

SRI SURGICAL EXPRESS INC  
Form 10-Q  
August 13, 2008  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2008

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-20997

**SRI/Surgical Express, Inc.**

(Exact name of registrant as specified in its charter)

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**Florida**  
(State of Incorporation)

**59-3252632**  
(I.R.S. Employer Identification No.)

**12425 Race Track Road**

**Tampa, Florida 33626**

(Address of Principal Executive Offices)

**(813) 891-9550**

(Registrant's Telephone Number)

Indicate by check whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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 the 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

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

Number of outstanding shares of each class of registrant's common stock as of August 6, 2008:

Common Stock, par value \$.001 6,495,978

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****SRI/SURGICAL EXPRESS, INC.****BALANCE SHEETS**

(In thousands)

	June 30, 2008 (unaudited)	December 31, 2007
<b>ASSETS</b>		
Cash and cash equivalents	\$ 628	\$ 656
Accounts receivable, net	12,481	11,613
Inventories, net	6,011	6,159
Prepaid expenses and other assets	1,538	2,847
Reusable surgical products, net	20,735	19,416
Property, plant and equipment, net	30,838	31,277
Total assets	\$ 72,231	\$ 71,968
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Liabilities:		
Notes payable	\$ 3,724	\$ 2,493
Accounts payable	9,137	7,984
Employee-related accrued expenses	1,622	1,572
Other accrued expenses	3,448	3,892
Mortgage payable	4,167	4,286
Bonds payable	6,730	7,060
Deferred tax liability, net		55
Total liabilities	28,828	27,342
Shareholders' equity:		
Preferred stock-authorized 5,000,000 shares of \$0.001 par value; no shares issued and outstanding at June 30, 2008 and December 31, 2007.		
Common stock-authorized 30,000,000 shares of \$0.001 par value; issued and outstanding 6,495,978 and 6,470,978 at June 30, 2008 and December 31, 2007, respectively.		
	6	6
Additional paid-in capital	31,915	31,454
Retained earnings	11,482	13,166
Total shareholders' equity	43,403	44,626
Total liabilities and shareholders' equity	\$ 72,231	\$ 71,968

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

**Table of Contents****SRI/SURGICAL EXPRESS, INC.****STATEMENTS OF OPERATIONS****(In thousands, except per share data)****(unaudited)**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Revenues	\$ 25,113	\$ 23,717	\$ 49,081	\$ 47,094
Cost of revenues	19,266	18,117	38,191	36,125
Gross profit	5,847	5,600	10,890	10,969
Distribution expenses	1,862	1,570	3,620	3,141
Selling and administrative expenses	4,207	4,301	8,657	8,652
Loss from operations	(222)	(271)	(1,387)	(824)
Interest expense	254	372	529	737
Other income	(91)	(90)	(185)	(122)
Loss before income taxes	(385)	(553)	(1,731)	(1,439)
Income tax expense (benefit)	5	(211)	(47)	(508)
Net loss	\$ (390)	\$ (342)	\$ (1,684)	\$ (931)
Loss per share:				
Basic	\$ (0.06)	\$ (0.05)	\$ (0.26)	\$ (0.15)
Diluted	\$ (0.06)	\$ (0.05)	\$ (0.26)	\$ (0.15)
Weighted average common shares outstanding:				
Basic	6,387	6,394	6,386	6,376
Diluted	6,387	6,394	6,386	6,376

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

**Table of Contents****SRI/SURGICAL EXPRESS, INC.****STATEMENTS OF CASH FLOWS****(In thousands)****(unaudited)**

	<b>Six Months Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (1,684)	\$ (931)
<b>Adjustments to reconcile net loss to net cash provided by operating activities:</b>		
Depreciation and amortization	1,736	1,700
Amortization of reusable surgical products	2,673	2,753
Stock-based compensation expense	461	324
(Reduction) provision for doubtful accounts	(1)	139
Provision for slow moving inventory	29	190
Provision for slow moving reusable surgical products and shrinkage	328	363
Deferred income taxes	(55)	(420)
<b>Change in operating assets and liabilities:</b>		
Increase in accounts receivable	(867)	(1,128)
Decrease (increase) in inventories	119	(1,094)
Decrease in prepaid expenses and other assets	1,309	208
Increase in accounts payable	1,153	909
(Decrease) increase in employee-related and other accrued expenses	(354)	964
<b>Net cash provided by operating activities</b>	<b>4,847</b>	<b>3,977</b>
<b>Cash flows from investing activities:</b>		
Purchases of property, plant and equipment	(944)	(909)
Purchases of reusable surgical products	(4,320)	(2,698)
<b>Net cash used in investing activities</b>	<b>(5,264)</b>	<b>(3,607)</b>
<b>Cash flows from financing activities:</b>		
Borrowings on notes payable	22,606	17,226
Repayments on notes payable	(21,759)	(17,408)
Repayment on mortgage payable	(119)	(119)
Repayment on bonds payable	(330)	(330)
Proceeds from exercise of stock options		249
Payments on obligation under capital lease	(9)	
<b>Net cash provided by (used in) financing activities</b>	<b>389</b>	<b>(382)</b>
Decrease in cash and cash equivalents	(28)	(12)
Cash and cash equivalents at beginning of period	656	283
<b>Cash and cash equivalents at end of period</b>	<b>\$ 628</b>	<b>\$ 271</b>
<b>Supplemental cash flow information:</b>		
Cash paid for interest	\$ 609	\$ 720

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Cash received for income taxes	\$ (418)	\$ (385)
Supplemental cash flow information:		
Assets acquired under capital lease	\$ 353	\$ 0

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

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**SRI/SURGICAL EXPRESS, INC.**

**NOTES TO FINANCIAL STATEMENTS**

**(unaudited)**

**NOTE A BASIS OF PRESENTATION**

The accompanying unaudited financial statements of SRI/Surgical Express, Inc. (the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the Securities and Exchange Commission's (the SEC) instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they omit or condense footnotes and certain other information normally included in complete financial statements prepared in accordance with accounting principles generally accepted in the United States of America. In the opinion of management, all adjustments of a normal recurring nature that are necessary to present fairly the financial information for the interim periods reported have been made. The accompanying unaudited financial statements should be read in conjunction with the financial statements and notes included in the Company's Form 10-K for the year ended December 31, 2007, filed with the SEC. The results of operations for the six months ended June 30, 2008, are not necessarily indicative of the results that can be expected for the entire year ending December 31, 2008.

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

The Company operates on a 52-53 week fiscal year ending the Sunday nearest December 31. The unaudited financial statements are reflected as of June 30, 2008 and 2007 for presentation purposes only. The actual end of each period was June 29, 2008 and July 1, 2007, respectively. There are 26 weeks included for each of the six month periods ended June 30, 2008 and 2007.

**NOTE B SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Use of Estimates*

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

*Accounts Receivable, net*

The Company has accounts receivable from hospitals and surgery centers. The Company does not believe that there are substantial credit risks associated with those receivables that should lead it to require a form of collateral from its customers. The allowance for doubtful accounts as of June 30, 2008, and December 31, 2007, was approximately \$827,000 and \$865,000, respectively. The allowance for doubtful accounts relates to accounts receivable not expected to be collected and is based on management's assessment of specific customer balances, the overall aging of the balances, and the financial stability of the customers. The Company does not customarily charge interest on accounts receivable.

*Inventories, net*

Inventories consist of raw materials, principally consumables, supplies, and disposable surgical products; work in progress; and finished goods consisting of company-assembled packs of various combinations of raw materials and reusable surgical products. Inventories are valued at the lower of cost or market, with cost being determined on the first-in, first-out method.

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As of June 30, 2008 and December 31, 2007, inventory consists of the following:

	June 30, 2008	December 31, 2007
	(in 000 s)	
Raw materials	\$ 3,015	\$ 3,092
Work in progress	211	232
Finished goods	3,339	3,360
	6,565	6,684
Less: Inventory reserve	(554)	(525)
	\$ 6,011	\$ 6,159

*Reusable Surgical Products, net*

The Company's reusable surgical products, consisting principally of linens (gowns, towels, drapes), basins (stainless steel medicine cups, carafes, trays, basins), and surgical instruments, are stated at cost. Amortization of linens and basins is computed on a basis similar to the units of production method. Estimated useful lives for each product are based on the estimated total number of available uses for each product. The expected total available usage for its linen products using the three principal fabrics (accounting for approximately 80% of the reusable surgical products) is 75, 100, and 125 uses, based on several factors, including the Company's actual historical experience with these products. The Company believes Radio Frequency Identification (RFID) technology enables it to evaluate the useful lives of linen products more efficiently. Basins are amortized over their estimated useful life, which ranges from 25 to 200 uses. Owned surgical instruments are amortized straight-line over a period of four years. Accumulated amortization as of June 30, 2008 and December 31, 2007, was approximately \$13.7 million and \$13.2 million, respectively.

As of June 30, 2008, and December 31, 2007, the Company had reserves for shrinkage, obsolescence, and scrap related to reusable surgical products of approximately \$1,265,000 and \$1,211,000, respectively.

*Revenue Recognition*

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

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

*Stock-Based Compensation*

The Company accounts for its stock-based compensation plans in accordance with the provisions of Statement of Financial Accounting Standard No. 123R, *Share-Based Payments*, (SFAS 123R). Under SFAS 123R, all stock-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period. The cost for all stock-based awards granted subsequent to December 31, 2005, represents the grant-date fair value that was estimated in accordance with the provisions of SFAS 123R, utilizing the binomial (Lattice) model. Stock-based compensation expense was \$234,000 and \$180,000, or \$234,000 and \$131,000, net of income tax, for the three months ended June 30, 2008.



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and 2007, respectively, which contributed to a \$0.04 and \$0.02 reduction in basic and diluted earnings per share for each of the three months ended June 30, 2008 and 2007, respectively. Stock-based compensation expense was \$461,000 and \$324,000, or \$461,000 and \$244,000, net of income tax, for the six months ended June 30, 2008 and 2007, respectively, which contributed to a \$0.07 and \$0.04 reduction in basic and diluted earnings per share for the six-months ended June 30, 2008 and 2007, respectively.

The Company did not receive any proceeds from stock option exercises under all share-based payment arrangements for each of the three and six months ended June 30, 2008. The proceeds from stock option exercises under all stock-based payment arrangements for each of the three and six months ended June 30, 2007 were \$249,000. There were no capitalized stock-based compensation costs at June 30, 2008 or 2007.

### *Stock Option Plans*

#### The 1995 Stock Option Plan

The 1995 Stock Option Plan is designed to provide employees with incentive or non-qualified options to purchase up to 700,000 shares of common stock. The options vest ratably over four to five years from the date of the grant. All outstanding options vest upon a change in control of the Company. Options granted under this Plan expire no later than ten years after the date granted or sooner in the event of death, disability, retirement or termination of employment. As of June 30, 2008 and 2007, options to purchase 81,700 and 119,600 shares, respectively, were outstanding under this Plan. The 1995 Stock Option Plan terminated on December 21, 2005, although that termination does not adversely affect any options outstanding under the Plan.

#### The 1996 Non-Employee Director Plan

As amended on May 16, 2001, the Non-Employee Director Plan is designed to provide for the grant of non-qualified stock options to purchase up to 200,000 shares of common stock to members of the Board of Directors who are not employees of the Company. At the completion of the Company's initial public offering, each non-employee director was granted options to purchase 4,000 shares of common stock for each full remaining year of the director's term. Thereafter, on the date on which a new non-employee director was first elected or appointed, he or she was automatically granted options to purchase 4,000 shares of common stock for each year of his or her initial term, and was granted options to purchase 4,000 shares of common stock for each year of any subsequent term to which he or she was elected. As of March 2006, the equity component of the director compensation plan was restructured, so that each non-employee director receives an annual grant of options to purchase 7,500 shares of common stock as of the date of the Annual Shareholder Meeting, beginning with the 2006 Annual Meeting. All options vest ratably over a three-year term and have an exercise price equal to the fair market value of the common stock on the date of grant. As of June 30, 2008 and 2007, options to purchase 120,000 shares were outstanding, and no options were available to be granted under this Plan. The 1996 Non-Employee Director Plan terminated on July 14, 2006, although that termination does not adversely affect any options outstanding under the Plan.

#### The 1998 Stock Option Plan

As amended on May 16, 2001, the 1998 Stock Option Plan is designed to provide employees with incentive or non-qualified options to purchase up to 600,000 shares of common stock. The options vest ratably over four to five years from the date of the grant. All outstanding options vest upon a change in control of the Company. Options granted under this Plan expire no later than ten years after the date granted or sooner in the event of death, disability, retirement, or termination of employment. As of June 30, 2008 and 2007, options to purchase 392,400 and 356,720 shares, respectively, were outstanding, and 0 and 176,084 options, respectively, were available to be granted under this Plan. The 1998 Stock Option Plan terminated on February 17, 2008, although that termination does not adversely affect any options outstanding under the Plan.

#### The 2004 Stock Compensation Plan

The 2004 Stock Compensation Plan is designed to further the interests of the Company and its shareholders by providing incentives in the form of incentive or non-qualified stock options or restricted stock

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grants to key employees and non-employee directors who contribute materially to the success and profitability of the Company. Under this Plan, restricted stock grants are not considered outstanding options upon grant but are considered issued and outstanding stock. Any forfeited restricted stock awards are considered to be available for grant. The equity awards typically vest ratably over five years from the date of the grant. All outstanding grants vest upon a change in control of the Company. Options granted under this Plan expire no later than ten years after the date granted or sooner in the event of death, disability, retirement, or termination of employment. At the Company's annual meeting of shareholders on May 24, 2007, the shareholders approved an amendment to the 2004 Stock Compensation Plan to authorize an additional 500,000 shares under the Plan. As of June 30, 2008 and 2007, restricted stock and options to purchase 311,500 and 281,000 shares, respectively, were outstanding, and 617,700 and 648,200 shares, respectively, were available to be granted as options or restricted stock under this Plan.

The following table summarizes option and restricted stock grant activity from January 1, 2008 through June 30, 2008:

<b>Shares Available for Grant</b>	<b>Options Outstanding</b>
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