months ended December 31, 2007. We sold 833,000 veterinary reagent discs during the three months ended December 31, 2008, as compared to 896,000 veterinary reagent discs sold during the three months ended December 31, 2007. The decrease in revenues from veterinary reagent discs was comprised of a decrease in revenues in Europe of 49%, or \$840,000, primarily due to the timing of purchases by a distributor during the third quarter of fiscal 2009 and the impact of the global economic downturn, which lowered the average consumption rate of veterinary reagent discs. The decrease in revenues was partially offset by (a) an increase in revenues in North America of 6%, or \$556,000, primarily due to the expanded installed base of our VetScan chemistry analyzers and higher average selling prices, and (b) an increase in revenues in Asia Pacific and rest of the world of 93%, or \$264,000, primarily due to the expanded installed base of our VetScan chemistry analyzers.

(ii) Total revenues from hematology reagent kits sold increased 13%, or \$140,000, during the three months ended December 31, 2008, as compared to the three months ended December 31, 2007. The increase in revenues from hematology reagent kits was primarily due to an expanded installed base of our hematology instruments and comprised of (a) an increase in revenues in North America of 9%, or \$85,000, (b) an increase in revenues in Europe of 31%, or \$15,000, and (c) an increase in revenues in Asia Pacific and rest of the world of 148%, or \$40,000.

**Gross Profit for Veterinary Market Segment**

Gross profit for the veterinary market segment increased 12%, or \$1.1 million, during the three months ended December 31, 2008, as compared to the three months ended December 31, 2007. Gross profit percentages for the veterinary market segment during the three months ended December 31, 2008 and 2007 were 59% and 52%, respectively. In absolute dollars, the increase in gross profit for the veterinary market segment was due to (a) higher average selling prices on veterinary reagent discs sold during the three months ended December 31, 2008, (b) an increase in gross profit from hematology reagent kits sold during the three months ended December 31, 2008, and

(c) cost improvements on hematology instruments sold during the three months ended December 31, 2008.



**Table of Contents*****Nine Months Ended December 31, 2008 Compared to Nine Months Ended December 31, 2007***

The following table presents revenues, cost of revenues, gross profit and percent of revenues by operating segments for the nine months ended December 31, 2008 and 2007 (in thousands, except percentages):

	<b>Nine Months Ended December 31,</b>		<b>Percent of Revenues(1)</b>		<b>Change Increase/ (Decrease)</b>	
	<b>2008</b>		<b>2007</b>	<b>Percent of Revenues(1)</b>	<b>Percent Change</b>	
<b>Revenues:</b>						
Medical Market	\$ 19,719	100%	\$ 16,455	100%	\$ 3,264	20%
Percentage of total revenues	25%		22%			
Veterinary Market	54,465	100%	52,498	100%	1,967	4%
Percentage of total revenues	69%		71%			
Other(2)	5,040		4,860		180	4%
Percentage of total revenues	6%		7%			
Total revenues	79,224		73,813		5,411	7%
<b>Cost of revenues:</b>						
Medical Market	9,772	50%	8,194	50%	1,578	19%
Veterinary Market	22,672	42%	23,525	45%	(853)	(4%)
Other(2)	2,830		1,612		1,218	76%
Total cost of revenues	35,274		33,331		1,943	6%
<b>Gross profit:</b>						
Medical Market	9,947	50%	8,261	50%	1,686	20%
Veterinary Market	31,793	58%	28,973	55%	2,820	10%
Other(2)	2,210		3,248		(1,038)	(32%)
Gross profit	\$ 43,950		\$ 40,482		\$ 3,468	9%

(1) The percentages reported are based on revenues by operating segment.

(2) Represents unallocated items, not specifically identified to any

particular  
business  
segment.

## Medical Market

### Revenues for Medical Market Segment

During the nine months ended December 31, 2008, total revenues in the medical market increased 20%, or \$3.3 million, as compared to the nine months ended December 31, 2007. Components of the change were as follows:

**Instruments.** Total revenues from sales of our Piccolo chemistry analyzers increased 4%, or \$298,000, during the nine months ended December 31, 2008, as compared to the nine months ended December 31, 2007. We sold a total of 617 Piccolo chemistry analyzers during the nine months ended December 31, 2008, as compared to 593 Piccolo chemistry analyzers sold during the nine months ended December 31, 2007. The changes in revenues were attributed to (a) an increase in Piccolo chemistry analyzers sold to the U.S. government of 180%, or \$1.2 million, primarily due to an increase in the U.S. Military's needs for these products during the first and third quarters of fiscal 2009, which were not predictable, and (b) an increase in revenues in Asia Pacific and rest of the world of 58%, or \$69,000. The increase was partially offset by (c) a decrease in revenues in North America (excluding the U.S. government) of 17%, or \$928,000, primarily due to economic conditions and the resulting impact of reduced capital spending at the physician office level, and (d) a decrease in revenues in Europe of 7%, or \$81,000.

**Reagent discs.** Total revenues from reagent discs sold in the medical market increased 37%, or \$3.1 million, during the nine months ended December 31, 2008, as compared to the nine months ended December 31, 2007. We sold 1.3 million medical reagent discs during the nine months ended December 31, 2008, as compared to 928,000 medical reagent discs sold during the nine months ended December 31, 2007. The changes in revenues from medical reagent discs consisted of (a) an increase in revenues in North America (excluding the U.S. government) of 46%, or \$2.7 million, primarily due to the expanded installed base of our Piccolo chemistry analyzers and (b) an increase in revenues in Europe of 74%, or \$623,000, primarily due to sales to a new distributor in Europe to supply medical reagent discs into local government hospitals, primarily in the third quarter of fiscal 2009. The increase was partially offset by a decrease in medical reagent discs sold to the U.S. government of 13%, or \$216,000, primarily due to the U.S. Military's decreased needs for these products, which were not predictable. Medical reagent discs sales in Asia Pacific and rest of the world were substantially the same as in the nine months ended December 31, 2007.

**Table of Contents****Gross Profit for Medical Market Segment**

Gross profit for the medical market segment increased 20%, or \$1.7 million, during the nine months ended December 31, 2008, as compared to the nine months ended December 31, 2007. Gross profit percentages for the medical market segment during each of the nine months ended December 31, 2008 and 2007 was 50%. In absolute dollars, the increase in gross profit for the medical market segment was due to an increase in medical reagent discs sold during the nine months ended December 31, 2008.

**Veterinary Market****Revenues for Veterinary Market Segment**

During the nine months ended December 31, 2008, total revenues in the veterinary market increased 4%, or \$2.0 million, as compared to the nine months ended December 31, 2007. Components of the change were as follows:

**Instruments.** Total revenues from our veterinary instruments sold increased 1%, or \$53,000, during the nine months ended December 31, 2008, as compared to the nine months ended December 31, 2007. We sold a total of 1,807 VetScan chemistry analyzers and hematology instruments during the nine months ended December 31, 2008, as compared to an aggregate of 1,735 veterinary instruments sold during the nine months ended December 31, 2007. The primary factors of the change were as follows:

(i) Sales of our VetScan chemistry analyzers increased 22%, or \$1.7 million, and consisted of (a) an increase in revenues in North America of 30%, or \$1.6 million, primarily due to quality improvements on our VetScan chemistry analyzers and a shift in our sales and marketing focus to our VetScan chemistry analyzers and reagent discs during the second and third quarters of fiscal 2009, and (b) an increase in revenues in Asia Pacific and rest of the world of 44%, or \$158,000, primarily due to renewed distributor sales in Japan. The increase was partially offset by a decrease in revenues in Europe of 2%, or \$48,000.

(ii) Sales of our hematology instruments decreased 22%, or \$1.6 million, and consisted of (a) a decrease in revenues in North America of 24%, or \$1.6 million, primarily due to a shift in our sales and marketing focus to our VetScan chemistry analyzers and reagent discs during the second and third quarters of fiscal 2009, and (b) a decrease in revenues in Asia Pacific and rest of the world of 7%, or \$30,000. Sales of our hematology instruments in Europe were substantially the same as in the nine months ended December 31, 2007.

**Reagent discs and kits.** Total revenues from reagent discs and hematology reagent kits sold in the veterinary market increased 5%, or \$2.0 million, during the nine months ended December 31, 2008, as compared to the nine months ended December 31, 2007. The primary factors of the change were as follows:

(i) Total revenues from reagent discs sold in the veterinary market increased 4%, or \$1.4 million, during the nine months ended December 31, 2008, as compared to the nine months ended December 31, 2007. We sold 2.6 million veterinary reagent discs during the nine months ended December 31, 2008, as compared to 2.7 million veterinary reagent discs sold during the nine months ended December 31, 2007. The increase in revenues from veterinary reagent discs consisted of the following: (a) an increase in revenues in North America of 2%, or \$589,000, primarily due to higher average selling prices, partially offset by a decrease in units sold to our distributors, (b) an increase in revenues in Europe of 12%, or \$593,000, primarily due to the expanded installed base of our VetScan chemistry analyzers and higher average selling prices, and (c) an increase in revenues in Asia Pacific and rest of the world of 21%, or \$251,000, primarily due to the expanded installed base of our VetScan chemistry analyzers.

(ii) Total revenues from hematology reagent kits sold increased 21%, or \$571,000, during the nine months ended December 31, 2008, as compared to the nine months ended December 31, 2007. The increase in revenues from hematology reagent kits was attributed to (a) an increase in revenues in North America of 19%, or \$489,000, primarily due to an expanded installed base of our hematology instruments and a higher average selling price on reagents kits for our VetScan HM5, a 5-part differential hematology instrument, (b) an increase in revenues in Europe of 12%, or \$19,000, and (c) an increase in revenues in Asia Pacific and rest of the world of 70%, or \$63,000.

**Gross Profit for Veterinary Market Segment**

Gross profit for the veterinary market segment increased 10%, or \$2.8 million, during the nine months ended December 31, 2008, as compared to the nine months ended December 31, 2007. Gross profit percentages for the veterinary market segment during the nine months ended December 31, 2008 and 2007 were 58% and 55%, respectively. In absolute dollars, the increase in gross profit for the veterinary market segment was due to (a) an

increase in VetScan chemistry analyzers and hematology reagent kits sold during the nine months ended December 31, 2008 and (b) higher average selling prices on veterinary reagent discs sold during the nine months ended December 31, 2008. The increase in gross profit was offset by a decrease in hematology instruments sold during the nine months ended December 31, 2008.

**Table of Contents****Cost of Revenues**

The following sets forth our cost of revenues for the periods indicated (in thousands, except percentages):

	<b>Three Months Ended December 31,</b>		<b>Change</b>		<b>Nine Months Ended December 31,</b>		<b>Change</b>	
	<b>2008</b>	<b>2007</b>	<b>Increase/ (Decrease)</b>	<b>Percent Change</b>	<b>2008</b>	<b>2007</b>	<b>Increase/ (Decrease)</b>	<b>Percent Change</b>
Cost of revenues	\$ 11,859	\$ 12,081	\$ (222)	(2%)	\$ 35,274	\$ 33,331	\$ 1,943	6%
Percentage of total revenues	44%	47%			45%	45%		

Cost of revenues includes the costs associated with manufacturing, assembly, packaging, warranty repairs, test and quality assurance for our instruments, reagent discs and hematology reagent kits and manufacturing overhead, including costs of personnel and equipment associated with manufacturing support.

***Three and Nine Months Ended December 31, 2008 Compared to Three and Nine Months Ended December 31, 2007***

The decrease in cost of revenues, in absolute dollars, during the three months ended December 31, 2008, as compared to the three months ended December 31, 2007, was primarily due to a decrease in the sales volume of veterinary reagent discs and cost improvements on hematology instruments sold during the three months ended December 31, 2008. The decrease was partially offset by an increase in the sales volume of medical reagent discs and VetScan chemistry analyzers during the three months ended December 31, 2008.

The increase in cost of revenues, in absolute dollars, during the nine months ended December 31, 2008, as compared to the nine months ended December 31, 2007, was primarily due to an increase in the sales volume of medical reagent discs and Vetscan chemistry analyzers during the nine months ended December 31, 2008. The increase was partially offset by a decrease in the sales volume of veterinary reagent discs and both a decrease in the sales volume and costs improvements on hematology instruments during the nine months ended December 31, 2008.

**Operating Expenses****Research and Development**

The following sets forth our research and development expenses for the periods indicated (in thousands, except percentages):

	<b>Three Months Ended December 31,</b>		<b>Change</b>		<b>Nine Months Ended December 31,</b>		<b>Change</b>	
	<b>2008</b>	<b>2007</b>	<b>Increase/ (Decrease)</b>	<b>Percent Change</b>	<b>2008</b>	<b>2007</b>	<b>Increase/ (Decrease)</b>	<b>Percent Change</b>
Research and development expenses	\$ 2,037	\$ 1,629	\$ 408	25%	\$ 6,116	\$ 5,104	\$ 1,012	20%
Percentage of total revenues	8%	6%			8%	7%		

Research and development expenses consist of personnel costs (including salaries, benefits and share-based compensation expense), consulting expenses and materials and related expenses associated with the development of new tests and test methods, clinical trials, product improvements and enhancement of existing products.

***Three and Nine Months Ended December 31, 2008 Compared to Three and Nine Months Ended December 31, 2007***

The increase in research and development expenses, in absolute dollars, during the three and nine months ended December 31, 2008, as compared to the three and nine months ended December 31, 2007, was primarily due to new product development and enhancement of existing products and clinical trials. Research and development expenses

are based on the project activities planned and the level of spending depends on budgeted expenditures. The projects primarily relate to new product development in both the medical and veterinary markets and costs related to compliance with FDA regulations and clinical trials. Share-based compensation expense during the three months ended December 31, 2008 and 2007 was \$64,000 and \$39,000, respectively, and during the nine months ended December 31, 2008 and 2007 was \$178,000 and \$110,000, respectively.

We anticipate the dollar amount of research and development expenses to increase in fiscal 2009 from fiscal 2008 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.

**Table of Contents****Sales and Marketing**

The following sets forth our sales and marketing expenses for the periods indicated (in thousands, except percentages):

	<b>Three Months Ended December 31,</b>		<b>Change Increase/ Percent (Decrease) Change</b>		<b>Nine Months Ended December 31,</b>		<b>Change Increase/ Percent (Decrease) Change</b>	
	<b>2008</b>	<b>2007</b>			<b>2008</b>	<b>2007</b>		
Sales and marketing expenses	\$ 6,061	\$ 6,056	\$ 5	<1%	\$ 18,382	\$ 17,666	\$ 716	4%
Percentage of total revenues	22%	24%			23%	24%		

Sales and marketing expenses consist of personnel costs (including salaries, benefits and share-based compensation expense), commissions and travel-related expenses for personnel engaged in selling, costs associated with advertising, lead generation, marketing programs, trade shows and services related to customer and technical support.

***Three and Nine Months Ended December 31, 2008 Compared to Three and Nine Months Ended December 31, 2007***

The increase in sales and marketing expenses, in absolute dollars, during the nine months ended December 31, 2008, as compared to the nine months ended December 31, 2007, was primarily due to personnel-related costs resulting from an increase in headcount in various divisions including sales and marketing, customer service and technical service, to support the growth in both our medical and veterinary markets. Share-based compensation expense during the three months December 31, 2008 and 2007 was \$143,000 and \$91,000, respectively, and during the nine months ended December 31, 2008 and 2007 was \$401,000 and \$259,000, respectively.

**General and Administrative**

The following sets forth our general and administrative expenses for the periods indicated (in thousands, except percentages):

	<b>Three Months Ended December 31,</b>		<b>Change Increase/ Percent (Decrease) Change</b>		<b>Nine Months Ended December 31,</b>		<b>Change Increase/ Percent (Decrease) Change</b>	
	<b>2008</b>	<b>2007</b>			<b>2008</b>	<b>2007</b>		
General and administrative expenses	\$ 2,241	\$ 1,571	\$ 670	43%	\$ 5,855	\$ 4,760	\$ 1,095	23%
Percentage of total revenues	8%	6%			7%	6%		

General and administrative expenses consist of personnel costs (including salaries, benefits and share-based compensation expense), and expenses for outside professional services related to general corporate functions, including accounting, human resources and legal.

***Three and Nine Months Ended December 31, 2008 Compared to Three and Nine Months Ended December 31, 2007***

The increase in general and administrative expenses, in absolute dollars, during the three and nine months ended December 31, 2008, as compared to the three and nine months ended December 31, 2007, was primarily due to (a) an increase in personnel-related costs, which includes share-based compensation expense, (b) fees and costs associated with the negotiation of a licensing agreement entered into with Inverness Medical Switzerland GmbH and (c) fees and costs related to pursuing strategic opportunities during the three months ended December 31, 2008. Share-based compensation expense during the three months ended December 31, 2008 and 2007 was \$225,000 and \$122,000,

respectively, and during the nine months ended December 31, 2008 and 2007 was \$613,000 and \$374,000, respectively.

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

The following sets forth our interest and other income (expense), net, for the periods indicated (in thousands, except percentages):

	<b>Three Months Ended December 31,</b>		<b>Change Increase/ Percent (Decrease) Change</b>		<b>Nine Months Ended December 31,</b>		<b>Change Increase/ Percent (Decrease) Change</b>	
	<b>2008</b>	<b>2007</b>			<b>2008</b>	<b>2007</b>		
Interest and other income (expense), net	\$ 352	\$ 552	\$ (200)	(36)%	\$ 1,140	\$ 1,580	\$ (440)	(28)%
Interest and other income (expense), net, consists primarily of interest income earned on cash, cash equivalents and short-term and long-term investments.								



**Table of Contents*****Three and Nine Months Ended December 31, 2008 Compared to Three and Nine Months Ended December 31, 2007***

The decrease in interest and other income (expense), net, during the three and nine months ended December 31, 2008, as compared to the three and nine months ended December 31, 2007, was primarily attributed to lower interest yields in our investment portfolio compared to the same period in fiscal 2008.

**Income Tax Provision**

The following sets forth our income tax provision for the periods indicated (in thousands, except percentages):

	<b>Three Months Ended December 31,</b>		<b>Nine Months Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Income tax provision	\$ 1,762	\$ 1,700	\$ 5,308	\$ 5,341
Effective tax rate	34%	35%	36%	37%

***Three and Nine Months Ended December 31, 2008 Compared to Three and Nine Months Ended December 31, 2007***

Our effective tax rate for the three months ended December 31, 2008 and 2007 was 34% and 35%, respectively, and for the nine months ended December 31, 2008 and 2007 was 36% and 37%, respectively.

During the three and nine months ended December 31, 2008 and 2007, the effective tax rate included a tax benefit for tax-exempt investments and included a tax benefit for the federal research and development tax credit. During the three and nine months ended December 31, 2008, the effective tax rate also included a benefit for federal qualified production activities. The decrease in the effective tax rate for the three and nine months ended December 31, 2008, as compared to the three and nine months ended December 31, 2007, was due to the recording of a tax benefit for federal and California research and development tax credits relating to the prior year which have been recorded in the three months ended December 31, 2008 as a discrete item.

We did not have any unrecognized tax benefits as of December 31, 2008 or December 31, 2007. During the three and nine months ended December 31, 2008 and 2007, we did not recognize any interest or penalties related to unrecognized tax benefits.

**LIQUIDITY AND CAPITAL RESOURCES**

Total cash, cash equivalents and short-term and long-term investments at December 31, 2008 and March 31, 2008 were as follows (in thousands, except percentages):

	<b>December 31, 2008</b>	<b>March 31, 2008</b>
Cash and cash equivalents	\$ 60,158	\$ 17,219
Short-term investments	14,489	6,991
Long-term investments		35,463
Total cash, cash equivalents and investments	\$ 74,647	\$ 59,673
Percentage of total assets	54%	49%

**Cash Flow Changes**

Cash provided by (used in) the nine months ended December 31, 2008 and 2007 were as follows (in thousands):

	<b>Nine Months Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
Net cash provided by operating activities	\$ 10,109	\$ 10,621
Net cash provided by (used in) investing activities	27,505	(11,460)

Edgar Filing: ABAXIS INC - Form 10-Q

Net cash provided by financing activities	5,362	2,448
Effect of exchange rate changes on cash and cash equivalents	(37)	
Net increase in cash and cash equivalents	\$ 42,939	\$ 1,609

At December 31, 2008, we had net working capital of \$105.3 million compared to \$52.5 million at March 31, 2008. Cash and cash equivalents at December 31, 2008 were \$60.2 million, compared to \$17.2 million at March 31, 2008. The increase in cash and cash equivalents during the nine months ended December 31, 2008 was primarily due to net cash provided by operating activities of \$10.1 million and proceeds from redemptions of investments in auction rate securities of \$37.0 million, partially offset by purchases of property and equipment of \$2.0 million.

## **Table of Contents**

### **Operating Activities**

During the nine months ended December 31, 2008, we generated \$10.1 million in cash from operating activities. The cash provided by operating activities during the nine months ended December 31, 2008 was primarily the result of net income of \$9.4 million, adjusted for the effects of non-cash adjustments including depreciation and amortization of \$3.2 million, share-based compensation expense of \$1.3 million and deferred income taxes of \$4.1 million, partially offset by a decrease of \$5.1 million related to excess tax benefits from share-based awards.

Other changes in operating activities during the nine months ended December 31, 2008 were as follows:

- (i) Net trade receivables increased by \$684,000, from \$20.9 million at March 31, 2008 to \$21.6 million as of December 31, 2008, primarily due to sales in the last month of the quarter ended December 31, 2008.
  - (ii) Net inventories decreased by \$1.6 million, from \$18.7 million at March 31, 2008 to \$17.1 million as of December 31, 2008, primarily due to (a) improvements in the quality of the parts from suppliers and (b) transfer to property and equipment to support our sales and marketing activities.
  - (iii) Prepaid expenses increased by \$814,000, from \$427,000 at March 31, 2008 to \$1.2 million as of December 31, 2008, primarily due to the timing of payments.
  - (iv) Current net deferred tax asset increased by \$1.1 million, from \$2.4 million at March 31, 2008 to \$3.5 million as of December 31, 2008, primarily as a result of certain operating expenses recognized in the nine months ended December 31, 2008 which are currently non-deductible for tax purposes and an increase in California research and development tax credits carryovers.
  - (v) Accounts payable decreased by \$501,000, from \$6.4 million at March 31, 2008 to \$5.9 million as of December 31, 2008, primarily due to the timing and payment of services and inventory purchases.
  - (vi) Accrued payroll and related expenses decreased by \$1.5 million, from \$4.3 million at March 31, 2008 to \$2.8 million as of December 31, 2008, primarily due to a decrease in accrued bonus as of December 31, 2008 because the Company did not achieve the established quarterly net sales and quarterly pre-tax income goals during the third quarter of fiscal 2009.
  - (vii) Other accrued liabilities increased by \$103,000, from \$1.4 million at March 31, 2008 to \$1.5 million as of December 31, 2008.
  - (viii) Total deferred revenue increased by \$485,000, resulting from an increase in the current portion of deferred revenue of \$115,000, from \$807,000 at March 31, 2008 to \$922,000 as of December 31, 2008, and an increase in the non-current portion of deferred revenue of \$370,000, from \$1.1 million at March 31, 2008 to \$1.5 million as of December 31, 2008, primarily due to an increase in maintenance contracts offered to customers from time to time as incentives in the form of free goods in connection with the sale of our products.
  - (ix) Total warranty reserves increased by \$437,000, resulting from an increase in the current portion of warranty reserves of \$418,000, from \$1.2 million at March 31, 2008 to \$1.6 million as of December 31, 2008, and an increase in the non-current portion of warranty reserves of \$19,000, from \$729,000 at March 31, 2008 to \$748,000 as of December 31, 2008. The net change in warranty reserves is based on (a) the number of instruments in standard warranty and estimated repair costs and (b) an estimate of defective reagent discs and replacement costs.
- 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.

### **Investing Activities**

Net cash provided by investing activities during the nine months ended December 31, 2008 totaled \$27.5 million, compared to net cash used in investing activities of \$11.5 million during the nine months ended December 31, 2007. Changes in investing activities were as follows:

**Investments.** Cash used to purchase certificates of deposits totaled \$21.6 million during the nine months ended December 31, 2008. Cash provided by proceeds from (a) maturities of certificates of deposits and municipal bonds totaled \$14.1 million and (b) redemptions of auction rate securities totaled \$37.0 million during the nine months ended December 31, 2008. For a discussion regarding the redemption of our auction rate securities, see Notes 3 and 4 of the

Notes to the Condensed Consolidated Financial Statements (Unaudited).

**Table of Contents**

**Property and Equipment.** Cash used to purchase property and equipment totaled \$2.0 million during the nine months ended December 31, 2008, primarily to support (a) sales and marketing activities and (b) more efficient production lines. 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 during the nine months ended December 31, 2008 totaled \$5.4 million, primarily consisting of \$5.1 million related to excess tax benefits from share-based awards and \$522,000 related to proceeds from stock options exercised, partially offset by the payment of income withholding taxes of \$280,000 due upon vesting of restricted stock units.

**Line of Credit**

We have a line of credit with Comerica Bank-California which provides for borrowings of up to \$2.0 million. The line of credit may be terminated upon notification by either party and any outstanding balance is payable upon demand. The line of credit bears interest at the bank's prime rate minus 0.25%, which totaled 3.00% at December 31, 2008, and is payable monthly. At December 31, 2008, of the \$2.0 million available, \$97,000 was committed to secure a letter of credit for our facilities lease. At December 31, 2008, there was no amount outstanding under our line of credit. The weighted average interest rates on the line of credit during the three months ended December 31, 2008 and 2007 were 3.81% and 7.27%, respectively.

The line of credit agreement contains certain financial covenants, which are evaluated on a quarterly basis. At December 31, 2008, we were in compliance with each of these covenants. Included in these financial covenants, among other stipulations, are the following requirements:

We must have a minimum net income of \$25,000 before preferred stock dividends and accretion on preferred stock 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 required to be profitable, as defined, on a fiscal year to date basis beginning, with respect to the current fiscal year, with the six month period ended September 30, 2008 and to have net income before preferred stock dividends and accretion on preferred stock of at least \$1.2 million for the fiscal year ending March 31, 2009.

We are required to comply with certain financial covenants as follows:

**Financial Covenants****Requirements**

Quick ratio, as defined

Not less than 2.00 to 1.00

Cash flow coverage, as defined

Not less than 1.25 to 1.00

Debt to net worth ratio, as defined

Not greater than 1.00 to 1.00

Tangible effective net worth, as defined

Not less than \$25.7 million

Borrowings under the line of credit are collateralized by our net book value of assets of \$122.2 million at December 31, 2008, including our intellectual property.

**Purchase Commitments**

A discussion of our amended original equipment manufacturing agreement with Diatron Messtechnik GmbH and licensing agreement with Inverness Medical Switzerland GmbH is included in Note 8 of the Notes to the Condensed Consolidated Financial Statements (Unaudited).

**Contingencies**

We are involved from time to time in various litigation matters in the normal course of business. While the outcome of these proceedings and claims cannot be predicted with certainty, we do not believe that the ultimate resolution of these matters will have a material effect on our financial position or results of operations.

**Off-Balance Sheet Arrangements**

We have no off-balance sheet arrangements.

**Financial Condition**

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 12 months. Our future capital requirements will largely depend upon the increased market acceptance of our

point-of-care blood analyzer products.

## **Table of Contents**

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 opportunities.

### **RECENT ACCOUNTING PRONOUNCEMENTS**

A discussion of recent accounting pronouncements is included in Note 2 of the Notes to the Condensed Consolidated Financial Statements (Unaudited).

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

#### **Interest Rate Risk**

We are exposed to the impact of interest rate changes with respect to our short-term and long-term investments and line of credit.

Our investment objective is to invest excess cash in cash equivalents and in various types of investments to maximize yields without significantly increased risk. At December 31, 2008, our short-term investments totaled \$14.5 million, consisting of certificates of deposits.

Historically, our investment portfolio had included auction rate securities, which became illiquid as a result of the negative condition in the global credit markets. In September 2008, the bank where our auction rate securities were held, reached agreements with the Financial Industry Regulatory Authority, the State of Michigan Attorney General and the Michigan Office of Financial and Insurance Regulation regarding the repurchase of auction rate securities. In October 2008, we received a commitment from our bank to repurchase all of our remaining auction rate securities, which repurchases were completed in the third quarter of fiscal 2009. During the nine months of fiscal 2009, we redeemed \$37.0 million of our auction rate securities at 100% of par value. As of December 31, 2008, we no longer held any auction rate securities.

We have the ability to hold the certificates of deposits in our investment portfolio at December 31, 2008 until maturity and therefore, we believe we have no material exposure to interest rate risk. A sensitivity analysis assuming a hypothetical 10% movement in interest rates applied to our total investment balances at December 31, 2008 indicated that such market movement would not have a material effect on our business, operating results or financial condition. We have not experienced any significant loss on our investment portfolio.

For our line of credit, which provides for borrowings of up to \$2.0 million, the interest rate is equal to the bank's prime rate minus 0.25%, which totaled 3.00% at December 31, 2008. Consequently, an increase in the prime rate would expose us to higher interest expenses. A sensitivity analysis assuming a hypothetical 10% movement in the prime rate applied to our line of credit balance at December 31, 2008 indicated that such market movement would not have a material effect on our business, operating results or financial condition, as there was no amount outstanding on our line of credit at December 31, 2008.

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.

#### **Foreign Currency Rate Fluctuations**

We operate primarily in the United States and a majority of our revenues, cost of revenues, operating expenses and capital purchasing activities for the nine months ended December 31, 2008 were transacted in U.S. dollars. However, we are exposed to foreign currency exchange rate fluctuations on the hematology instruments and hematology reagent kits purchased from Diatron Messtechnik GmbH, which are primarily denominated in Euros.

In the first quarter of fiscal 2009, operations from our Germany sales office were stated in Euros and translated into U.S. dollars at the period-end exchange rates. On July 1, 2008, the Germany sales office was incorporated as Abaxis Europe GmbH to market, promote and distribute diagnostic systems for medical and veterinary uses. Abaxis Europe GmbH is our wholly-owned subsidiary and its functional currency is in U.S. dollars. The period-end translation of the non-functional currency assets and liabilities (primarily assets and liabilities on our subsidiary's condensed balance sheet that are not denominated in U.S. dollars) at the period-end exchange rates resulted in foreign currency gains and losses, which were included in our Condensed Consolidated Statements of Operations in Interest and other income (expense), net.

To the extent the U.S. dollar strengthens against the Euro currency, the translation of the foreign currency denominated transactions may result in reduced cost of revenues and operating expenses. Similarly, our cost of revenues and operating expenses will increase if the U.S. dollar weakens against the Euro currency.

Other than the foregoing, there have been no material changes in our market risk during the three months ended December 31, 2008 compared to the disclosures in Part II, Item 7A of our Annual Report on Form 10-K for the fiscal year ended March 31, 2008.



## **Table of Contents**

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

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

Based on our management's evaluation, with the participation of our principal executive officer and principal financial officer, as of the end of the period covered by this report, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (which are defined under Securities and Exchange Commission rules as controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Securities Exchange Act of 1934, as amended, (the "Exchange Act") is recorded, processed, summarized and reported within required time periods), were effective as of December 31, 2008.

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

During the quarter ended December 31, 2008, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

#### **Inherent Limitations on Controls and Procedures**

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Accordingly, even an effective system of internal control will provide only reasonable assurance that the objectives of the internal control system are met.

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

Not applicable.

## **PART II OTHER INFORMATION**

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

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

#### **Item 1A. Risk Factors**

#### **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.

When used in these risk factors, the words "anticipates," "believes," "continue," "could," "estimates," "expects," "future," "may," "might," "plans," "projects," "will" and similar expressions identify forward-looking statements. Our actual results 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.

In evaluating our business, you should carefully consider the following risks in addition to the other information in our Annual Report on Form 10-K for the fiscal year ended March 31, 2008 as filed with the Securities and Exchange Commission on June 13, 2008. We note these factors for investors as permitted by the Private Securities Litigation Reform Act of 1995. It is not possible to predict or identify all such factors and, therefore, you should not consider the following risks to be a complete statement of all the potential risks or uncertainties that we face.

***We are not able to predict sales in future quarters and a number of factors affect our periodic results, which makes our quarterly operating results less predictable.***

We are not able to accurately predict our sales in future quarters. Our revenue in the medical and veterinary markets is derived primarily by selling to distributors who resell our products to the ultimate user. 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 blood chemistry analyzers, as we typically sell our blood chemistry analyzers to new users. Accordingly, our sales in any one quarter are not indicative of our sales in any future period.



## **Table of Contents**

We generally operate with a 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.

The sales cycle for our products can fluctuate, which may cause revenue and operating results to vary significantly from period to period. We believe this fluctuation is due primarily to (i) seasonal patterns in the decision making processes by our independent distributors and direct customers, (ii) inventory or timing considerations by our distributors and (iii) on the purchasing requirements of the U.S. Military to acquire our products. Accordingly, we believe that period to period comparisons of our results of operations are not necessarily meaningful.

In the future, our periodic operating results may vary significantly depending on, but not limited to, a number of factors, including:

- 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 blood chemistry analyzers and our reagent disc products;
- the amount we spend on research and development; and
- changes in our strategy.

### ***We would fail to achieve anticipated revenue if the market does not accept our products.***

We believe that 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 overall cost and require 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.

In the human medical market, we have relatively limited experience in large-scale sales of our Piccolo blood chemistry analyzers. Although we believe that our blood chemistry analyzers offer consumers many advantages, including substantial cost savings according to our analyses, in terms of implementation of the actual product, 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 Piccolo blood chemistry analyzers and our other products, we will suffer lost sales and could fail to achieve anticipated revenue. Historically, in the veterinary market, we have marketed our VetScan systems through both direct sales and distribution channels to veterinarians. We continue to develop new animal blood tests to expand and we cannot be assured that these tests will be accepted by the veterinary market.

### ***We could fail to achieve anticipated revenue if problems related to the manufacture of our new blood chemistry analyzers are not resolved.***

We manufacture our blood chemistry analyzers at our manufacturing facilities in Union City, California. During fiscal 2008, we experienced problems related to the manufacture of our new blood chemistry analyzer, which are primarily related to difficulties and delays in obtaining certain key components that we purchase from various suppliers. These manufacturing problems were primarily related to quality control issues for key components that we obtain from our suppliers and to design issues of the key components required in our blood chemistry analyzer. Our difficulties in obtaining an adequate amount of quality components for the manufacture of our blood chemistry analyzer had a materially adverse impact on our sales of VetScan chemistry analyzers in fiscal 2008. We have taken, and are continuing to take, steps to resolve these issues, including securing quality parts from our suppliers, but there can be no assurance that our efforts to resolve these manufacturing difficulties will be successful or that similar

manufacturing problems will not arise. If we do not continue to resolve these manufacturing problems on our new blood chemistry analyzer or prevent similar problems in the future, we may not be able to manufacture sufficient quantities to meet anticipated demand and, therefore, will not be able to effectively market and sell our new blood chemistry analyzer; accordingly, our revenue and business would be materially adversely affected.

**Table of Contents**

***We rely on patents and other proprietary information, the loss of which would negatively affect our business.***

As of December 31, 2008, 39 patent applications have been filed on our behalf with the United States Patent and Trademark Office ( USPTO ), of which 30 patents have been issued and 29 patents are currently active. 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 us, 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 USPTO 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 USPTO, 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 must increase sales of our Piccolo and VetScan products or we may not be able to maintain profitability.***

As of December 31, 2008, we had retained earnings of \$6.5 million. Our ability to continue to be profitable will depend, in part, on our ability to increase our sales volumes of our Piccolo and VetScan products. Increasing the sales volume of our products will depend upon, among other things, our ability to:

- continue to improve our existing products and develop new and innovative 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 sustain profitability.

***We must continue to develop our sales, marketing and distribution experience in the human diagnostic market or our business will not grow.***

Although we have gained experience marketing our VetScan products in the veterinary diagnostic market, we have limited sales, marketing and distribution experience with our Piccolo chemistry analyzers in the human diagnostic market. Accordingly, we cannot assure you that:

- we will be able to establish and maintain effective distribution arrangements in the human diagnostic market;
- any distribution arrangements that we are able to establish will be successful in marketing our products; or
- the costs associated with sales, marketing and distributing our products will not be excessive.

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

## **Table of Contents**

### ***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 to pay material uninsured claims.***

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 occurs in limited quantities, that we have not anticipated or otherwise. Our Piccolo and VetScan chemistry analyzers may be unable to detect all errors which could result in the misdiagnosis of human or veterinary patients.

Should we inadvertently manufacture and ship defective products, we may be subject to substantial claims under our warranty policy or product liability laws. 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 chemistry analyzers. Therefore, even if a mass defect within a lot or lots of reagent discs were detected by our Piccolo and VetScan chemistry analyzers, the replacement of such reagent discs free of charge would be costly and could materially harm our financial condition. Further, in the event that a product defect is not detected in our Piccolo chemistry analyzer, 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 current 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 could subject us to claims above the amount of our coverage and would materially adversely affect our business and our financial condition.

### ***We must effectively train and integrate the members of our sales team in order to achieve our anticipated revenue or expand our business.***

As of December 31, 2008, we had 77 full-time sales personnel directly involved in our sales and marketing activities, many of whom have been employed by us for a limited period of time. In addition, we experience significant turnover in our sales and marketing personnel. If we are to increase our direct sales, we will need to train new sales personnel 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 resources 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 chemistry analyzers. Historically, we have developed reagent discs suitable for the human medical and veterinary diagnostic markets. We have received 510(k) clearances from the U.S. Food and Drug Administration ( FDA ) for 25 test methods in the human medical 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 reagent discs. Our failure to meet these challenges will materially adversely affect our operating results and financial condition.

### ***We rely primarily on distributors to sell our products and we rely on sole distributor arrangements in a number of countries. Our failure to successfully develop and maintain these relationships could adversely affect our business.***

We sell our medical and veterinary products primarily through a limited number of 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 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.

We depend on a number of distributors in the United States who distribute our VetScan products. During the three and nine months ended December 31, 2008, there were no distributors or direct customers that accounted for more than 10% of total worldwide revenues. Our largest distributor in the United States, DVM Resources, accounted for 12% and 13% of our total worldwide revenues for the three and nine months ended December 31, 2007, respectively. We depend on our distributors to assist us in promoting our products in the veterinary market, and accordingly, if one or more of our distributors were to stop selling our products in the future, we may experience a sharp decline or delay in our sales revenue.

**Table of Contents**

In the United States medical market, we depend on a few distributors for our Piccolo products. We entered into formal distribution agreements with the following distributors to sell and market Piccolo chemistry analyzers and medical reagent discs: National Distribution & Contracting, Inc. in our third quarter of fiscal 2008, McKesson Medical-Surgical Inc. in our first quarter of fiscal 2008, Cardinal Health in our fourth quarter of fiscal 2007, Henry Schein's Medical Group in our first quarter of fiscal 2007 and PSS World Medical, Inc. in our third quarter of fiscal 2006. We depend on these distributors to assist us in promoting market acceptance of our Piccolo chemistry analyzers. Internationally, we rely on only a few distributors for our products in both the medical and veterinary diagnostic markets. In the first quarter of fiscal 2008 we terminated our distributor agreement with T. Chatani & Co., Ltd. ( T. Chatani ) in Japan. T. Chatani had agreed to continue to service Abaxis customers, which included selling our reagent discs and hematology reagent kits, for a limited period, which ended during the fourth quarter of fiscal 2008. In October 2007, we signed an exclusive distribution agreement with Central Scientific Commerce, Inc. ( CSC ) to distribute the complete line of our medical and veterinary products in Japan. In the third quarter of fiscal 2008, CSC began the process of registering our new instruments, the VetScan VS2, VetScan HM5 and Piccolo xpress in Japan. The registration process was completed in the first quarter of fiscal 2009, and consequently, CSC can begin to import and market our instruments along with our reagent discs and kits. However, we cannot assure you that our new distribution relationship with CSC will be as successful as our prior distribution arrangement, or at all. Furthermore, an inability of, or any delays by, our distributor in receiving the necessary approvals for our new or other products can adversely impact our revenues in Japan.

We currently rely on distributors that carry either our medical or veterinary products in the following countries: Afghanistan, Australia, Austria, Bahrain, Belgium, Canada, Czech Republic, Denmark, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Korea, Macao, the Netherlands, New Zealand, the Philippines, Portugal, Romania, Russia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, Ukraine, the United Arab Emirates, the United Kingdom and the United States. Our distributors in each of these countries are responsible for obtaining the necessary approvals to sell our new and existing products. These distributors may not be successful in obtaining proper approvals for our new and existing 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 on favorable terms, or at all. In addition, 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 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 products internationally.

***We depend on limited or sole suppliers for several key components in our products, many of whom we have not entered into contractual relationships with and failure of our suppliers to provide the components to us could harm our business.***

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, 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 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 stand-alone products: 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., Toyobo Specialties (formerly Shinko American Inc.) and Sigma Aldrich Inc.

**Blood Chemistry Analyzer Components:** Our blood analyzer products use several technologically-advanced components that we currently purchase from a limited number of vendors, including components from Hamamatsu Corporation and PerkinElmer, Inc. and components from a single-source supplier, UDT Sensors (a division of OSI Optoelectronics). Our analyzers also use a printer that is primarily made by Seiko North America



Corporation. The loss of the supply of any of these components could force us to redesign our blood chemistry analyzers.

**Hematology Instruments and Reagents:** Our hematology instruments are manufactured by Diatron Messtechnik GmbH in Hungary and are purchased by us as a completed instrument. In addition, to date, we have qualified only three suppliers to produce the reagents for our hematology instruments: Clinical Diagnostic Solutions, Inc., Diatron and Mallinckrodt Baker BV.

We operate on a purchase order basis with all of the suppliers of our molded plastic reagent discs, reagent chemicals, blood chemistry analyzer components, hematology instruments and hematology reagents and, therefore, 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 may be potential alternate suppliers available for these critical components, to date we have not qualified additional vendors beyond those referenced above and cannot assure you we would be able to enter into arrangements with additional vendors on favorable terms, or at all.

## **Table of Contents**

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 may not be able to compete effectively with larger, more established entities or their products, or with future organizations or future products, which could cause our sales to decline.***

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 (a listing of our competitors is listed below).

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

- range of tests offered;
- 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 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. In addition, 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 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., i-STAT Corporation (which was purchased by Abbott Laboratories), Johnson & Johnson (including its subsidiary, Ortho-Clinical Diagnostics, Inc.), Kodak (DT60 analyzer), Polymedco, Inc. and F. Hoffman-La Roche (Reflotron system). Our principal competitors in the veterinary diagnostic market are Idexx Laboratories, Inc. and Heska Corporation. Most of our competitors have significantly larger product lines to offer and 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 significantly 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 (the CMS) set 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 would 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.



## **Table of Contents**

*We are subject to numerous governmental regulations and regulatory changes are difficult to predict and may be damaging to our business.*

### **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 FDA. 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) 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 December 31, 2008, we have received market clearance from the FDA for our Piccolo chemistry analyzer and 25 reagent tests that we have on 13 reagent discs. We are currently developing additional tests that we will have to clear with the FDA through the 510(k) notification procedures. These new test products are crucial for our success in the human medical market. If we do not receive 510(k) clearance for a particular product, we will not be able to market that product in the United States, which could harm our future sales.

### **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. To date, we have complied with the following federal, state, local and international regulatory requirements:

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 manufacturing facility in Union City, California.

In May 2002, we received our ISO 9001 certification, expanding our compliance with international quality standards.

In December 2003, we received ISO 13485 Quality System certification as required by the 2003 European In Vitro Device Directive. This certified our quality system specifically to medical devices.

In both March 2003 and September 2005, the FDA conducted a facility inspection and verified our compliance with the 21 CFR 820 Regulation.

In November 2006, we received our recertification to the ISO 13485:2003 Quality System Standard for medical devices.

In August 2008, the FDA conducted an additional facility inspection to verify our compliance with 21 CFR 820 Regulation.

We cannot assure you that we will successfully pass the latest FDA inspection or any 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 also affected by the Clinical Laboratory Improvement Amendments (the CLIA) of 1988. The CLIA are intended to insure the quality and reliability of all medical testing in the United States regardless of where the tests are performed. The current CLIA regulations divide laboratory tests into the following three categories:

waived;

moderately complex; and

highly complex.

## **Table of Contents**

Many of the tests performed using the Piccolo chemistry analyzer 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 some Piccolo products to customers who meet the standards of a laboratory. To receive laboratory certification, a testing facility must be certified by the CMS. After the testing facility receives a laboratory certification, it must then meet the CLIA regulations. Because we can only sell some Piccolo products to testing facilities that are certified laboratories, the market for some products is correspondingly constrained.

We can currently offer the following Piccolo reagent discs as waived tests to the medical market: Basic Metabolic Panel, Comprehensive Metabolic Panel, Electrolyte Panel, General Chemistry 6, General Chemistry 13, Kidney Check, Lipid Panel, Lipid Panel Plus, Liver Panel Plus, MetLyte 8 Panel and Renal Function Panel. Waived status permits untrained personnel to run the Piccolo chemistry analyzer using these tests; thus, extending the sites (doctors offices and other point-of-care environments) that can use the Piccolo chemistry analyzer. Although we are engaged in an active program to test and apply for CLIA waivers for additional analytes, we cannot assure you that we will successfully receive CLIA waived status from the FDA for other products. Consequently, for the reagent discs that have not received CLIA waived status, the market for our Piccolo products may be confined to those testing facilities that are certified as laboratories and our growth can be limited accordingly.

### **Need to Comply with Various Federal, State, Local and International Regulations**

Federal, state, local and international 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. Foreign certifications that we have received include the following, among others:

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 2003 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 2003 European In Vitro Device Directive.

In September 2005, we received the Canadian Medical Device Conformity Assessment System stamp on our ISO 13485 certificate to signify compliance with Health Canada regulations.

In March 2006, we received our certification to the 2003 version of the ISO 13485 Quality System Standard for medical devices.

In November 2006, we received our recertification to the ISO 13485:2003 Quality System Standard for medical devices.

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 FDA and of the State of California, including the Quality System Regulation, current regulations depend on administrative interpretations. Future interpretations made by the FDA, CMS or other regulatory bodies may adversely affect our business.

***We have incurred and may continue to incur, in future periods, significant share-based compensation charges under SFAS No. 123(R), which may adversely affect our reported financial results.***

Effective April 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004),

Share-Based Payment (SFAS No. 123(R)), issued by the Financial Accounting Standards Board, which requires the measurement of all share-based payments to employees, using a fair-value-based method and the recording of such expense in our results of operations. The fair value of restricted stock unit awards used in our expense recognition method is measured based on the number of shares granted and the closing market price of our common stock on the date of grant. Such value is recognized as an expense, net of an estimated forfeiture rate, for those shares expected to vest over the corresponding requisite service period. Our policy is to recognize the expense of restricted stock unit grants based on the vested portions of the awards. Since fiscal 2007, we granted restricted stock unit awards annually to employees based on the following time-based vesting schedule over a four-year period: five percent vesting after the first year; additional ten percent after the second year; additional 15 percent after the third year; and the remaining 70 percent after the fourth year of continuous employment. During fiscal 2007, 2008 and the first nine months of

fiscal 2009, share-based compensation expense related to restricted stock units had a material impact on our earnings per share and on our financial statements and we expect that it will continue to adversely impact our reported results of operations, particularly in the fourth year of vesting for the restricted stock unit awarded to employees. As of December 31, 2008, our unrecognized compensation expense related to restricted stock unit awards granted to employees and directors to date totaled \$13.1 million, which is expected to be recognized over a weighted average period of 2.39 years.

## **Table of Contents**

***We depend on key members of our management and scientific staff and, if we fail to retain and recruit qualified individuals, our ability to execute our business strategy and generate sales would be harmed.***

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. We may not be able to continue to attract and retain skilled and experienced marketing, sales and manufacturing personnel on acceptable terms in the future because numerous medical products and other high technology companies compete for the services of these qualified individuals. We currently do not maintain key man life insurance on any of our employees.

***We are subject to increasingly complex requirements from recent legislation requiring companies to evaluate internal control over financial reporting.***

Rules adopted by the Securities and Exchange Commission pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 require an assessment of internal control over financial reporting by our management and an attestation of the effectiveness of our internal controls over financial reporting by an independent registered public accounting firm. We have an ongoing program to perform the assessment, testing and evaluation to comply with these requirements and we expect to continue to incur significant expenses to Section 404 compliance on an ongoing basis.

Our management assessed the effectiveness of our internal control over financial reporting as of our fiscal years ended March 31, 2008 and 2007. Although we received an unqualified opinion on our financial statements for the fiscal years ended March 31, 2008 and 2007, and on the effectiveness of our internal control over financial reporting as of March 31, 2008 and 2007, we cannot predict the outcome of our testing in future periods. In the event that our internal controls over financial reporting are not effective as defined under Section 404, or any failure to implement required new or improved controls, or difficulties encountered in implementation could harm operating results or prevent us from accurately reporting financial results or cause a failure to meet our reporting obligations in the future. If management cannot assess internal control over financial reporting is effective, or our independent registered public accounting firm is unable to provide an unqualified attestation report on such assessment, investor confidence and our share value may be negatively impacted.

***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 the next 12 months, although no assurances can be given. The terms of our line of credit contain a number of covenants concerning financial tests that we must meet, and these tests are more fully explained under the subheading

Management's Discussion and Analysis of Financial Condition and Results of Operations in this Quarterly Report on Form 10-Q.

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 covenants of our line of credit, we may have to raise additional funds from the issuance of public or private securities. In the event that we cannot maintain compliance with these financial covenants, 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.





## **Table of Contents**

### ***We must comply with strict and potentially costly environmental regulations or we could pay significant fines.***

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), which cost approximately \$90,000 in fiscal 2008, and includes other environmental health and safety expenses 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.

### ***Our facilities and manufacturing operations are vulnerable to natural disasters and other unexpected losses; system failures or delays may harm our business.***

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 blood chemistry analyzers or the reagent discs used in the blood chemistry 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 location in Union City, California experienced a system failure or regulatory problem that temporarily shuts 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 currently primarily 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. A strong U.S. dollar, when compared to local currencies in Asia, excluding the Japanese yen, may negatively impact our revenue. Our operating results could also be adversely affected by the seasonality of international sales and the economic conditions of our overseas markets.

### ***Our operating results could be materially affected by unanticipated changes in our tax provisions or exposure to additional income tax liabilities.***

Our determination of our tax liability (like any company's determination of its tax liability) is subject to review by applicable tax authorities. Any adverse outcome of such a review could have an adverse effect on our operating results and financial condition. In addition, the determination of our provision for income taxes and other tax liabilities requires significant judgment including our determination of whether a valuation allowance against deferred tax assets is required. Although we believe our estimates and judgments are reasonable, the ultimate tax outcome may differ from the amounts recorded in our financial statements and may materially affect our financial results in the period or periods for which such determination is made.

### ***Our stock price is highly volatile and investing in our stock involves a high degree of risk, which could result in substantial losses for investors.***

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 quarter ended December 31, 2008, the closing sale prices of our common stock on the NASDAQ Global Market ranged from \$10.28 to \$19.58 per share and the closing sale price for our quarter ended December 31, 2008 was \$16.03 per share. During the last eight fiscal

quarters ended December 31, 2008, our stock price closed at a high of \$39.74 on December 24, 2007 and a low of \$10.28 on October 27, 2008. Many factors may affect the market price of our common stock, including:

- fluctuation in our operating results;
- announcements of technological innovations or new commercial products by us or our competitors;
- changes in governmental regulation in the United States and internationally;
- prospects and proposals for health care reform;

**Table of Contents**

governmental or third-party payors controls on prices that our customers may pay for our products;  
developments or disputes concerning our patents or our other proprietary rights;  
product liability claims and 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 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**

At our annual meeting of shareholders held on October 28, 2008, the following matters were considered and voted upon:

- (a) The election of six (6) directors to hold office until the next annual meeting of shareholders. The votes cast and withheld for such nominees were as follows:

Nominee	FOR	WITHHELD
Clinton H. Severson	19,851,576	301,564
Richard J. Bastiani, Ph.D.	19,795,214	357,926
Henk J. Evenhuis	19,894,810	258,330
Brenton G.A. Hanlon	19,795,647	357,493
Prithipal Singh, Ph.D.	17,413,899	2,739,241
Ernest S. Tucker III, M.D.	19,838,715	314,425

- (b) The results of voting on the amendment to increase the number of shares authorized for issuance under the Abaxis, Inc. 2005 Equity Incentive Plan, were as follows:

FOR	AGAINST	ABSTAIN
14,199,346	2,921,155	32,983

- (c) The results of voting on the ratification of the appointment of Burr, Pilger & Mayer LLP as our independent registered public accounting firm for the fiscal year ending March 31, 2009, were as follows:

FOR	AGAINST	ABSTAIN
20,088,036	38,346	26,758

**Item 5. Other Information**

Not applicable.



**Table of Contents**

**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Description of Document</b>
<b>3.1</b>	Restated Articles of Incorporation (Filed with the Securities and Exchange Commission as an exhibit with our Annual Report on Form 10-K for the fiscal year ended March 31, 1993 and incorporated herein by reference.)
<b>3.2</b>	Certificate of Amendment of Amended and Restated Articles of Incorporation (Filed with the Securities and Exchange Commission as an exhibit with our Quarterly Report on Form 10-Q for the quarterly period ended December 31, 1996 and incorporated herein by reference.)
<b>3.3</b>	By-laws (Filed with the Securities and Exchange Commission in our Registration Statement No. 33-44326 on December 11, 1991 and incorporated herein by reference.)
<b>3.4</b>	Amendment to the By-laws (Filed with the Securities and Exchange Commission as an exhibit with our Current Report on Form 8-K on July 30, 2007 and incorporated herein by reference.)
<b>4.1</b>	Registration Rights Agreement, dated as of March 29, 2002 (Filed with the Securities and Exchange Commission as an exhibit with our Current Report on Form 8-K on May 13, 2002 and incorporated herein by reference.)
<b>4.2</b>	Reference is made to Exhibit 3.1, Exhibit 3.2, Exhibit 3.3 and Exhibit 3.4.
<b>10.1</b>	Abaxis, Inc. 2005 Equity Incentive Plan, as amended as of October 28, 2008. (Filed with the Securities and Exchange Commission as an exhibit with our Current Report on Form 8-K on November 3, 2008 and incorporated herein by reference.)
<b>10.2</b>	Abaxis, Inc. Executive Change of Control Severance Plan, as amended on December 23, 2008.
<b>31.1</b>	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
<b>31.2</b>	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
<b>32.1#</b>	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
<b>32.2#</b>	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

# This certification accompanies

this Quarterly Report on Form 10-Q. The certification is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Abaxis, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Quarterly Report on Form 10-Q and irrespective of any general incorporation language contained in any such filing.

**Table of Contents**

**SIGNATURES**

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

ABAXIS, INC.  
*(Registrant)*

Date: February 9, 2009

BY: /s/ Clinton H. Severson  
Clinton H. Severson  
President, Chief Executive Officer and Director  
(Principal Executive Officer)

Date: February 9, 2009

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



**Table of Contents**

**EXHIBIT INDEX**

<b>Exhibit No.</b>	<b>Description of Document</b>
<b>10.2</b>	Abaxis, Inc. Executive Change of Control Severance Plan, as amended on December 23, 2008.
<b>31.1</b>	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
<b>31.2</b>	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
<b>32.1#</b>	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
<b>32.2#</b>	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

# This certification accompanies this Quarterly Report on Form 10-Q. The certification is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Abaxis, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Quarterly

Report on Form  
10-Q and  
irrespective of  
any general  
incorporation  
language  
contained in any  
such filing.