

DIGIRAD CORP
Form 10-Q
July 23, 2009
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED June 30, 2009

“ **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: 000-50789

Digirad Corporation

(Exact name of registrant as specified in its charter)

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Delaware
(State or Other Jurisdiction of

33-0145723
(I.R.S. Employer

Incorporation or Organization)

Identification No.)

13950 Stowe Drive, Poway, CA
(Address of Principal Executive Offices)

92064
(Zip Code)

(858) 726-1600

(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether 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.

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☒ (Do not check if a smaller reporting company)

Smaller reporting company ☐

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

As of July 13, 2009, the registrant had 18,968,697 shares of Common Stock (\$0.0001 par value) outstanding.

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DIGIRAD CORPORATION

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****Digirad Corporation****Consolidated Balance Sheets****(In thousands, except par value amounts)**

	June 30, 2009 (Unaudited)	December 31, 2008
Assets		
Current assets:		
Cash and cash equivalents	\$ 15,735	\$ 13,525
Securities available-for-sale	15,767	14,759
Accounts receivable, net	8,716	9,324
Inventories, net	6,944	4,978
Property and equipment held for sale		1,122
Other current assets	1,663	1,982
Total current assets	48,825	45,690
Property and equipment, net	11,587	13,428
Intangible assets, net	1,518	1,833
Goodwill	184	184
Restricted cash		60
Total assets	\$ 62,114	\$ 61,195
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 2,407	\$ 2,197
Accrued compensation	3,560	3,457
Accrued warranty	736	906
Other accrued liabilities	2,787	2,811
Deferred revenue	2,520	2,723
Total current liabilities	12,010	12,094
Deferred rent	122	142
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.0001 par value: 10,000 shares authorized at June 30, 2009 and December 31, 2008; no shares issued or outstanding at June 30, 2009 and December 31, 2008		
Common stock, \$0.0001 par value: 80,000 shares authorized at June 30, 2009 and December 31, 2008; 18,760 and 18,944 shares issued and outstanding (net of treasury shares) at June 30, 2009 and December 31, 2008, respectively	2	2
Less: Treasury stock, at cost; 209 shares at June 30, 2009 and no shares at December 31, 2008	(267)	
Additional paid-in capital	153,547	153,225
Accumulated other comprehensive income (loss)	118	(22)
Accumulated deficit	(103,418)	(104,246)

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Total stockholders' equity	49,982	48,959
Total liabilities and stockholders' equity	\$ 62,114	\$ 61,195

See accompanying notes.

Table of Contents**Digirad Corporation****Consolidated Statements of Operations****(In thousands, except per share amounts)****(Unaudited)**

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Revenues:				
DIS	\$ 13,565	\$ 14,224	\$ 27,416	\$ 28,078
Product	4,994	5,673	8,853	10,090
Total revenues	18,559	19,897	36,269	38,168
Cost of revenues:				
DIS	9,528	11,387	19,722	22,299
Product	3,143	3,955	5,550	6,901
Total cost of revenues	12,671	15,342	25,272	29,200
Gross profit	5,888	4,555	10,997	8,968
Operating expenses:				
Research and development	854	661	1,626	1,305
Marketing and sales	2,016	2,277	3,724	4,397
General and administrative	2,235	2,852	4,644	6,011
Amortization of intangible assets	145	179	315	369
Restructuring loss			145	
Total operating expenses	5,250	5,969	10,454	12,082
Income (loss) from operations	638	(1,414)	543	(3,114)
Other income (expense):				
Interest income	122	223	225	538
Interest expense	(2)	(11)	(5)	(19)
Other	26	46	65	44
Total other income	146	258	285	563
Net income (loss)	\$ 784	\$ (1,156)	\$ 828	\$ (2,551)
Net income (loss) per common share basic and diluted	\$ 0.04	\$ (0.06)	\$ 0.04	\$ (0.13)
Weighted average shares outstanding basic	19,044	18,936	19,033	18,940
Weighted average shares outstanding diluted	19,361	18,936	19,255	18,940

See accompanying notes.

Table of Contents**Digirad Corporation****Consolidated Statements of Cash Flows****(In thousands)****(Unaudited)**

	Six months ended June 30,	
	2009	2008
Operating activities		
Net income (loss)	\$ 828	\$ (2,551)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation	2,396	2,808
Amortization of intangible assets	315	369
Provision for bad debt	34	148
Stock-based compensation	316	413
Restructuring loss	145	
(Gain) loss on disposal of assets	(64)	11
Amortization of premium on securities available-for-sale	240	104
Changes in operating assets and liabilities:		
Accounts receivable	574	(474)
Inventories	(1,929)	(197)
Other assets	379	(261)
Accounts payable	210	(418)
Accrued compensation	136	223
Other accrued liabilities	(553)	(699)
Net cash provided by (used in) operating activities	3,027	(524)
Investing activities		
Purchases of property and equipment	(352)	(3,682)
Proceeds from sale of property and equipment	939	
Purchases of securities available-for-sale	(8,360)	(9,376)
Maturities of securities available-for-sale	7,251	10,200
Net cash used in investing activities	(522)	(2,858)
Financing activities		
Issuances of common stock	5	1
Repurchases of common stock	(267)	
Repayment of obligations under capital leases	(33)	(160)
Net cash used in financing activities	(295)	(159)
Net increase (decrease) in cash and cash equivalents	2,210	(3,541)
Cash and cash equivalents at beginning of period	13,525	14,922
Cash and cash equivalents at end of period	\$ 15,735	\$ 11,381

See accompanying notes.

Table of Contents**DIGIRAD CORPORATION****NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

(in thousands, except per share amounts)

1. Interim Financial Information***Organization and Business***

Digirad Corporation (Digirad), a Delaware corporation, is a leading provider of cardiovascular imaging services and solid-state nuclear medicine imaging products to physician offices, hospitals and other medical services providers. Digirad has two reportable segments, Digirad Imaging Solutions (DIS) and Product. The accompanying consolidated financial statements include the operations of both segments. Intercompany accounts and transactions have been eliminated in consolidation. Substantially all of our revenue arises from sales activity in the United States. Through DIS, we provide in-office services to physicians, offering certified personnel, required licensure, an imaging system and other support and supplies for the performance of nuclear and ultrasound imaging procedures under the supervision of our physician customers. DIS physician customers enter into annual lease contracts for imaging services generally delivered on a per-day basis. Our Product segment sells solid-state gamma cameras and provides camera service and maintenance contracts.

Basis of Presentation

We have prepared the accompanying unaudited consolidated financial statements in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and disclosures required by generally accepted accounting principles for complete financial statements. In the opinion of our management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2009 are not necessarily indicative of the results that may be expected for the entire year. For further information, see our financial statements and related disclosures thereto for the year ended December 31, 2008 in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 13, 2009. We have evaluated subsequent events through July 23, 2009, the filing date of this Form 10-Q.

Net Income (Loss) Per Share

We calculate net income (loss) per share in accordance with the Statement of Financial Accounting Standards No. 128, *Earnings Per Share* (SFAS 128). SFAS 128 requires presentation of basic and diluted earnings per share. Basic earnings per share (EPS) is calculated by dividing net income (loss) by the weighted average number of common shares outstanding and the weighted average number of vested restricted stock units for the period, without consideration for common stock equivalents. Diluted EPS is computed by dividing net income (loss) by the weighted average number of common shares outstanding and the weighted average number of dilutive common stock equivalents, such as stock options and non-vested restricted stock units, for the period. Common stock equivalents are only included in the calculation of diluted earnings per share when their effect is dilutive. The following table sets forth the computation of basic and diluted net income per share for the three and six months ended June 30, 2009 and 2008 (in thousands, except per share amounts):

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Net income (loss)	\$ 784	\$ (1,156)	\$ 828	\$ (2,551)
Shares used to compute basic net income (loss) per share	19,044	18,936	19,033	18,940
Dilutive potential common shares:				
Stock options	228		167	
Restricted stock units	89		55	
Shares used to compute diluted net income (loss) per share	19,361	18,936	19,255	18,940
Basic and diluted net income (loss) per share	\$ 0.04	\$ (0.06)	\$ 0.04	\$ (0.13)

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Comprehensive Income (Loss)

Comprehensive income (loss) consists of the following components (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Net income (loss), as reported	\$ 784	\$ (1,156)	\$ 828	\$ (2,551)
Unrealized gain (loss) on marketable securities	378	(315)	140	(283)
Comprehensive income (loss)	\$ 1,162	\$ (1,471)	\$ 968	\$ (2,834)

Table of Contents***Fair-value of Financial Instruments***

The carrying value of financial instruments, such as cash and cash equivalents, securities available-for-sale, accounts receivable, accounts payable and accrued liabilities approximate their fair value because of their short term nature. We do not hold or issue financial instruments for trading purposes.

Cash and Cash Equivalents. We consider all investments with a maturity of three months or less when acquired to be cash equivalents. Cash equivalents primarily represent funds invested in money market funds whose cost equals fair market value.

Securities, Available-for-Sale. Securities consist of high-grade auction rate securities, corporate debt securities and government sponsored entities. We classify all securities as available-for-sale, as the sale of such securities may be required prior to maturity to implement management strategies. These securities are carried at fair value, with the unrealized gains and losses reported as a component of other comprehensive income (loss) in stockholders' equity until realized. Realized gains and losses from the sale of available-for-sale securities, if any, are determined on a specific identification basis. A decline in the market value of any available-for-sale security below cost that is determined to be other than temporary will result in a revaluation of its carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. No such impairment charges were recorded for any period presented. Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the straight-line method. Interest income is recognized when earned. Realized gains and losses on investments in securities are included in other income within the Consolidated Statements of Operations. Net realized losses were not material in 2009 or 2008. The amortization, accretion and interest income are included in interest income within the Consolidated Statements of Operations. The composition of securities available for sale are as follows (in thousands):

As of June 30, 2009	Maturity in	Amortized Cost	Unrealized		Fair Value
	Years		Gains	Losses	
U.S. treasury securities	2 or less	\$ 4,096	\$ 34	\$	\$ 4,130
Government sponsored entities	4 or less	3,437	8	(11)	3,434
Corporate debt securities	4 or less	8,116	96	(9)	8,203
		\$ 15,649	\$ 138	\$ (20)	\$ 15,767

As of December 31, 2008	Maturity in	Amortized Cost	Unrealized		Fair Value
	Years		Gains	Losses	
U.S. treasury securities	2 or less	\$ 7,190	\$ 74	\$	\$ 7,264
Government sponsored entities	2 to 3	1,530		(16)	1,514
Corporate debt securities	3 or less	3,561	3	(83)	3,481
Auction rate securities	1 or less	2,500			2,500
		\$ 14,781	\$ 77	\$ (99)	\$ 14,759

New Accounting Pronouncements

On April 9, 2009, the FASB issued FSP FAS 107-1, *Interim Disclosures about Fair Value of Financial Instruments*, and FSP FAS 115-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, which we adopted on a prospective basis beginning April 1, 2009. These positions extend the disclosure requirements of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments* (SFAS No. 107), and Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS No. 115) to interim financial statements of publicly traded companies. The application of FSP FAS 107-1 and FSP FAS 115-2 did not have an impact on our consolidated financial position, results of operations or cash flows.

On May 28, 2009, the FASB issued Financial Accounting Standards No. 165, *Subsequent Events* (SFAS No. 165), which we adopted on a prospective basis beginning April 1, 2009. SFAS No. 165 is intended to establish general standards of accounting and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for selecting that date. The application of SFAS No. 165 did not have an impact on our consolidated financial position, results of operations or cash flows.

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On January 1, 2009, we adopted FSP FAS 142-3, *Determination of the Useful Life of Intangible Assets*. FSP FAS 142-3 amends the factors that should be considered in developing a renewal or extension assumptions used for purposes of determining the useful life of a recognized intangible asset under Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). FSP FAS 142-3 is intended to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under Statement of Financial Accounting Standards No. 141(R), *Business Combinations* (SFAS 141(R)) and other U.S. generally accepted accounting principles. The application of FSP FAS 142-3 did not have a material impact on our consolidated financial position, results of operations or cash flows.

2. Financial Statement Details

Inventories consist of the following (in thousands):

	June 30, 2009	December 31, 2008
Raw materials	\$ 2,696	\$ 1,997
Work-in-progress	3,767	3,056
Finished goods	1,340	520
	7,803	5,573
Less reserves for excess and obsolete inventories	(859)	(595)
	\$ 6,944	\$ 4,978

Property and equipment consist of the following (in thousands):

	June 30, 2009	December 31, 2008
Machinery and equipment	\$ 23,932	\$ 24,743
Computers and software	3,411	3,955
Leasehold improvements	951	768
	28,294	29,466
Less accumulated depreciation and amortization	(16,707)	(16,038)
	\$ 11,587	\$ 13,428

Other accrued liabilities consist of the following (in thousands):

	June 30, 2009	December 31, 2008
Radiopharmaceuticals and consumable medical supplies	\$ 584	\$ 507
Outside services and consulting	459	373
Customer deposits	349	142
Professional fees	316	420
Facilities and related costs	310	400
Other accrued liabilities	769	969
	\$ 2,787	\$ 2,811

3. Investments

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We measure available-for-sale securities at fair value on a recurring basis in accordance with SFAS 157, *Fair Value Measurements*. Under SFAS 157, fair value is based on 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. In order to increase consistency and comparability in fair value measurements, SFAS 157 establishes a fair value hierarchy that prioritizes observable and unobservable inputs used to measure fair value into three broad levels. These levels, in order of highest priority to lowest priority, are described below:

Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for assets or liabilities.

Level 2: Observable prices that are based on inputs not quoted on active markets, but corroborated by market data.

Level 3: Unobservable inputs are used when little or no market data is available.

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The fair values of our available-for-sale securities were determined using the following inputs (in thousands):

	Total	Fair Value Measurements at June 30, 2009 Using Quoted Prices in		
		Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale securities:				
U.S. treasury securities	\$ 4,130	\$ 4,130	\$	\$
Government sponsored entities	3,434		3,434	
Corporate debt securities	8,203		8,203	
Total available-for-sale securities:	\$ 15,767	\$ 4,130	\$ 11,637	\$

Our investments in U.S. treasury securities were valued based on publicly available quoted prices for identical securities as of June 30, 2009. Our investments in government sponsored entities and corporate debt securities were valued by a third party pricing vendor using proprietary valuation models and analytical tools. The inputs to these models related to similar instruments and were both objective and publicly available.

4. Intangible Assets

Intangible assets consisted of the following (in thousands):

	June 30, 2009		
	Gross Amount	Accumulated Amortization	Net Book Value
Intangibles subject to amortization:			
Customer relationships	\$ 2,600	\$ 1,360	\$ 1,240
Covenants not to compete	300	130	170
Patents	165	57	108
Total intangibles assets:	\$ 3,065	\$ 1,547	\$ 1,518

	December 31, 2008		
	Gross Amount	Accumulated Amortization	Net Book Value
Intangibles subject to amortization:			
Customer relationships	\$ 2,600	\$ 1,083	\$ 1,517
Covenants not to compete	300	100	200
Patents	165	49	116
Total intangible assets:	\$ 3,065	\$ 1,232	\$ 1,833

All patents and their related amortization are recorded within the Product segment. All other intangible assets, including goodwill, and their related amortization expense are recorded within the DIS segment. The aggregate amortization expense related to intangible assets with finite lives for the three and six months ended June 30, 2009 was \$0.1 million and \$0.3 million, respectively. Estimated future amortization expense related to intangible assets with finite lives at June 30, 2009 is as follows:

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	In Thousands
2009 (remaining 6 months)	\$ 265
2010	429
2011	334
2012	236
2013	166
Thereafter	88
Total	\$ 1,518

5. Warranty

We provide a warranty on certain of our products and accrue the estimated cost at the time revenue is recorded. Warranty expense is charged to product cost of revenues. Substantially all of the warranty periods are 12 months before customer-sponsored maintenance begins. Warranty reserves are established based on historical experience with failure rates and repair costs and the number of systems covered by warranty. Warranty reserves are depleted as gamma cameras are repaired. The costs consist principally of materials, personnel, and overhead. We review warranty reserves quarterly and, if necessary, make adjustments.

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The activities in our warranty reserve are as follows (in thousands):

	Three months ended June 30, 2009	Three months ended June 30, 2008	Six months ended June 30, 2009	Six months ended June 30, 2008
Balance at beginning of period	\$ 809	\$ 785	\$ 906	\$ 930
Charges to cost of revenues	180	280	324	436
Costs applied to liability	(253)	(300)	(494)	(601)
Balance at end of period	\$ 736	\$ 765	\$ 736	\$ 765

6. Restructuring

In response to historical operating losses within our DIS business segment, we initiated a realignment of our imaging business in the fourth quarter of 2008. The realignment included the sale or closure of underperforming DIS hub locations in order to allow us to better focus on hub locations that benefit from our Centers of Influence marketing model. These sales and closures involve the sale or abandonment of property and equipment and staff reductions at the hub locations impacted by the restructuring plans, as well as the reduction of certain management positions. As of June 30, 2009, we have completed our restructuring plan.

Restructuring activity through June 30, 2009 is comprised of the following (in thousands):

	Six months ended June 30, 2009				Liability as of June 30, 2009	Total costs incurred as of June 30, 2009	Total expected costs as of June 30, 2009
	Liability as of December 31, 2008	Charges	Cash Payments	Non-cash Settlements			
Restructuring charges:							
Loss on property and equipment	\$	\$ 22	\$ (14)	\$ (8)	\$	\$ 1,019	\$ 1,019
Severance	203	47	(170)	(80)		309	309
Lease obligations	39	76	(29)		86	115	115
Other	10		(10)			10	10
Total restructuring charges	\$ 252	\$ 145	\$ (223)	\$ (88)	\$ 86	\$ 1,453	\$ 1,453

Restructuring activities are recorded in accordance with SFAS No. 146 and are included in the income (loss) from operations within our DIS business segment. There were no restructuring charges for the three months ended June 30, 2009. The majority of the losses pertained to property and equipment that were sold or disposed of in the quarters ended March 31, 2009 and December 31, 2008. Severance costs that require no future performance or service are recorded at the time they are communicated to the affected employees. Losses on leased property at the hub locations are recorded when the lease is abandoned.

7. Segments

Our reporting segments have been determined based on the nature of the products and/or services offered to customers or the nature of their function in the organization. We evaluate performance based on the operating income contributed by each segment. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies in our Annual Report on Form 10-K. Segment results are as follows (in thousands):

	Three months ended June 30, 2009	Three months ended June 30, 2008	Six months ended June 30, 2009	Six months ended June 30, 2008
Gross profit by segment:				

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DIS	\$ 4,037	\$ 2,837	\$ 7,694	\$ 5,779
Product	1,851	1,718	3,303	3,189

Consolidated gross profit	\$ 5,888	\$ 4,555	\$ 10,997	\$ 8,968
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Income (loss) from operations by segment:

DIS	\$ 894	\$ (1,260)	\$ 1,181	\$ (2,532)
Product	(256)	(154)	(638)	(582)

Consolidated income (loss) from operations	\$ 638	\$ (1,414)	\$ 543	\$ (3,114)
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Depreciation and amortization of tangible and intangible assets by segment:

DIS	\$ 1,149	\$ 1,396	\$ 2,430	\$ 2,725
Product	131	220	281	452

Consolidated depreciation and amortization	\$ 1,280	\$ 1,616	\$ 2,711	\$ 3,177
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As of June 30,
2009 2008

Identifiable assets by segment:

DIS	\$ 21,814	\$ 29,723
Product	40,300	35,858

Consolidated assets	\$ 62,114	\$ 65,581
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8. Income Taxes

As of December 31, 2008, we had unrecognized tax benefits of approximately \$1.5 million. There has been no significant change in unrecognized tax benefits through June 30, 2009. Due to the existence of the valuation allowance, future changes in our unrecognized tax benefits will not impact our effective tax rate. We do not expect our unrecognized tax benefits to change significantly over the next 12 months.

We file income tax returns in the U.S. and in various state jurisdictions with varying statutes of limitations. We are no longer subject to income tax examination by tax authorities for years prior to 2003; however, our net operating loss and research credit carry-forwards arising prior to that year are subject to adjustment. Our policy is to recognize interest expense and penalties related to income tax matters as a component of income tax expense. There were no accrued interest and penalties associated with uncertain tax positions as of June 30, 2009.

9. Commitments and Contingencies

Acquisition

On May 1, 2007, we completed the acquisition of substantially all of the assets and liabilities of Ultrascan, Inc. (Ultrascan), a provider of ultrasound imaging systems and services to physicians' offices and hospitals. Additional consideration, payable in cash and common stock, of up to \$3.9 million may be payable to the seller, or its designees, in the event that certain financial milestones are achieved over a four year period commencing on the date of the acquisition. The additional consideration will be added to goodwill if and when it is earned.

Stock Repurchase Program

On February 4, 2009, our board of directors authorized a stock buyback program to repurchase up to an aggregate of \$2.0 million of our issued and outstanding common shares. The timing of stock repurchases and the number of shares of common stock to be repurchased are in compliance with Rule 10b-18 under the Securities Exchange Act of 1934. The timing and extent of the repurchase depends upon market conditions, applicable legal requirements, and other factors. During the three and six months ended June 30, 2009, we repurchased 198,000 and 209,000 shares, respectively, of our common stock at a cost totaling \$0.3 million at a weighted average price of \$1.28 per share.

Compliance with Laws and Regulations

We are directly, or indirectly through our clients, subject to extensive regulation by the federal government, the states and foreign countries in which we conduct business. The healthcare laws applicable to us are complex and are subject to variable interpretations. We have established a compliance program to identify any compliance issues, correct any identified issues and assist us in remaining in compliance with the applicable healthcare laws, and have instituted other safeguards intended to help prevent any violations of the laws and to remedy any situations that could give rise to violations. We can provide no assurance that these measures will be successful in preventing compliance violations and the resulting fines, penalties or damages.

Legal Matters

In the normal course of business, we have been, and will likely continue to be, subject to litigation or administrative proceedings incidental to our business, such as claims related to customer disputes, employment practices, wage and hour disputes, product liability, professional liability, commercial disputes, licensure restrictions or denials, and warranty or patent infringement. Responding to litigation or administrative proceedings, regardless of whether they have merit, can be expensive and disruptive to normal business operations. As litigation and the administrative proceedings are inherently uncertain, we cannot predict the outcome of such matters. While the ultimate outcome of litigation is always uncertain, we do not believe that it will have a material adverse effect on our business or financial results.

10. Subsequent Events

In the second quarter of 2009, our shareholders approved a stock option exchange program pursuant to which eligible holders of stock options would be offered the opportunity to exchange their eligible options to purchase shares of common stock outstanding under the Company's existing equity incentive plans, for a smaller number of new options at a lower exercise price. On July 9, 2009, we cancelled options to purchase an aggregate of 1,132,201 shares of our common stock, and in exchange, granted new options to purchase an aggregate of 406,820 shares of our common stock.

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

The following discussion and analysis should be read in conjunction with our financial statements and notes thereto included in this report on Form 10-Q, and the audited financial statements and notes thereto as of and for the year ended December 31, 2008 included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 13, 2009. Operating results are not necessarily indicative of results that may occur in future periods.

This report contains various forward-looking statements regarding our business, financial condition, results of operations and future plans and projects. Forward-looking statements discuss matters that are not historical facts and can be identified by the use of words such as believes, expects, anticipates, intends, estimates, projects, can, could, may, will, would or similar expressions. In this report, for example, forward-looking statements regarding, among other things, the efficacy of our centers of influence model, our expectations about the rate of revenue growth in specific business segments and the reasons for that growth and our profitability, our expectations regarding an increase in sales, strategic traction and marketing and sales spending, uncertainties relating to our ability to compete, uncertainties relating to our ability to increase our market share, changes in coverage and reimbursement policies of third-party payors and the effect on our ability to sell our products and services, our ability to timely develop new products or services that will be accepted by the market, competition from alternative imaging modalities, declining average selling prices for our Product offerings, reduced supplies of radiopharmaceuticals, and the profitability of our DIS core footprint.

Although these forward-looking statements reflect the good faith judgment of our management, such statements can only be based upon facts and factors currently known to us. Forward-looking statements are inherently subject to risks and uncertainties, many of which are beyond our control. As a result, our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth below under the caption Risk Factors. For these statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. You should not unduly rely on these forward-looking statements, which speak only as of the date on which they were made. They give our expectations regarding the future, but are not guarantees. We undertake no obligation to update publicly or revise any forward-looking statements, whether as a result of new information, future events or otherwise, unless required by law.

Overview

We are a leading provider of diagnostic imaging products and personnel and equipment leasing services that improve patient care while driving positive healthcare economics. We designed and commercialized the first solid-state nuclear gamma camera for the detection of cardiovascular disease and other medical conditions. Our imaging systems are portable as well as fixed, and provide enhanced operability, improved patient comfort and, in the case of our triple-headed Cardius® 3 XPO system, shorter image acquisition time when compared to traditional vacuum tube cameras. Our nuclear cameras fit easily into floor spaces as small as seven feet by eight feet and facilitate the delivery of nuclear medicine procedures in a physician's office, an outpatient hospital setting or within multiple departments of a hospital.

We generate revenues within two primary operating segments: our personnel and equipment leasing service business (Digirad Imaging Solutions, or DIS) and our Product segment. Through DIS, we offer a comprehensive personnel and equipment leasing services program as an alternative to purchasing a gamma camera or ultrasound machine for physicians who wish to perform nuclear imaging, echocardiography, vascular ultrasound, or any combination of these procedures in their offices by leasing the imaging system, certified personnel and other support required to perform imaging in the physician's office. The flexibility of our products and our DIS leasing service allows physicians more control over the diagnosis and treatment of their patients in their offices and to retain revenue from procedures they would otherwise refer elsewhere. DIS leasing services are primarily provided to cardiologists and internists who enter into annual contracts for personnel and equipment services delivered on a per-day basis. Our typical lease contracts provide service coverage ranging from once per month to five times per week. We experience some seasonality in our DIS business related to summer vacations, holidays and inclement weather, which historically has most negatively affected our third quarter. Our product revenue results primarily from selling solid-state gamma cameras and camera maintenance contracts. We sell our imaging systems to physician offices, hospitals, and imaging centers primarily in the United States, although we have sold a small number of imaging systems internationally.

Our Market

The target market for our products and services is comprised of approximately 26,000 cardiologists, 130,000 internists and family practitioners, and hospitals in the United States that perform or could perform nuclear cardiac and ultrasound procedures. As of June 30, 2009, we have provided imaging services through DIS to more than 900 physicians and physician groups. We have sold 643 cameras through our Product segment. More than half of our DIS nuclear and ultrasound imaging customers are internists or other primary care practitioners, and the remainder are cardiologists. Our market has been negatively affected by declining

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reimbursements from Medicare and Medicaid programs, pricing pressures, decreases in radiopharmaceutical supplies and continuing efforts by some third party payors to reduce health care expenditures by requiring physicians to obtain specific accreditations or certifications, or disallowing reimbursement if imaging is performed in-house.

Trends and Drivers

The medical device industry, including the market for nuclear and ultrasound imaging systems and services, is highly competitive. Our business continues to be negatively affected by many factors, including declining healthcare reimbursement rates for cardiac imaging procedures, competition from alternative imaging modalities such as CT Angiography, declining average selling prices for our Product offerings, and reduced supplies of radiopharmaceuticals. We expect each of these trends to continue.

Our primary focus for 2009 is to improve both our profitability and our cash flow results. To this end, we initiated a restructuring plan during the fourth quarter of 2008 to create greater efficiency in DIS by selling or closing underperforming locations. This, combined with a more efficient management structure, is expected to result in a more profitable core DIS footprint that can be leveraged with our COI marketing strategy.

In our Product segment, we plan to build on our 2008 Product segment achievements by introducing new products targeted specifically at the larger physician practices and hospital market segments. These initiatives are intended to drive us towards consistent profitability and cash flow. Our restructuring initiatives contributed to the achievement of operating income for the six months of 2009, and the increase in cash, cash equivalents and securities available-for-sale of \$3.2 million from December 31, 2008. In March 2009, we announced that we had received U.S. Food and Drug Administration (FDA) 510(k) clearance for our new Cardius® X-ACT imaging system. Cardius® X-ACT is a rapid cardiac SPECT/VCT imaging system that features a low-dose volume computed tomography (VCT) attenuation correction system that significantly reduces artifacts in the images caused by overlying tissues increasing interpretive ease and accuracy.

First Half 2009 Financial Highlights

Our consolidated revenues were \$36.3 million during the six months ended June 30, 2009 (2009), which represented a decrease of \$1.9 million, or 5.0%, over the comparable prior year period (2008) due to a decrease in revenue within both the Product and DIS segments. DIS revenue decreased \$0.7 million due to the sale or closure of several underperforming locations in connection with our restructuring plan initiated in the fourth quarter of 2008. Product revenues decreased \$1.2 million, or 12.3%, as economic factors contributed to a decline in the number of cameras sold from 31 cameras in 2008 to 27 cameras in 2009, and a shift in our gamma camera sales mix to a larger number of refurbished cameras. The decline in our camera sales revenues was partially mitigated by a 12.9% increase in maintenance contract revenues in 2009 compared to 2008. In addition, we experienced low product bookings in 2009 compared to historical levels. Our consolidated net income for the six months ended June 30, 2009 was \$0.8 million, compared to a net loss of \$2.6 million during the same period in 2008. The improvement in our operating results was due to increased DIS segment gross profits as we increased the utilization of our portable nuclear cameras and ultrasound machines and DIS personnel costs and a reduction in our operating expenses which were primarily achieved through the flattening of the management structure and other restructuring initiatives implemented by us in the fourth quarter of 2008. We completed our restructuring plan in the first quarter of 2009.

Our DIS business currently operates in 19 states and the District of Columbia. In 2009, DIS operated 86 nuclear gamma cameras and 69 ultrasound imaging systems, compared to 102 nuclear gamma cameras and 62 ultrasound imaging systems in 2008. We are seeking to improve our overall profitability through more efficient utilization of our fleet of gamma cameras and ultrasound machines. We measure efficiency by tracking system utilization, which is measured based on the percentage of days that our nuclear gamma cameras and ultrasound machines are used to deliver services to customers out of the total number of days that they are available to deliver such services. System utilization increased to 63% in 2009, compared to 60% for 2008, primarily due to the closure of underperforming hubs and the disposal of gamma cameras.

Results of Operations

The following table sets forth our results from operations, expressed as percentages of revenues for the three and six months ended June 30, 2009 and 2008:

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Revenues:				
DIS	73.1%	71.5%	75.6%	73.6%

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Product	26.9	28.5	24.4	26.4
Total revenues	100.0	100.0	100.0	100.0
Total cost of revenues	68.3	77.1	69.7	76.5
Gross profit	31.7	22.9	30.3	23.5
Operating expenses:				
Research and development	4.6	3.3	4.5	3.4
Marketing and sales	10.9	11.4	10.2	11.5
General and administrative	12.0	14.4	12.8	15.8
Amortization of intangible assets	0.8	0.9	0.9	1.0
Restructuring loss			0.4	
Total operating expenses	28.3	30.0	28.8	31.7
Income (loss) from operations	3.4	(7.1)	1.5	(8.2)
Other income	0.8	1.3	0.8	1.5
Net income (loss)	4.2%	(5.8)%	2.3%	(6.7)%

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Comparison of Three Months Ended June 30, 2009 and 2008

Revenues

Consolidated. Consolidated revenue was \$18.6 million for 2009, which represents a decrease of \$1.3 million, or 6.7%, compared to 2008, as a result of lower DIS and Product revenues. DIS revenue accounted for 73.1% of total revenues for 2009, compared to 71.5% for 2008. We expect DIS revenue to continue to represent the larger percentage of our consolidated revenue in future periods.

DIS. Our DIS revenue was \$13.6 million for 2009, which represents a decrease of \$0.7 million, or 4.6%, compared to the prior year quarter. The decrease resulted from the sale or closure of underperforming locations in connection with the restructuring plan initiated in the fourth quarter of 2008.

Product. Our Product revenue was \$5.0 million for 2009, which represents a decrease of \$0.7 million, or 12.0%, compared to the prior year quarter. The decrease in revenue resulted from fewer gamma camera sales and the lowering of average sales prices as our product sales mix was represented by a larger number of refurbished cameras. We believe that the decrease in gamma camera sales and the demand for refurbished cameras is due to the slowing economy, the reduction in available credit for potential buyers, and continued pressure on healthcare imaging reimbursement rates. The decrease in revenue from the sale of fewer gamma cameras was partially offset by a 12.4% increase in maintenance contract revenues.

Gross Profit

Consolidated. Consolidated gross profit was \$5.9 million for 2009, representing an increase of \$1.3 million, or 29.3%, compared to the prior year quarter. The increase in consolidated gross profit is principally the result of the realignment of our DIS segment initiated in the fourth quarter of 2008, increased utilization of our DIS assets and personnel costs and other efficiency and cost improvements. Consolidated gross profit as a percentage of revenue increased to 31.7% for 2009 from 22.9% for 2008.

DIS. Cost of DIS revenue consists primarily of labor, radiopharmaceuticals, equipment depreciation, and other costs associated with the provision of services. Cost of DIS revenue was \$9.5 million for 2009, representing a decrease of \$1.9 million, or 16.3%, compared to the prior year quarter. The decrease in cost of DIS revenue is primarily a result of decreased labor, radiopharmaceutical, and depreciation costs. DIS gross profit was \$4.0 million for 2009, which represents an increase of \$1.2 million, or 42.3%. DIS gross profit as a percentage of revenue increased to 29.8% for 2009 from 19.9% for 2008. The improvement in operational performance is primarily associated with the realignment of the segment, which included the sale or closure of underperforming locations, along with improved asset utilization.

Product. Cost of Product revenue primarily consists of materials, labor and overhead costs associated with the manufacturing and warranty of our products. Cost of goods sold for the Product segment was \$3.1 million for 2009, representing a decrease of \$0.8 million, or 20.5%, compared to the prior year quarter as fewer gamma cameras were sold and as our product sales mix was represented by a larger number of refurbished cameras. Product gross profit was \$1.9 million for 2009, which represents an increase of \$0.1 million, or 7.7%. Product gross profit as a percentage of revenue increased to 37.1% for 2009 from 30.3% for 2008 primarily due to the change in the mix of camera revenues, along with certain efficiency and cost improvements.

Operating Expenses

Research and Development. Research and development expenses are the costs associated with the design, development and enhancement of our products, and consist of salaries, development material costs, facility and overhead costs, consulting fees, and non-recurring engineering costs. We continue to invest in research and development with a focus on innovation as we seek to improve our existing technology. In March 2009, we received U.S. Food and Drug Administration (FDA) 510(k) clearance for our new Cardius® X-ACT imaging system. Research and development expenses were \$0.9 million for 2009, which represents an increase of \$0.2 million, or 29.2%, compared to the prior year quarter. The increase in research and development expenses was primarily

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attributable to higher personnel and development costs. Research and development expenses were 17.1% of product revenue for 2009 compared to 11.7% in 2008. We plan to invest further in our technology platform to penetrate new and existing market segments and attract new customers.

Marketing and Sales. Marketing and sales expenses consist primarily of salaries, commissions, bonuses, recruiting costs, travel, marketing and collateral materials and trade show costs. Marketing and sales expenses were \$2.0 million for 2009, representing a decrease of \$0.3 million, or 11.5%, compared to the prior year quarter, principally as a result of lower personnel costs. Marketing and sales expenses were 10.9% of total revenue for 2009 compared to 11.4% for 2008.

General and Administrative. General and administrative expenses consist primarily of salaries and other related costs for accounting, human resources, information technology and executive personnel, legal related costs, professional fees, outside services, insurance, and our board of directors. General and administrative expenses were \$2.2 million for 2009, representing a decrease of \$0.6 million, or 21.6% compared to the prior year quarter, principally as a result of lower personnel costs. General and administrative expenses were 12.0% of total revenue for 2009 compared to 14.4% for 2008.

Other Income

Other income consists primarily of interest income, net of interest and other expenses. The decrease in other income of \$0.1 million is attributable to a decrease in interest rates.

Net Income (Loss)

Our net income was \$0.8 million for 2009 compared to a net loss of \$1.2 million for 2008, primarily as a result of increased DIS segment gross profits and the reduction in our operating expenses. DIS gross profit increased primarily due to the realignment of our DIS segment initiated in the fourth quarter of 2008, increased utilization of our DIS assets and personnel costs and other efficiency and cost improvements. The reduction in our operating expenses was primarily achieved through the flattening of the management structure and other restructuring initiatives implemented by us in the fourth quarter of 2008 and the first quarter of 2009.

Comparison of Six Months Ended June 30, 2009 and 2008

Revenues

Consolidated. Consolidated revenue was \$36.3 million for 2009, which represents a decrease of \$1.9 million, or 5.0%, over 2008, primarily as a result of lower DIS and Product revenues. DIS revenue accounted for 75.6% of total revenues for 2009, compared to 73.6% for 2008.

DIS. Our DIS revenue was \$27.4 million for 2009, which represents a decrease of \$0.7 million, or 2.4%, over the prior year period. The decrease resulted from the sale or closure of underperforming locations in connection with the restructuring plan initiated in the fourth quarter of 2008.

Product. Our Product revenue was \$8.9 million for 2009, which represents a decrease of \$1.2 million, or 12.3%, compared to the prior year period. We believe that economic factors, including the uncertainty in the credit market and a slowing economy, as well as continued healthcare imaging reimbursement pressures resulted in decreased gamma camera sales, and an increase in refurbished camera sales. The decrease in revenue from the sale of fewer gamma cameras was partially offset by a 12.9% increase in maintenance contract revenues.

Gross Profit

Consolidated. Consolidated gross profit was \$11.0 million for 2009, representing an increase of \$2.0 million, or 22.6%, compared to the prior year period. The increase in consolidated gross profit is principally the result of the realignment of our DIS segment initiated in the fourth quarter of 2008, increased utilization of our DIS assets and other efficiency and cost improvements. Consolidated gross profit as a percentage of revenue increased to 30.3% for 2009 from 23.5% for 2008.

DIS. Cost of DIS revenue was \$19.7 million for 2009, representing a decrease of \$2.6 million, or 11.6%, over the prior year period, primarily due to decreased labor, radiopharmaceutical, and depreciation costs. DIS gross profit was \$7.7 million for 2009, which represents an increase of \$1.9 million, or 33.1%. DIS gross profit as a percentage of revenue increased to 28.1% for 2009 from 20.6% for 2008. The improvement in operational performance is primarily associated with the realignment of the segment, which included the sale or closure of underperforming locations, along with improved asset utilization.

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Product. Cost of goods sold was \$5.6 million for 2009, representing a decrease of \$1.4 million, or 19.6%, compared to the prior year period. Product gross profit increased to \$3.3 million for 2009, representing an increase of \$0.1 million, or 3.6%, compared to the prior year period. Product gross profit as a percentage of revenue increased to 37.3% for 2009 from 31.6% for 2008 primarily due to the change in the mix of camera revenues, along with certain efficiency and cost improvements.

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Operating Expenses

Research and Development. Research and development expenses were \$1.6 million for 2009, which represents an increase of \$0.3 million, or 24.6%, compared to the prior year period. The increase in research and development expenses was primarily attributable to higher personnel costs and development costs associated with the development of the Cardius® X-ACT imaging system. Research and development expenses were 18.4% and 12.9% of product revenue for 2009 and 2008, respectively.

Marketing and Sales. Marketing and sales expenses were \$3.7 million for 2009, which represents a decrease of \$0.7 million, or 15.3%, compared to the prior year period, principally as a result of lower personnel costs. Marketing and sales expenses were 10.2% of total revenue for 2009 compared to 11.5% for 2008.

General and Administrative. General and administrative expenses were \$4.6 million for 2009, represents a decrease of \$1.4 million, or 22.7%, compared to the prior year period, principally as a result of lower personnel costs. General and administrative expenses were 12.8% of total revenue for 2009 compared to 15.8% for 2008.

Other Income

Other income consists primarily of interest income, net of interest and other expenses. The decrease in other income of \$0.3 million is attributable to a decrease in interest rates.

Net Income (Loss)

Our net income was \$0.8 million for 2009 compared to a net loss of \$2.6 million for 2008, primarily as a result of increased DIS segment gross profits and the reduction in our operating expenses. DIS gross profit increased primarily due to the realignment of our DIS segment initiated in the fourth quarter of 2008, increased utilization of our DIS assets and personnel costs and other efficiency and cost improvements. The reduction in our operating expenses was primarily achieved through the flattening of the management structure and other restructuring initiatives implemented by us in the fourth quarter of 2008 and the first quarter of 2009.

Liquidity and Capital Resources

We require working capital principally to finance accounts receivable and inventory and for capital expenditures. Our working capital requirements vary from period to period depending on several factors, including our manufacturing volumes, the timing of our deliveries and the payment cycles of our customers. Our capital expenditures consist primarily of DIS nuclear cameras, ultrasound equipment, and vans to transport our people and equipment to customer locations.

As of June 30, 2009, we had cash, cash equivalents and securities available-for-sale of \$31.5 million. We currently invest our cash reserves in money market funds, U.S. treasury, government and corporate debt securities. Based upon our current level of expenditures, we believe our current working capital, together with cash flows from operating activities, will be more than adequate to meet our anticipated cash requirements for working capital, debt service and capital expenditures for at least the next 12 months.

Net cash provided by operations totaled \$3.0 million in 2009, primarily due to our ability to generate net income (adjusted for depreciation and other non-cash expenses), and the collection of accounts receivable, notwithstanding an increase in inventory. Net cash used in investing activities amounted to \$0.5 million in 2009 and is primarily due to net purchases of securities available-for-sale, offset by the net proceeds from sales of fixed assets associated with our restructuring initiative. Net cash used in financing activities amounted to approximately \$0.3 million in 2009, and primarily represents the repurchase of our common stock under a Rule 10b-18 plan. On February 4, 2009, our board of directors authorized a stock buyback program to repurchase up to an aggregate of \$2.0 million of our issued and outstanding common shares. The timing of stock repurchases and the number of shares of common stock to be repurchased will be made in compliance with Rule 10b-18 under the Securities Exchange Act of 1934 and will depend upon market conditions, applicable legal and contractual requirements, and other factors. Purchases under this program totaled \$0.3 million during the six months ended June 30, 2009.

The acquisition of assets and liabilities of Ultrascan may require additional consideration of cash and common stock of up to \$3.9 million to be paid to the seller or its designees in the event that certain financial milestones are achieved through May 2011. The additional consideration will be added to goodwill if and when it is earned.

Table of Contents**Critical Accounting Policies**

Management's discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements which are prepared in accordance with accounting principles that are generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities, related 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. We continually evaluate our estimates and judgments, the most critical of which are those related to revenue recognition and inventory valuation. We base our estimates and judgments on historical experience and other factors that we believe to be reasonable under the circumstances. Materially different results can occur as circumstances change and additional information becomes known.

There were no significant changes during the six months ended June 30, 2009 to the items that we disclosed as our critical accounting policies and estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2008.

New accounting requirements.

On April 9, 2009, the FASB issued FSP FAS 107-1, *Interim Disclosures about Fair Value of Financial Instruments*, and FSP FAS 115-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, which we adopted on a prospective basis beginning April 1, 2009. These positions extend the disclosure requirements of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments* (SFAS No. 107), and Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS No. 115) to interim financial statements of publicly traded companies. The application of FSP FAS 107-1 and FSP FAS 115-2 did not have an impact on our consolidated financial position, results of operations or cash flows.

On May 28, 2009, the FASB issued Financial Accounting Standards No. 165, *Subsequent Events* (SFAS No. 165), which we adopted on a prospective basis beginning April 1, 2009. SFAS No. 165 is intended to establish general standards of accounting and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for selecting that date. The application of SFAS No. 165 did not have an impact on our consolidated financial position, results of operations or cash flows.

On January 1, 2009, we adopted FSP FAS 142-3, *Determination of the Useful Life of Intangible Assets*. FSP FAS 142-3 amends the factors that should be considered in developing a renewal or extension assumptions used for purposes of determining the useful life of a recognized intangible asset under Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). FSP FAS 142-3 is intended to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under Statement of Financial Accounting Standards No. 141(R), *Business Combinations* (SFAS 141(R)) and other U.S. generally accepted accounting principles. The application of FSP FAS 142-3 did not have a material impact on our consolidated financial position, results of operations or cash flows.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk due to changes in interest rates relates primarily to the increase or decrease in the amount of interest income we can earn on our investment portfolio. Our risk associated with fluctuating interest rates is limited to our investments in interest rate sensitive financial instruments. Under our current policies, we do not use interest rate derivative instruments to manage exposure to interest rate changes. We attempt to increase the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in investment grade securities. A 100 basis point adverse move in interest rates along the entire interest rate yield curve would not materially affect the fair value of our interest sensitive financial instruments. Changes in interest rates over time will increase or decrease our interest income.

ITEM 4. CONTROLS AND PROCEDURES**Disclosure Controls and Procedures**

We maintain disclosure controls and procedures and internal controls that are designed to provide reasonable assurance that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our

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Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures and internal controls, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable, and not absolute, assurance of achieving the desired control objectives. In reaching a reasonable level of assurance, management necessarily is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures and internal controls.

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As required by the Securities and Exchange Commission Rule 13a-15(e) and Rule 15d-15(e), we carried out an evaluation, under the supervision of and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting during the second quarter of fiscal 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In the normal course of business, we have been and will likely continue to be subject to litigation or administrative proceedings incidental to our business, such as claims related to customer disputes, employment practices, wage and hour disputes, product liability, professional liability, commercial disputes, licensure restrictions or denials, and warranty or patent infringement. Responding to litigation or administrative proceedings, regardless of whether they have merit, can be expensive and disruptive to normal business operations. As litigation and the administrative proceedings are inherently uncertain, we cannot predict the outcome of such matters. We can provide no assurance that the ultimate outcome, either individually or in the aggregate, will not have a material adverse effect on our business or financial results.

ITEM 1A. RISK FACTORS

We are subject to changing health care regulatory rules which could adversely affect us.

Various potential changes to health care regulatory rules could require us to change our operations significantly and could harm us financially. Nuclear medicine is a designated health service under the federal physician self-referral prohibition law known as the Stark Law, which states that a physician may not refer designated health services to an entity with which the physician or an immediate family member has a financial relationship, unless an exception applies. DIS physician customers may be able to meet the in-office ancillary services exception to the Stark Law if they meet the definition of a Group Practice under Stark, appropriately supervise the individuals performing the nuclear imaging services and bill for them, and if the services are performed in the same building in which the physicians regularly practice medicine. From time to time, the Centers for Medicare & Medicaid Services (CMS) and Congress have proposed to modify the Stark regulations in a manner that may restrict physicians in some business arrangements from utilizing the in-office ancillary services exception to the Stark Law.

The competing health care reform/availability proposals under consideration by the Legislative and Administrative branches of the federal government could have a positive or negative impact on our business depending on which plan and provisions are adopted with respect to how medical providers are reimbursed, services are authorized and diagnostic services and investments are addressed. The potential adoption of healthcare reform proposals on a state-by-state basis could require us to develop state-specific marketing and sales approaches and adversely affect the results of operations.

Our revenues may decline due to reductions in Medicare reimbursement rates or increased third party payor certification requirements.

The success of our DIS business is largely dependent on our customers' ability to build a financially viable imaging business utilizing leased DIS personnel and equipment and radiopharmaceuticals. Our customers have been faced with the downward trend in Medicare reimbursement rates, as well as the continuing efforts by some third party payors to reduce health care expenditures by requiring physicians to obtain specific accreditations or certifications, and their efforts to restrict the use of mobile or leased cameras.

As of the end of June 2009, various proposals to reduce reimbursement rates for the diagnostic tests performed by our purchase and lease customers have been introduced. If passed as written, there will be a significant reduction in imaging reimbursement that will require us to quickly adapt our business model. If we are not able to quickly and easily adapt, such as where change requires the submission of applications to government entities or third party payors, there could be a detrimental impact on our revenue.

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The American Recovery and Reinvestment Act of 2009 (the stimulus bill) adopted in early 2009 contains provisions for federal use of radiology benefit managers (RBM) whose main goal is to limit the use of diagnostic imaging services, especially those not performed by radiologists. Private carriers are similarly adopting the services of these RBMs that may require pre-certification, pre-authorization and other pre-service requirements or denials of the diagnostic imaging performed by Digirad customers. This may delay or lower the number of customers Digirad can sign up to its purchase or lease arrangements.

We may incur additional losses due to the downturn in the U.S. economy.

Our revenues may be significantly impacted by the downturn in the U.S. economy. The slowing economy may also drive greater pricing pressures from our competition, increase the rate at which we lose business, or lead to disruptions in our supply chain, any of which could result in operating losses or negative cash flows. Further, we cannot assure that an improvement in economic conditions would result in an immediate improvement in our operating results or cash flows.

Because our business is not widely diversified, obsolescence of our current product offerings could seriously harm our business.

We sell products and lease our imaging systems and personnel primarily in the nuclear and ultrasound imaging markets. Our nuclear imaging systems may become obsolete or unmarketable if new technologies are introduced to the market or if new industry standards emerge or as a result of the comparative effectiveness research that may be performed on our diagnostic modalities as provided under the American Recovery and Reinvestment Act of 2009 (the stimulus bill) adopted in early 2009.

We may not be able to leverage our assets to diversify our products and services in order to generate revenue beyond the nuclear and ultrasound imaging markets in a timely manner. If we are unable to diversify our product and service offerings, our financial condition may suffer.

We compete against businesses that have different competitive strengths.

The market for nuclear imaging cameras continues to decrease, thereby making competition a greater challenge. Our competition has negatively impacted our sales prices and volume. Some of our competitors enjoy significant advantages over us, including greater name recognition, greater financial and technical resources, established relationships with healthcare professionals, larger distribution networks, and greater resources for product development as well as marketing and sales. Additionally, certain medical device companies have developed alternative portable cameras that directly compete with our product offerings. If we are unable to expand our current market share, our revenues could decline.

In addition, our DIS customers may switch to another service provider. Our DIS segment competes against small local or regional businesses, some of which have the advantage of a lower cost structure, and against imaging centers that install nuclear gamma cameras and make them available to physicians in their geographic vicinity. If these competitors are able to win significant portions of our business, our sales could decline significantly. Our financial condition could be adversely affected under such circumstances.

Our operations are highly dependent upon the availability of certain radiopharmaceuticals and third-party suppliers, thereby making us vulnerable to supply problems and price fluctuations, which could harm our business.

Our personnel and equipment leasing service involves the use of certain radiopharmaceuticals. We have experienced disruptions in the supply of these radiopharmaceuticals which have caused us to cancel services that would have otherwise been provided. If we are unable to obtain an adequate supply of the necessary radiopharmaceuticals, we may be unable to lease our personnel and equipment through our DIS operation, and our business may be harmed.

As of the end of June 2009, there was a significant reduction in the availability of radioactive medical isotopes worldwide. For example, a nuclear reactor in Chalk River, Ontario, which supplies 50% of certain medical isotopes to the United States market, is currently off-line for repairs and will not return to service before late 2009 or early 2010. The lack of production of radiopharmaceuticals in Canada has exacerbated an already short supply of medical isotopes worldwide. Continued shortages could affect our DIS business by reducing the number of days of service or moving physicians toward alternate imaging modalities. Our financial condition would be adversely affected under such circumstances.

In addition, we rely on a limited number of third parties to manufacture and supply certain key components of our products. Alternative sources of production and supply may not be readily available. For example, key components of the detector heads and the processing and control software utilized in our gamma cameras are manufactured or supplied by a single source. We have also outsourced production of significant portions of our end product to a single contract manufacturer. If a disruption in the availability

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of parts or in the operations of these suppliers were to occur, our ability to build gamma cameras could be materially affected. For this reason, we have backup plans in place that are designed to prevent delays in production. If these plans are unsuccessful, delays in the production of our gamma cameras for an extended period of time could cause a loss of revenue, which could significantly harm our business and results of operations.

Failure to retain key executives, qualified technologists and sales personnel could limit our growth and adversely affect our business.

Our future growth and ability to generate profits depends, in part, upon our ability to identify, hire, and retain nuclear medicine technologists, certified cardiographic technicians, ultrasound technologists, and sales personnel. The inability to retain such employees would diminish the knowledge and experience that we, as an organization, possess and might delay or prevent the achievement of our objectives. Hiring qualified management and technical personnel may be difficult due to the limited number of qualified candidates and the intense competition for these types of employees. Furthermore, we have historically suffered high employee turnover in regards to imaging technologists. If we are unable to reduce employee turnover, our business and financial condition may be adversely affected.

Our quarterly and annual financial results are difficult to predict and are likely to fluctuate from period to period.

We have experienced seasonality in the leasing services offered by our DIS operation. While our physicians are obligated to pay us for all lease days to which they have committed, our contracts permit some flexibility in scheduling when services are to be performed. We cannot predict with certainty the degree to which seasonal circumstances such as the summer slowdown, winter holiday vacations and weather conditions may affect the results of our operations. In addition, due to the way that customers in our target markets acquire our products, a large percentage of our camera orders are booked during the last month of each quarterly accounting period. As such, a delivery delay of only a few days may significantly impact our quarter-to-quarter comparisons. Moreover, the sales cycle in our Product segment for our cameras is typically lengthy, which may cause us to experience significant revenue fluctuations. For these reasons, quarterly and annual sales and operating results may vary in the future. Therefore, period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indicators of future performance. Because of these and other factors, our operating results in one or more future reporting periods may fail to meet the expectations of securities analysts or investors, which could cause our stock price to decline significantly.

Our common stock is thinly traded and our options plan could affect the trading price of our common stock.

Our common stock is thinly traded and any significant sales of our common stock may cause volatility in our common stock price. We have also registered shares of common stock that we may issue under our employee benefit plans. Accordingly, these shares can be freely sold in the public market upon issuance, subject to restrictions under the securities laws. If any of these stockholders cause a large number of securities to be sold in the public market, the sales could reduce the trading price of our common stock. Stockholders holding a significant number of our common stock will be able to significantly influence all matters requiring approval by our stockholders, including the election of directors and the approval of mergers or other business combination transactions.

We spend considerable time and money complying with federal and state laws, regulations, and other rules, and if we are unable to comply with such laws, regulations and other rules, we could face substantial penalties.

We are directly, or indirectly through our clients, subject to extensive regulation by both the federal government and the states in which we conduct our business, including: the federal Medicare and Medicaid anti-kickback laws, other Medicare laws, regulations, rules, manual provisions, and policies that prescribe the requirements for coverage and payment for services performed by us and our DIS customers; the federal False Claims statutes; the federal Health Insurance Portability and Accountability Act of 1996, or HIPAA; the Stark Law; the federal Food, Drug and Cosmetic Act; federal and state radioactive materials laws; state food and drug and pharmacy laws and regulations; state laws that prohibit the practice of medicine by non-physicians and fee-splitting arrangements between physicians and non-physicians; state scope-of-practice laws; and federal rules prohibiting the mark-up of diagnostic tests to Medicare under certain circumstances. If our DIS customers are unable or unwilling to comply with these statutes, regulations, rules and policies, utilization rates of our services and products could decline and our business could be harmed.

We maintain a compliance program to identify and correct any compliance issues and remain in compliance with all applicable laws, to train employees, to audit and monitor our operations, and to achieve other compliance goals. Like most companies with compliance programs, we occasionally discover compliance concerns. In such cases, we take responsive action including corrective measures when necessary. There can be no assurance that our responsive actions will insulate us from liability associated with any detected compliance concerns.

If our past or present operations are found to be in violation of any of the laws, regulations, rules or policies described above or the other laws or regulations to which we or our customers are subject, we may be subject to civil and criminal penalties, damages, fines, exclusion from federal

or state health care programs, or the curtailment or restructuring of our operations. Similarly, if our

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customers are found to be non-compliant with applicable laws, they may be subject to sanctions which could have a negative impact on us. If we are excluded from federal or state health care programs, our customers who participate in those programs could not do business with us. Any penalties, damages, fines, curtailment or restructuring of our operations could adversely affect our ability to operate our business and our financial results. Any action against us for violation of these laws, even if we successfully defend against it, could cause us to incur significant legal expenses, divert our management's attention from the operation of our business, and damage our reputation.

Our manufacturing operations and executive offices are located at a single facility that may be at risk from fire, earthquakes or other natural or man-made disasters.

Our manufacturing operations and executive offices are located at a single facility in Poway, California, near known fire areas and earthquake fault zones. Any future natural disaster could cause substantial delays in our operations, damage to our manufacturing equipment and inventory, and cause us to incur additional expenses. Although we have taken precautions to insure our facilities and continuing operations, this may not be adequate to cover our losses in any particular case. A disaster could significantly harm our business and results of operations.

The medical device industry is characterized by litigation that could be costly, result in the diversion of our management's time and efforts, and require us to pay damages which may not be covered by our insurance.

Our operations entail risks relating to claims or litigation relating to product liability, radioactive contamination, patent infringement, trade secret disclosure, warranty claims, product recalls, property damage, misdiagnosis, personal injury and death. Any litigation or claims against us, or claims we bring against others, may cause us to incur substantial costs, could place a significant strain on our financial resources, divert the attention of our management from our core business and harm our reputation. We may incur significant liability in the event of any such litigation, regardless of the merit of the action. If we are unable to obtain insurance, or if our insurance is inadequate to cover claims, our cash reserves and other assets could be negatively impacted. Additionally, costs associated with maintaining our insurance could become prohibitively expensive, and our ability to become profitable could be diminished.

Our ability to protect our intellectual property and proprietary technology through patents and other means is uncertain.

Our success depends significantly on our ability to protect our proprietary rights to the technologies used in our products. Our pending U.S. and foreign patent applications, which include claims to material aspects of our products and procedures that are not currently protected by issued patents, may not issue as patents in a form that will be advantageous to us. Any patents we have obtained or do obtain may be challenged by re-examination or otherwise invalidated or eventually found unenforceable. Both the patent application process and the process of managing patent disputes can be time consuming and expensive. Competitors may attempt to challenge or invalidate our patents, or may be able to design alternative techniques or devices that avoid infringement of our patents, or develop products with functionalities that are comparable to ours. In the event a competitor infringes upon our patent or other intellectual property rights, litigation to enforce our intellectual property rights or to defend our patents against challenge, even if successful, could be expensive and time consuming and could require significant time and attention from our management. We may not have sufficient resources to enforce our intellectual property rights or to defend our patents against challenges from others.

Anti-takeover provisions in our organizational documents, our Stockholders Rights Plan and Delaware law may prevent or delay removal of current management or a change in control.

Our restated certificate of incorporation and restated bylaws contain provisions that may delay or prevent a change in control, discourage bids at a premium over the market price of our common stock, and adversely affect the market price of our common stock and the voting and other rights of the holders of our common stock. The rights issued pursuant to our Stockholder Rights Plan will become exercisable, subject to certain exceptions, the tenth day after a person or group announces acquisition of 15% or more of our common stock or announces commencement of a tender or exchange offer, the consummation of which would result in ownership by the person or group of 15% or more of our common stock. In addition, as a Delaware corporation, we are subject to Delaware law, including Section 203 of the Delaware General Corporation Law. In general, Section 203 prohibits a Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years following the date that the stockholder became an interested stockholder unless certain specific requirements are met as set forth in Section 203. These provisions, alone or together, could have the effect of deterring or delaying changes in incumbent management, proxy contests or changes in control.

Table of Contents**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

On February 4, 2009, our Board of Directors approved a stock repurchase program whereby we may, from time to time, purchase up to \$2.0 million worth of our common stock in the open market, in privately negotiated transactions or otherwise, at prices that we deem appropriate. The plan has no expiration date. Details of purchases made during the six months ended June 30, 2009 are as follows:

		Total Number of Shares Purchased During the Period	Average Price Paid Per Share for Period Presented	Total Cumulative Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Dollar Value of Shares that May Yet Be Purchased Under the Plan
Period:					
February 4, 2009	February 28, 2009	8,700	\$ 0.98	8,700	\$ 1,991,474
March 1, 2009	March 31, 2009	2,600	0.99	11,300	1,988,900
May 1, 2009	May 31, 2009	183,500	1.29	194,800	1,758,352
June 1, 2009	June 30, 2009	14,300	1.29	209,100	1,740,438
Six months ended June 30, 2009:		209,100	\$ 1.28	209,100	\$ 1,740,438

In addition to the above purchases, John Sayward, a member of our board of directors and an affiliated purchaser as defined in Rule 10b-18(a)(3), purchased 20,000 shares of common stock in the open market at an average price of \$1.02 per share in February 2009.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

The Annual Meeting of Stockholders was held on April 29, 2009 at 13950 Stowe Drive, Poway, California at 11:00 a.m. PDT. Of the 18,953,937 shares of common stock entitled to vote at the meeting, 15,081,366 shares, representing 80% of the votes eligible to be cast, were represented at the meeting in person or by proxy, constituting a quorum. The voting results are presented below.

- (a) The stockholders elected five directors for a one-year term to expire at the 2010 Annual Meeting of Stockholders:

Name	Votes in Favor	Votes Withheld
Gerhard F. Burbach	10,437,688	4,643,678
John Sayward	13,836,979	1,244,387
R. King Nelson	13,720,905	1,360,461
Kenneth E. Olson	13,837,329	1,244,037
Todd P. Clyde	14,774,795	306,571

- (b) The stockholders ratified the selection of Ernst & Young LLP as our independent auditors for the fiscal year ending December 31, 2009 by a vote of 13,992,839 in favor, 1,071,679 votes against and 16,848 votes withheld.
- (c) The stockholders approved a stock option exchange program pursuant to which eligible holders of stock options would be offered the opportunity to exchange their eligible options to purchase shares of common stock outstanding under the Company's existing equity incentive plans, for a smaller number of new options at a lower exercise price by a vote of 5,789,210 in favor, 4,987,853 votes

against and 4,304,303 votes withheld.

ITEM 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

Exhibit Number	Description
3.1(1)	Restated Certificate of Incorporation
3.2(2)	Restated Bylaws
4.1(3)	Form of Specimen Stock Certificate
4.2(4)	Amended and Restated Investors Rights Agreement by and among Digirad Corporation and the investors listed on the schedule attached thereto, dated April 23, 2002, as amended
31.1	Certification of Chief Executive Officer pursuant to Rules 13a-14(a) and 15d-14(a) promulgated pursuant to the Securities Exchange Act of 1934, as amended
31.2	Certification of Chief Financial Officer pursuant to Rules 13a-14(a) and 15d-14(a) promulgated pursuant to the Securities Exchange Act of 1934, as amended
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
(1)	This exhibit was previously filed as an exhibit to the Company's quarterly report on Form 10-Q originally filed with the Securities and Exchange Commission on August 11, 2004, as amended thereafter, and is incorporated herein by reference.
(2)	The exhibit was previously filed as an exhibit to the Company's quarterly report on Form 8-K filed with the Securities and Exchange Commission on May 9, 2007, and is incorporated herein by reference.
(3)	This exhibit was previously filed as an exhibit to the Registration Statement on Form S-1 (File No. 333-113760) originally filed with the Securities and Exchange Commission on March 19, 2004, as amended thereafter, and is incorporated herein by reference.
(4)	This exhibit was previously filed as an exhibit to the Company's quarterly report on Form 10-Q filed with the Securities and Exchange Commission on November 2, 2004, and is incorporated herein by reference.

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SIGNATURES

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

DIGIRAD CORPORATION

Date: July 23, 2009

By: /s/ TODD P. CLYDE
Todd P. Clyde
President and Chief Executive Officer

(Principal Executive Officer)

Date: July 23, 2009

By: /s/ RICHARD B. SLANSKY
Richard B. Slansky
Executive Vice President and Chief Financial Officer

(Principal Financial and Accounting Officer)

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