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VITAL SIGNS INC
Form 10-Q
May 17, 2004

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 March 31, 2004 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: 0-18793

VITAL SIGNS, INC.
(Exact name of registrant as specified in its charter)

New Jersey
(State or other jurisdiction of
incorporation or organization)

11-2279807
(I.R.S. Employer
Identification No.)

20 Campus Road
Totowa, New Jersey 07512
(Address of principal executive office, including zip code)

973-790-1330
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed
since last report)

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 X No
 --- ---

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

Yes X No
 --- ---

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Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

At May 12, 2004 there were 12,812,253 shares of Common Stock, no par value, outstanding.

VITAL SIGNS, INC.

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PART I.

Financial Information

Item 1.

Financial Statements

Certain information and footnote disclosures required under generally accepted accounting principles have been condensed or omitted from the following consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission. Vital Signs, Inc. (the "registrant", the "Company", "Vital Signs", "we", "us", or "our") believes that the disclosures are adequate to assure that the information presented is not misleading in any material respect. It is suggested that the following consolidated financial statements be read in conjunction with the year-end consolidated financial statements and notes thereto included in the registrant's Annual Report on Form 10-K for the year ended September 30, 2003.

The results of operations for the interim periods presented herein are not necessarily indicative of the results to be expected for the entire fiscal year, or any other period.

INDEPENDENT ACCOUNTANT'S REPORT

To the Board of Directors
Vital Signs, Inc.

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We have reviewed the accompanying consolidated balance sheet of Vital Signs, Inc. and Subsidiaries as of March 31, 2004 and the related consolidated statements of operations for the three months and six months ended March 31, 2004 and 2003, and the consolidated statements of cash flows for the six months ended March 31, 2004 and 2003. These financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the consolidated financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of Vital Signs, Inc. and Subsidiaries as of September 30, 2003 and the related consolidated statements of income, stockholders' equity and cash flows for the year then ended (not presented herein); and in our report dated November 5, 2003, except for the fourth paragraph of Note 16, as to which the date is December 26, 2003, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of September 30, 2003 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

GOLDSTEIN GOLUB KESSLER LLP
New York, New York

April 22, 2004

VITAL SIGNS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

MARCH 31,

2004

(IN THO

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ASSETS

(Unaudited)

Current Assets:

| | |
|---|-----------|
| Cash and cash equivalents..... | \$ 66,990 |
| Accounts receivable, less allowance for rebates and doubtful accounts of \$8,573 and \$7,075 respectively..... | 28,020 |
| Inventory..... | 19,077 |
| Prepaid expenses..... | 2,367 |
| Other current assets..... | 3,007 |
| Assets of discontinued business..... | -- |

Total Current Assets..... 119,461

| | |
|--|--------|
| Property, plant and equipment - net..... | 32,164 |
| Goodwill | 69,506 |
| Deferred income taxes..... | 1,162 |
| Other assets..... | 2,709 |

Total Assets..... \$225,002
=====

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities:

| | |
|---|----------|
| Accounts payable..... | \$ 6,424 |
| Current portion of long-term debt..... | -- |
| Accrued expenses..... | 5,907 |
| Accrued income taxes | 1,020 |
| Other current liabilities..... | 345 |
| Liabilities of discontinued business..... | -- |

Total Current Liabilities 13,696

Minority interest in subsidiary..... 3,154

Commitments and contingencies

Stockholders' Equity

| | |
|--|---------|
| Common stock - no par value; authorized 40,000,000 shares, issued and outstanding 12,812,253 and 12,915,566 shares, respectively..... | 27,058 |
| Accumulated other comprehensive income..... | 2,255 |
| Retained earnings..... | 178,839 |

Stockholders' equity..... 208,152

Total Liabilities and Stockholders' Equity..... \$225,002
=====

(See Notes to Consolidated Financial Statements)

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VITAL SIGNS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | FOR THE TH M |
|--|------------------------------------|
| | 2004 |
| | ----- (In Thousands, E ----- |
| Net Revenues: | |
| Net sales..... | \$38,583 |
| Service revenue..... | 8,054 |
| | ----- |
| | 46,637 |
| Cost of goods sold and services performed: | |
| Cost of goods sold..... | 18,933 |
| Cost of services performed..... | 4,466 |
| | ----- |
| | 23,399 |
| Gross profit..... | 23,238 |
| Operating expenses: | |
| Selling, general and administrative..... | 12,724 |
| Research and development..... | 2,033 |
| Impairment charge for China operations..... | --- |
| Other expense - net..... | 151 |
| | ----- |
| Total operating expenses..... | 14,908 |
| Operating Income..... | 8,330 |
| Other (income) expense..... | |
| Interest (income)..... | (202) |
| Interest expense..... | 1 |
| | ----- |
| Total other (income) expense..... | (201) |
| Income from continuing operations before provision for income taxes and minority interest in income of consolidated subsidiary..... | 8,531 |
| Provision for income taxes..... | 3,001 |
| | ----- |
| Income from continuing operations before minority interest in income of consolidated subsidiary..... | 5,530 |
| Minority interest in income of consolidated subsidiary..... | 116 |
| | ----- |
| Income from continuing operations..... | 5,414 |
| Discontinued Operations: | |
| Loss from operations of Vital Pharma, net of income tax benefit of (\$9) and (\$1,325)..... | (17) |
| | ----- |
| Net income (loss)..... | \$ 5,397 |
| | ===== |

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Earnings (loss) per Common Share:

| | |
|--|---------|
| Basic | |
| Income per share from continuing operations..... | \$ 0.42 |
| Loss per share from discontinued operations..... | \$ 0.00 |
| Net earnings (loss)..... | \$ 0.42 |
| Diluted | |
| Income per share from continuing operations..... | \$ 0.42 |
| Loss per share from discontinued operations..... | \$ 0.00 |
| Net earnings (loss)..... | \$ 0.42 |
| Basic weighted average number of shares outstanding..... | 12,837 |
| Diluted weighted average number of shares outstanding..... | 12,982 |
| Dividends paid per share..... | \$ 0.06 |

(see Notes to Consolidated Financial Statements)

VITAL SIGNS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

FOR THE S
M
2004

(In Thousands,

| | |
|---|----------|
| Net Revenues: | |
| Net sales..... | \$74,478 |
| Service revenue..... | 16,007 |
| | ----- |
| | 90,485 |
| Cost of goods sold and services performed: | |
| Cost of goods sold..... | 36,438 |
| Cost of services performed..... | 8,795 |
| | ----- |
| | 45,233 |
| Gross profit..... | 45,252 |
| Operating expenses: | |
| Selling, general and administrative..... | 25,070 |
| Research and development..... | 3,539 |
| Impairment charge for China operations..... | -- |
| Other expense - net..... | 221 |
| | ----- |
| Total operating expenses..... | 28,830 |
| Operating Income..... | 16,422 |

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| | |
|--|-----------|
| Other (income) expense | |
| Interest (income)..... | (385) |
| Interest expense..... | 25 |
| | ----- |
| Total other (income) expense..... | (360) |
| Income from continuing operations before provision for income taxes and minority interest in income of consolidated subsidiary..... | 16,782 |
| Provision for income taxes..... | 5,890 |
| | ----- |
| Income from continuing operations before minority interest in income of consolidated subsidiary..... | 10,892 |
| Minority interest in income of consolidated subsidiary..... | 254 |
| | ----- |
| Income from continuing operations..... | 10,638 |
| Discontinued Operations: | |
| Loss from operations of Vital Pharma, net of income tax benefit of (\$92) and (\$1,500)..... | (171) |
| | ----- |
| Net income..... | \$10,467 |
| | ===== |
| Earnings (loss) per Common Share: | |
| Basic | |
| Income per share from continuing operations..... | \$ 0.83 |
| Loss per share from discontinued operations..... | \$ (0.02) |
| Net earnings..... | \$ 0.81 |
| Diluted | |
| Income per share from continuing operations..... | \$ 0.82 |
| Loss per share from discontinued operations..... | \$ (0.02) |
| Net earnings..... | \$ 0.80 |
| Basic weighted average number of shares outstanding..... | 12,873 |
| Diluted weighted average number of shares outstanding..... | 13,013 |
| Dividends paid per share..... | \$ 0.12 |

(see Notes to Consolidated Financial Statements)

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| | |
|--|----------|
| Cash Flows from Operating Activities: | |
| Net income..... | \$10,467 |
| Add loss from discontinued operations..... | 171 |
| | ----- |
| Income from continuing operations..... | 10,638 |
| Adjustments to reconcile income from continuing operations to net cash provided by continuing operations | |
| Depreciation and amortization..... | 2,104 |
| Deferred income taxes..... | 356 |
| Minority interest in income of consolidated subsidiary..... | 254 |
| Non cash loss on write off of China receivable..... | --- |
| Increase in rebate allowance..... | --- |
| Changes in operating assets and liabilities: | |
| Decrease in accounts receivable..... | 1,765 |
| Decrease (increase) in inventory..... | 3,274 |
| Decrease in prepaid expenses and other current assets | 2,075 |
| Decrease (increase) in other assets | 614 |
| (Decrease) increase in accounts payable..... | (336) |
| Decrease in accrued expenses..... | (324) |
| (Decrease) increase in accrued income taxes | (2,372) |
| Increase in other liabilities..... | 197 |
| | ----- |
| Net cash provided by continuing operations..... | 18,245 |
| Net cash used in discontinued operations..... | (209) |
| | ----- |
| Net cash provided by operating activities..... | 18,036 |
| Cash flows from investing activities: | |
| Net proceeds from sales of assets of Vital Pharma..... | 417 |
| Net proceeds from sale of Vital Pharma real estate..... | 1,222 |
| Acquisition of property, plant and equipment..... | (1,156) |
| Capitalized software costs..... | (386) |
| Capitalized patent costs..... | (75) |
| Proceeds from sales of available for sale securities..... | --- |
| | ----- |
| Net cash provided by (used in) investing activities..... | 22 |
| Cash flows from financing activities: | |
| Dividends paid..... | (1,556) |
| Proceeds from exercise of stock options..... | 349 |
| Purchase of common stock..... | (3,778) |
| Principal payments on long-term debt and notes payable..... | (1,535) |
| | ----- |
| Net cash used in financing activities..... | (6,520) |
| Effect of foreign currency translation..... | (208) |
| | ----- |
| Net increase in cash and cash equivalents..... | 11,330 |
| Cash and cash equivalents at beginning of period..... | 55,660 |
| | ----- |
| Cash and cash equivalents at end of period..... | \$66,990 |
| | ===== |
| Supplemental disclosures of cash flow information: Cash paid during the six months for: | |
| Interest..... | \$ 65 |
| Income taxes..... | \$ 5,414 |

(See Notes to Consolidated Financial Statements)

VITAL SIGNS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. The consolidated balance sheet as of March 31, 2004, the consolidated statements of operations for the three and six months ended March 31, 2004 and 2003, and the consolidated statements of cash flows for the six months ended March 31, 2004 and 2003, have been prepared by Vital Signs, Inc. (the "registrant", the "Company", "Vital Signs", "we", "us", or "our") and are unaudited. In the opinion of management, all adjustments necessary to present fairly the financial position at March 31, 2004 and the results of operations for the three months and six months ended March 31, 2004 and 2003, and the cash flows for the six months ended March 31, 2004 and 2003, have been made.
2. See the Company's Annual Report on Form 10-K for the year ended September 30, 2003 (the "Form 10-K") for additional disclosures relating to the Company's consolidated financial statements.
3. At March 31, 2004, the Company's inventory was comprised of raw materials of \$11,600,000 and finished goods of \$7,477,000. At September 30, 2003, the Company's inventory was comprised of raw materials of \$12,570,000 and finished goods of \$9,287,000.
4. For Details of Legal Proceedings, see Part II, Item 1, "Legal Proceedings".
5. Net revenues consist of product sales and service revenues. For product sales, revenue is recognized in the same period as title to the product passes to the customer. For service revenue, revenue is recorded when the service is performed. A component of product sales is a deduction for rebates due on sales to distributors (see Footnote 10). A reconciliation of gross to net sales is provided below:

| (In thousands of Dollars) | Three Months Ended March 31, | | Six Months Ended March 31, | |
|---------------------------|---------------------------------|--------------------|-------------------------------|--------------------|
| | 2004 ---- | 2003 ---- | 2004 ---- | 2003 ---- |
| Gross sales | \$ 51,165 | \$ 46,893 | \$ 99,249 | \$ 93,019 |
| Rebates | (11,669) | (12,484) | (22,754) | (22,525) |
| Other deductions | (913) | (1,371) | (2,017) | (2,401) |
| | ----- | ----- | ----- | ----- |
| Net sales | 38,583 | 33,038 | 74,478 | 68,093 |
| Service revenues | 8,054 | 9,026 | 16,007 | 18,728 |
| | ----- | ----- | ----- | ----- |
| Total net revenues | \$ 46,637 ===== | \$ 42,064 ===== | \$ 90,485 ===== | \$ 86,821 ===== |

Other deductions consist of discounts, returns and allowances for credits

6. The Company has aggregated its business units into four reportable segments, anesthesia, respiratory/critical care, sleep and pharmaceutical technology services. There are no material intersegment sales. Anesthesia and Respiratory/Critical Care share certain manufacturing, sales and administration costs; therefore the operating profit, total assets, and capital expenditures are not specifically identifiable. However the Company has allocated these shared costs on a net sales

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basis to arrive at operating profit for the anesthesia and respiratory/critical care segments. Total assets and capital expenditures for anesthesia and respiratory/critical care have also been allocated on a net sales basis. Management evaluates performance on the basis of the gross profits and operating results of the four business segments. Summarized financial information concerning the Company's reportable segments is shown in the following table:

| | ANESTHESIA | RESPIRATORY/ CRITICAL CARE | SLEEP | PHARMACEUTICAL TECHNOLOGY SERVICES | OTHER* | CONSOLIDATED |
|---------------------------|------------|----------------------------------|----------|--|-----------|--------------|
| (IN THOUSANDS OF DOLLARS) | | | | | | |
| FOR THE THREE MONTHS | | | | | | |
| ENDED MARCH 31, | | | | | | |
| 2004 | | | | | | |
| Net revenues | \$19,654 | \$10,969 | \$12,221 | \$3,793 | \$ -- | \$46,637 |
| Gross profit | 10,799 | 5,667 | 5,343 | 1,429 | -- | 23,238 |
| Operating income | 4,913 | 2,746 | 428 | 243 | -- | 8,330 |
| 2003 | | | | | | |
| Net revenues | \$17,599 | \$11,029 | \$12,136 | \$4,600 | \$(3,300) | \$42,064 |
| Gross profit | 9,503 | 5,863 | 5,239 | 2,409 | (3,300) | 19,714 |
| Operating income | 3,457 | 2,166 | 1,279 | 843 | (3,300) | 4,445 |

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| | ANESTHESIA | RESPIRATORY/ CRITICAL CARE | SLEEP | PHARMACEUTICAL TECHNOLOGY SERVICES | OTH |
|---|------------|----------------------------------|----------|--|------------|
| (IN THOUSANDS OF DOLLARS) | | | | | |
| FOR THE SIX MONTHS ENDED MARCH 31, 2004 | | | | | |
| Net revenues | \$ 38,152 | \$21,634 | \$23,177 | \$ 7,522 | |
| Gross profit | 20,131 | 11,747 | 10,369 | 3,005 | |
| Operating income | 9,192 | 5,213 | 1,390 | 627 | |
| Total assets | 108,942 | 61,775 | 35,836 | 18,449 | |
| Capital expenditures | 410 | 232 | 219 | 295 | |
| 2003 | | | | | |
| Net revenues | \$ 34,613 | \$22,222 | \$23,420 | \$ 9,866 | \$ (3,000) |
| Gross profit | 18,845 | 12,311 | 10,418 | 4,655 | (3,000) |
| Operating income | 8,388 | 5,385 | 2,028 | 1,733 | (3,000) |
| Total assets | 97,311 | 62,475 | 34,702 | 20,114 | |
| Capital expenditures | 996 | 640 | 59 | 22 | |

(*) "Other" relates to an adjustment for the allowance for rebates in the three and six months ended March 31, 2003 in the anesthesia and respiratory/critical care business segments.

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7. Other comprehensive income for the three months and six months ended March 31, 2004 and 2003 consisted of:

| (IN THOUSANDS OF DOLLARS) | THREE MONTHS ENDED MARCH 31, | | |
|------------------------------|------------------------------|------------|----------|
| | 2004 | 2003 | 2004 |
| Net income (loss) | \$ 5,397 | \$ (1,222) | \$10,467 |
| Foreign currency translation | (1,164) | (29) | 448 |
| Other | -- | -- | -- |

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| | | | |
|----------------------|-------------------|---------------------|-------------------|
| Comprehensive income | \$ 4,233 ===== | \$ (1,251) ===== | \$10,915 ===== |
|----------------------|-------------------|---------------------|-------------------|

8. During the second quarter of fiscal 2004, the Company's Breas subsidiary expensed \$175,000 of discontinued product inventory, \$94,000 of estimated costs for a field upgrade, and \$94,000 to increase the reserve for service stock inventory.

9. During the first quarter of fiscal 2004, included in selling, general and administrative expenses are \$235,000 of expenses related to a special review performed by the Company's Audit Committee, and \$139,000 of unamortized cost related to the prepayment of the Company's Industrial Revenue Bond of \$1,500,000.

10. During the second quarter of fiscal 2003, the Company reviewed and adjusted its estimate for rebates due to distributors. As background, the Company's sales to distributors in the domestic anesthesia and respiratory/critical care business segments, which represented 24.3% of the Company's net sales during the second quarter of fiscal 2004, are made at the Company's established price. Each distributor subsequently provides the Company with documentation that the Company's products have been shipped to particular end-users (i.e. particular hospitals). In general, the end-user is entitled, on a case by case basis, to a price lower than the Company's established price. Accordingly, the Company owes the distributor a rebate - the difference between the established price and the lower price to which the end user is entitled - upon the Company's receipt of the documentation from the distributor. At the time that the distributor remits payment to the Company for the products purchased, the distributor deducts an amount for the related rebates. The allowance for rebates is recorded at the time the Company records the revenue for the product shipped to the distributor. The rebate is recorded as a sales allowance, as a reduction of net revenue. The Company had, for several years utilized a historical moving average to estimate the allowance for rebates. Based on the Company's review in the second quarter of fiscal 2003, the Company concluded that the moving average estimate does not necessarily result in the appropriate liability due to the distributor. Accordingly, the Company changed its method of estimating rebate claims to record the allowance for rebates based upon the documentation provided by the distributor of the shipments to the end-user, as well as estimates for inventory not yet sold by the distributor, adjusting from estimate to actual at the time of remittance. As a result of its review of the rebate allowance, the Company recorded an additional allowance for rebates of \$3,300,000 in the second quarter of fiscal 2003 to assure that Vital Signs established an appropriate reserve for rebate claims.

11. In fiscal 2003, the Internal Revenue Service (IRS) performed, in their normal course, a routine examination of the Company's 1997, 1998 and 1999 Federal tax returns. As a result of views expressed by the IRS, the Company increased its tax provision in the second quarter of fiscal 2003 by \$1,081,000, and increased interest expense by \$650,000 (\$429,000 after tax) for the related interest due. On October 6, 2003, the Company finalized the IRS tax audit for the years 1997, 1998 and 1999.

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12. During the second quarter of fiscal 2003, the Company concluded that it would be unable to collect its remaining receivable under normal terms from its China distributor, and provided a reserve against the receivable balance of \$553,000. In May 2003, the Company retained counsel in China to commence certain legal actions against its distributor in China to collect its receivable. In September 2003, the Company received and recognized as income in the fourth quarter of fiscal 2003 \$420,000 in cash from this distributor and also received the right to receive certain inventory. The Company has not received the inventory and continues to litigate for the return of its inventory.
13. In the second quarter of fiscal 2003, income from continuing operations included \$322,000 of expenses relating to costs for a public offering that was discontinued due to market conditions.
14. During the second quarter of fiscal 2003, the Company had received several non-binding bids for its Vital Pharma business. Based on the non-binding bids received, the Company reduced the amount of its investment in Vital Pharma, which is included in discontinued operations, and expensed \$3,300,000 in the second quarter of fiscal 2003, and subsequently in the third quarter of fiscal 2003 expensed an additional \$2,033,000. In October 2003, the Company sold Vital Pharma to ProClinical, Inc. for \$500,000 in cash and a three-year note receivable from ProClinical for \$2,000,000. No gain or loss was recorded on the transaction.
15. In December 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("SFAS") No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of SFAS No. 123". SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 "Accounting for Stock-Based Compensation", to require prominent disclosures in annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect in measuring compensation expense. The disclosure requirements of SFAS No. 148 are effective for periods beginning after December 15, 2002.

The Company has elected, in accordance with the provisions of SFAS No. 123, as amended by SFAS No. 148, to apply the current accounting rules under APB Opinion No. 25 and related interpretations in accounting for its stock options and, accordingly, has presented the disclosure-only information as required by SFAS No. 123. If the Company had elected to recognize compensation cost based on the fair value of the options granted at the grant date as prescribed by SFAS No. 123, the Company's net income and net income per common share for the three months and six months ended March 31, 2004 and 2003 would approximate the pro forma amounts indicated in the table below (dollars in thousands):

| | | THREE MONTH PERIOD ENDED MARCH 31, | SIX EN |
|------|------|---------------------------------------|-----------|
| | | ----- | ----- |
| 2004 | 2003 | | 2004 |
| | | | |

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| | | | |
|---|---------|------------|---------|
| Net income (loss)- as reported..... | \$5,397 | \$ (1,222) | \$10,46 |
| Net income (loss)- pro forma..... | 5,097 | (1,376) | 9,86 |
| Basic net income (loss) per common share - as reported..... | .42 | (.09) | .8 |
| Diluted net income (loss) per common share - as reported..... | .42 | (.09) | .8 |
| Basic net income (loss) per common share - Pro forma..... | .40 | (.11) | .7 |
| Diluted net income (loss) per common share - Pro forma..... | .39 | (.11) | .7 |

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The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for the three months and six months ended March 31, 2004 and 2003, respectively: expected volatility of 50% and 50%, respectively, risk-free interest rate of 3.7% and 5.2%, respectively, dividend yield rate of .7% and .5%, respectively, and all options have expected lives of 5 years.

16. In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation ("FIN") 46, Consolidation of Variable Interest Entities--an Interpretation of ARB No. 51. This interpretation provides guidance related to identifying variable interest entities (previously known as special purpose entities or SPEs) and determining whether such entities should be consolidated. Certain disclosures are required if it is reasonably possible that a company will consolidate or disclose information about a variable interest entity when it initially applies FIN 46. This interpretation was effective for the Company's second quarter ended March 31, 2004. The Company has no investment in or contractual relationship or other business relationship with a variable interest entity and therefore the adoption of FIN 46 will not have any impact on the Company's results of operations and financial condition.

The Company does not believe that any other recently issued but not yet effective accounting standards will have a material effect on the Company's financial position or results of operations.

Item 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

Forward Looking Statements

This Quarterly Report on Form 10-Q contains, and from time to time we expect to make, certain forward-looking statements regarding our business, financial condition and results of operations. The forward-looking statements are typically identified by the words "anticipates", "believes", "expects", "intends", "forecasts", "plans", "future", "strategy", or words of similar import. In connection with the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), we intend to

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caution investors that there are important factors that could cause our actual results to differ materially from those projected in our forward-looking statements, whether written or oral, made herein or that may be made from time to time by or on behalf of us. Investors are cautioned that such forward-looking statements are only predictions and that actual events or results may differ materially from such statements. We undertake no obligation to publicly release the results of any revisions to our forward-looking statements to reflect subsequent events or circumstances or to reflect the occurrence of unanticipated events.

We wish to ensure that any forward-looking statements are accompanied by meaningful cautionary statements in order to comply with the terms of the safe harbor provided by the Reform Act. Accordingly, we have set forth in Exhibit 99.1 to our Annual Report on Form 10-K for the year ended September 30, 2003 a list of important factors, certain of which are outside of management's control, that could cause our actual results to differ materially from those expressed in forward-looking statements or predictions made herein and from time to time by us. Reference is made to such Exhibit 99.1 for a list of such risk factors.

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Results of Operations

The following table sets forth, for the periods indicated, the percentage increase or decrease of certain items included in the Company's consolidated statement of income.

| | INCREASE FROM PRIOR PERIOD THREE MONTHS ENDED MARCH 31, 2004 COMPARED WITH THREE MONTHS ENDED MARCH 31, 2003 | INCREASE FROM PRIOR PERIOD SIX MONTHS ENDED MARCH 31, 2004 COMPARED WITH SIX MONTHS ENDED MARCH 31, 2003 |
|--|---|---|
| ----- | | |
| Consolidated Statement of Operations Data: | | |
| Net revenues..... | 10.9% | 4.2% |
| Gross profit..... | 17.9% | 5.4% |
| Total operating expenses..... | (2.4)% | 0.5% |
| Income from continuing operations..... | 306.2% | 34.7% |
| Net income..... | 541.7% | 110.1% |
| ----- | | |

Comparison of Results for the Three-Month Period Ended March 31, 2004 to the Three-Month Period Ended March 31, 2003.

Net Revenue. Net revenues for the three months ended March 31, 2004 increased by 10.9% (an increase of 7.7% excluding the favorable effect of foreign exchange) to \$46.6 million as compared to \$42.1 million in the comparable period last year. Of our total revenues, \$33.4 million (or 71.7%) were derived from domestic sales and \$13.2 million (or 28.3%) were derived from international sales. The following are the net revenues by business segment for the three months ended March 31, 2004 compared to the three months ended March 31, 2003.

| REVENUE BY BUSINESS SEGMENT | | | |
|------------------------------------|-----------------------------------|----------|------------|
| Dollars in Thousands | FOR THE QUARTER ENDED MARCH 31 | | PER CHA |
| | 2004 | 2003 | |
| Anesthesia | \$19,654 | \$17,599 | 11.7 |
| Respiratory/Critical Care | 10,969 | 11,029 | (0.5) |
| Sleep | 12,221 | 12,136 | 0.7 |
| Pharmaceutical Technology Services | 3,793 | 4,600 | (17.5) |
| Rebate allowance adjustment | -- | (3,300) | -- |
| | \$46,637 | \$42,064 | 10.9 |

The rebate allowance of \$3.3 million relates to our anesthesia and respiratory/critical care segments. Refer to Footnote 10 of the Notes to Consolidated Financial Statements for a description of the rebate allowance.

Sales of anesthesia products increased 11.7% from \$17.6 million for the three months ended March 31, 2003 to \$19.7 million for the three months ended March 31, 2004. The increase is due to an 85.2% increase in sales of Limb-[th]'TM', a patented anesthesia circuit, to \$1,921,000, a 16.9% increase in sales of anesthesia circuits to \$6,167,000, and a 23.6% increase in sales by the Company's Thomas Medical subsidiary to \$5,000,000. Domestic sales of anesthesia products increased 11.2%, from \$16,081,000 for the three months ended March 31, 2003 to \$17,886,000 for the three months ended March 31, 2004. International sales of anesthesia products increased 16.5%, from \$1,518,000 for the three months ended March 31, 2003 to \$1,768,000 for the three months ended March 31, 2004.

Sales of respiratory/critical care products decreased 0.5%, from \$11.0 million for the three months ended March 31, 2003 to \$10.9 million for the three

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months ended March 31, 2004, as an 8.4% decline in domestic sales offset a 22.0% increase in international sales. Domestic sales of respiratory/critical care products decreased from \$8,177,000 for the three months ended March 31, 2003 to \$7,490,000 for the three months ended March 31, 2004, primarily due to volume declines. International sales of respiratory/critical care products increased 21.9%, from \$2,852,000 for the three months ended March 31, 2003 to \$3,479,000 for the three months ended March 31, 2004 which resulted from increased volume levels.

Net revenues in the sleep business segment increased 0.7% (a decrease of 8.5% excluding foreign exchange) from \$12.1 million for the three months ended March 31, 2003 to \$12.2 million for the three months ended March 31, 2004. The growth in our sleep segment, which includes sleep diagnostic services and therapy products, was due primarily to increased revenue of 3.2% in our Breas subsidiary, our sleep ventilation business, resulting principally from favorable exchange rates. Excluding the effect

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of favorable exchange rates, Breas revenues declined 10.9%. This decline is due primarily to a volume decrease in our personal ventilator business, as well as the phase out of certain distributed product lines, as Breas focuses its strategy on self-manufactured equipment. Also included in this segment is Sleep Services of America, our sleep diagnostics and therapy company, whose revenues decreased by 3.7%, as the business continues to close sleep labs that are not returning an appropriate margin. In the sleep labs which remain open, revenue increased 16.5%. Pre-tax margins in our SSA business improved to 14.7% in the second quarter of fiscal 2004, as compared to 9.0% in the comparable period last year.

Service revenues in the Pharmaceutical Technology Services segment decreased 17.5%, from \$4.6 million for the three months ended March 31, 2004 to \$3.8 million for the three months ended March 31, 2004, as our larger pharmaceutical customers reduced their external resource usage with regards to 21 CFR Part 11 FDA regulatory compliance needs.

Cost of Goods Sold and Services Performed. Cost of goods sold and services performed increased 4.7% from \$22.4 million for the three months ended March 31, 2004 to \$23.4 million for the three months ended March 31, 2004.

Cost of goods sold increased 7.1%, from \$17.7 million for the three months ended March 31, 2003 to \$18.9 million for the three months ended March 31, 2004. The \$1,257,000 increase results primarily from the corresponding increase in sales volume in our anesthesia segment, resulting in an increase in cost of goods sold of approximately \$1.0 million, an increase of approximately \$670,000 at our Breas subsidiary due to foreign exchange rate changes and \$363,000 relating to additional inventory provisions at Breas. See Footnote 8 of the Notes to the Consolidated Financial Statements. These increases are partially offset by sales volume decreases at Breas of approximately \$380,000 and cost savings programs of approximately \$396,000 at our New Jersey and Colorado manufacturing plants.

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Cost of services performed decreased 4.5%, from \$4.7 million for the three months ended March 31, 2003 to \$4.5 million for the three months ended March 31, 2004, resulting primarily from reduced sales volumes in our Pharmaceutical Technology Services segment and at Sleep Services of America, our sleep diagnostics company, where the business continues to close sleep labs that are not returning an appropriate margin.

Gross Profit. Our gross profit increased 17.9%, from \$19.7 million for the three months ended March 31, 2003 to \$23.2 million for the three months ended March 31, 2004. Our overall gross profit margin was 49.8% for the three months ended March 31, 2004, an increase from the 46.9% achieved in the three months ended March 31, 2003, due to the effect of the rebate adjustment of \$3,300,000 described in Footnote 10 of the Notes to Consolidated Financial Statements. For gross profit information related to our four segments, refer to Footnote 6 of the Notes to Consolidated Financial Statements. Gross Profit as a percent of gross revenues was 60.5% for the three months ended March 31, 2004, slightly higher than 60.0% recorded for the three months ended March 31, 2003. For a reconciliation of gross revenues to net revenues, refer to Footnote 5 of the Notes to Consolidated Financial Statements.

Operating Expenses

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased 1.4%, from \$12.5 million for the three months ended March 31, 2003 to \$12.7 million for the three months ended March 31, 2004. The \$200,000 increase was primarily due to an increase of approximately \$350,000 at our Breas subsidiary due to foreign exchange rate changes, increased business insurance costs of \$125,000 and increased legal expense of \$123,000. These increases were partially offset by cost savings at our Breas and Stelex subsidiaries of approximately \$400,000.

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Research and Development Expenses. Research and development expenses increased by approximately \$615,000, or 43.4%, from \$1.4 million for the three months ended March 31, 2003 to \$2.0 million for the three months ended March 31, 2004 as the Company invests in the development of new Sleep CPAP and ventilation equipment and patient interfaces for our Breas subsidiary.

Impairment charge for China operations. During the second quarter of fiscal 2003, the Company concluded that it would be unable to collect its remaining receivable under normal terms from its China distributor, and provided a reserve against the receivable balance of \$553,000. In May 2003, the Company retained counsel in China to commence certain legal actions against its distributor in China to collect its receivable. In September 2003, the Company received and recognized as income in the fourth quarter of fiscal 2003 \$420,000 in cash from this distributor and also received the right to receive certain inventory. The company has not received the inventory and continues to litigate for the return of its inventory.

Other (Income) Expense--Net. Other expense included in operating expenses, decreased by \$603,000 from \$754,000 for the three months ended March 31, 2004 to \$151,000 for the three months ended March 31, 2004. Included in the three months ended March 31, 2003 were \$322,000 of costs for a public offering that was discontinued due to market conditions, \$205,000 for the closing cost of the Breas U.K. sales offices and \$29,000 for the closing of redundant

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Stelex offices and higher donations cost.

Other Items

Interest Income and Expense. Interest income increased 30.3%, from \$155,000 for the three months ended March 31, 2003 to \$202,000 during the three months ended March 31, 2004, resulting from the increase in the level of cash and cash equivalents being invested. Interest expense decreased 99.9%, from \$685,000 for the three months ended March 31, 2003 to \$1,000 during the three months ended March 31, 2004. Interest expense for the three months ended March 31, 2003 included \$650,000 of interest relating to past taxes due resulting from an Internal Revenue Service examination and interest of \$35,000 on our IRB loan, which was paid off in December 2003. Refer to Footnote 11 of the Notes to Consolidated Financial Statements.

Provision for Income Taxes. The provision for income tax expense for the three months ended March 31, 2004 and 2003 was \$3.0 million and \$2.5 million, respectively, reflecting effective tax rates of 35.2% and 64.1% for these periods, respectively. Included in the provision for the three months ended March 31, 2003 is an additional provision of \$1.1 million resulting from an examination by the Internal Revenue Service of the Company's 1997, 1998 and 1999 Federal income tax returns. The effective tax rate excluding this item was 36.4%. Refer to Footnote 11 of the Notes to Consolidated Financial Statements.

Discontinued Operations. On October 30, 2003 the Company sold the assets of its Vital Pharma subsidiary to Pro-Clinical, Inc. The Company received \$500,000 in cash and a three-year note receivable from ProClinical in the principal amount of \$2,000,000. The note is secured by a first lien against all of the assets sold. No gain or further loss was recorded on the sale. On December 29, 2003 the Company sold certain related real estate. The Company has accounted for these sales on a cost recovery basis. The net loss (after applying the tax benefit) from discontinued operation was approximately \$17,000 for the three months ended March 31, 2004 and approximately \$2,555,000 for the three months ended March 31, 2003. Refer to Footnote 14 of the Notes to Consolidated Financial Statements.

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Comparison of Results for the Six-month Period Ended March 31, 2004 to the Six-month Period Ended March 31, 2003

Net Revenue. Net revenues for the six months ended March 31, 2004 increased by 4.2% (an increase of 1.2% excluding the favorable effect of foreign exchange) to \$90.5 million as compared to \$86.8 million in the comparable period last year. Of our total revenues, \$65.9 million (or 72.8%) were derived from domestic sales and \$24.6 million (or 27.2%) were derived from international sales. Following are the net revenues by business segment for the six months ended March 31, 2004 compared to the six months ended March 31, 2003.

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REVENUE BY BUSINESS SEGMENT

| | FOR THE SIX-MONTHS ENDED MARCH 31, | | PERCENT CHANGE |
|------------------------------------|---------------------------------------|----------|-------------------|
| | 2004 | 2003 | |
| Anesthesia | \$38,152 | \$34,613 | 10.2% |
| Respiratory/Critical Care | 21,634 | 22,222 | (2.6%) |
| Sleep | 23,177 | 23,420 | (1.0)% |
| Pharmaceutical Technology Services | 7,522 | 9,866 | (23.8)% |
| Rebate allowance adjustment | -- | (3,300) | N/A |
| | \$90,485 | \$86,821 | 4.2% |

The rebate allowance of \$3.3 million relates to our anesthesia and respiratory/critical care segments. Refer to Footnote 10 of the Notes to Consolidated Financial Statements for a description of the rebate allowance.

Sales of anesthesia products increased 10.2% from \$34.6 million for the six months ended March 31, 2003 to \$38.2 million for the six months ended March 31, 2004. This increase was due to volume growth in anesthesia circuits including our Limb-[theta]'TM', a patented anesthesia circuit, which increased 68.8% to \$3.5 million and volume increases in our Thomas Medical Products subsidiary, which increased 28% to \$9.2 million. Domestic sales of anesthesia products increased 8.9%, from \$32.1 million to \$35.0 million. International sales of anesthesia products increased 27.5%, from \$2.5 million to \$3.2 million.

Sales of respiratory/critical care products decreased 2.6%, from \$22.2 million for the six months ended March 31, 2003 to \$21.6 million for the six months ended March 31, 2004. This was due primarily to lower domestic sales volumes, with domestic sales declining 12.6%, from \$17.1 million to \$14.9 million. International sales of respiratory/critical care products increased 30.4% from \$5.1 million for the six months ended March 31, 2003 to \$6.7 million for the six months ended March 31, 2004 reflecting higher sales volume.

Our sleep segment revenues decreased 1.0% (a decrease of 10.8% excluding favorable foreign exchange), from \$23.4 million for the six months ended March 31, 2003 to \$23.2 million for the six months ended March 31, 2004. Sleep Services of America's revenues decreased 4.2% from \$8.9 million for the six months ended March 31, 2003 to \$8.5 million for the six months ended March 31, 2004 as the business continues to close sleep labs that are not returning an appropriate margin. In the sleep labs which remain open, revenue increased 16.5%. Pre-tax margins in our SSA business improved to 16.2% in the second quarter of fiscal 2004, as compared to 8.0% in the comparable period last year. Revenues at our Breas subsidiary increased 0.9% (a decrease of 14.2% excluding

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favorable foreign exchange) from \$14.6 million for the six months ended March 31, 2003 to \$14.7 million for the six months ended March 31, 2004.

Service revenues in the Pharmaceutical Technology Services segment decreased 23.8%, from \$9.9 million for the six months ended March 31, 2003 to \$7.5 million for the six months ended March 31, 2004, in the second quarter of fiscal 2004, as our larger pharmaceutical customers reduce their external resource usage with regards to 21 CFR Part 11 FDA regulatory compliance needs.

Cost of Goods Sold and Services Performed. Cost of goods sold and services performed increased 3.1% from \$43.9 million for the six months ended March 31, 2003 to \$45.2 million for the six months ended March 31, 2004.

Cost of goods sold increased 7.8%, from \$33.8 million for the six months ended March 31, 2003 to \$36.4 million for the six months ended March 31, 2004. The \$2.6 million increase results primarily the corresponding increase in sales volume in our anesthesia segment, resulting in an increase in cost of goods sold of approximately \$2.1 million, an increase of approximately \$1.3 million at our Breas subsidiary due to foreign exchange rate changes and \$363,000 relating to additional inventory provisions at Breas. See Footnote 8 of the Notes to Consolidated Financial Statements. These increases are partially offset by sales volume decreases at Breas of approximately \$880,000 and cost savings programs of approximately \$280,000 at our New Jersey and Colorado manufacturing plants.

Cost of services performed decreased 12.8%, from \$10.1 million for the six months ended March 31, 2003 to \$8.8 million for the six months ended March 31, 2004, resulting primarily from reduced sales volumes in our Pharmaceutical Technology Services segment and at Sleep Services of America, our sleep diagnostics company, where the business continues to close sleep labs that are not returning an appropriate margin.

Gross Profit. Our gross profit increased 5.4%, from \$42.9 million for the six months ended March 31, 2003 to \$45.3 million for the six months ended March 31, 2004. Our overall gross profit margin was 50.0% for the six months ended March 31, 2004 and 49.4% for the six months ended March 31, 2003. For gross profit information related to our four segments, refer to Footnote 6 of the Notes to Consolidated Financial Statements. Gross Profit as a percent of gross revenues was 60.8% for the six months ended March 31, 2004, slightly higher than 60.7% recorded for the six months ended March 31, 2003. For a reconciliation of gross revenues to net revenues, refer to Footnote 5 of the Notes to Consolidated Financial Statements.

Operating Expenses

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased 1.8%, from \$24.6 million for the six months ended March 31, 2003 to \$25.1 million for the six months ended March 31, 2004. The \$500,000 increase is primarily due to an increase of \$750,000 at our Breas subsidiary for unfavorable foreign exchange rate changes, increased business insurance costs of \$300,000 and increased legal expense of \$250,000. These increases were partially offset by cost savings at our Breas and Stelex subsidiaries of approximately \$900,000.

Research and Development Expenses. Research and development expenses increased by approximately \$600,000, or 21.2%, from \$2.9 million for the six months ended March 31, 2003 to \$3.5 million for the six months ended March 31, 2004 as the Company invests in the development of new Sleep CPAP and ventilation

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equipment and interfaces for our Breas subsidiary.

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Impairment charge for China operations. As noted above, during the second quarter of fiscal 2003, the Company concluded that it would be unable to collect its remaining receivable under normal terms from its China distributor, and provided a reserve against the receivable balance of \$553,000.

Other (Income) Expense--Net. Other (income) expense included in operating expense decreased \$365,000 from \$586,000 for the six months ended March 31, 2003 to \$221,000 for the six months ended March 31, 2004. Included in the six months ended March 31, 2003 were one time costs of \$322,000 for the costs of a public offering that was discontinued due to market conditions, \$205,000 for the closing cost for several European sales offices and \$29,000 for the closing of redundant Stelex offices.

Other Items

Interest Income and Expense. Interest income increased 33.2%, from \$289,000 for the six months ended March 31, 2003 to \$385,000 during the six months ended March 31, 2004, resulting from the increase in the level of cash and cash equivalents being invested. Interest expense decreased \$702,000, from \$727,000 for the six months ended March 31, 2003 to \$25,000 during the six months ended March 31, 2004. Interest expense for the six months ended March 31, 2003 included \$650,000 of interest relating to past taxes due resulting from an Internal Revenue Service examination and interest of \$35,000 on our IRB loan, which was paid off in December 2003. (see Footnote 11 of the Notes to Consolidated Financial Statements).

Provision for Income Taxes. The provision for income tax expense for the six months ended March 31, 2004 and 2003 was \$5.9 million and \$5.8 million, respectively, reflecting effective tax rates of 35.1% and 41.8% for these periods, respectively. Included in the provision for the six months ended March 31, 2003 is an additional provision of \$1.1 million resulting from an examination by the Internal Revenue Service of the Company's 1997, 1998 and 1999 Federal income tax returns. The effective tax rate excluding this item was 34.0%. (See Footnote 11 of the Notes to Consolidated Financial Statements).

Discontinued Operations. On October 30, 2003 the Company sold the assets of its Vital Pharma subsidiary to Pro-Clinical, Inc. The Company received \$500,000 in cash and a three-year note receivable from ProClinical for \$2,000,000. The note is secured by a first lien against all of the assets sold. No gain or further loss was recorded on the sale. On December 29, 2003 the Company sold certain related real estate. The Company has accounted for these sales on a cost recovery basis. The net loss (after applying the tax benefit) from discontinued operation was approximately \$171,000 for the six months ended March 31, 2004 and approximately \$2,912,000 for the six months ended March 31, 2003. (See Footnote 14 of the Notes to Consolidated Financial Statements).

Liquidity and Capital Resources

Historically, our primary liquidity requirements have been to finance

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business acquisitions and to support operations. We have funded these requirements principally through internally generated cash flow. At March 31, 2004, we had cash and cash equivalents of approximately \$67 million and we had no long-term debt. We have a \$20 million line of credit with JP Morgan Chase Bank. There were no amounts outstanding on the JP Morgan Chase Bank line of credit at March 31, 2004.

Vital Signs continues to generate cash flows from its operations. During the six months ended March 31, 2004, cash and cash equivalents increased by \$11.3 million. Operating activities provided \$18.0 million net cash, of which \$18.2 million was provided from continuing operations and \$200,000 was used by our discontinued operation at Vital Pharma. Investing activities provided \$400,000 of net proceeds from the sale of Vital Pharma's assets and \$1.2 million net proceeds on the sale of Vital Pharma's real estate which was fully offset by \$1.6 million used for capital expenditures. Financing activities used \$6.5

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million, consisting of \$3.8 million for the repurchase of common stock, \$1.5 million used to pay down an Industrial Revenue Bond, and \$1.5 million paid for dividends, offset by \$349,000 of cash received from the exercise of stock options.

Cash and cash equivalents were \$67 million at March 31, 2004 as compared to \$55.7 million at September 30, 2003. At March 31, 2004 our working capital was \$105.8 million as compared to \$98.5 million at September 30, 2003. At March 31, 2004 the current ratio was 8.7 to 1, as compared to 6.4 to 1 at September 30, 2003.

Capital expenditures for the six month period ended March 31, 2004 were approximately \$1.6 million, and included expenditures for equipment used as part of cost improvement projects at our New Jersey facility (\$381,000), Colorado facility (\$370,000), California facility (\$87,000) and Thomas Medical Products facility (\$120,000), new laboratory equipment (\$120,000) for the sleep labs at SSA and the capitalized costs of software development (\$386,000) and patents (\$75,000). We expect that our total capital expenditures for fiscal 2004 should not exceed our total capital spending of \$4.6 million in fiscal 2003. This statement represents a forward-looking statement under the Reform Act. Actual results may differ from this statement for a number of reasons, including the possibility that the Company determines that its business requires new equipment in order to meet competitive and/or technological challenges.

Our current policy is to retain working capital and earnings for use in our business, subject to the payment of certain cash dividends. Such funds may be used for business acquisitions, product acquisitions, and product development, among other things. We regularly evaluate and negotiate with domestic and foreign medical device companies regarding potential business or product line acquisitions, licensing arrangements and strategic alliances.

Our Board of Directors has authorized the expenditure of up to \$20 million for the repurchase of Vital Signs' stock. From November 14, 2003 to March 31, 2004, we had repurchased 217,600 shares for \$6.4 million, at an average price of \$29.22. Any purchases under Vital Signs' stock repurchase program may be made from time-to-time in the open market, through block trades or otherwise. Depending on market conditions and other factors, these purchases

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may be commenced or suspended at any time or from time-to-time without prior notice.

Our Board of Directors has approved \$1.6 million in dividends (amounting to \$.12 per share) in the current fiscal year.

Critical Accounting Principles and Estimates

We have identified the following critical accounting principles that affect the more significant judgments and estimates used in the preparation of our consolidated financial statements. The preparation of our consolidated financial statements in conformity with generally accepted accounting principles requires us to make estimates and judgments that affect our reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to asset impairment, revenue recognition, allowance for doubtful accounts, and contingencies and litigation. These estimates are based on the information that is currently available to us and on various other assumptions that we believe to be reasonable under the circumstances. We state these accounting policies in the notes to our consolidated financial statements and at relevant places in this discussion and analysis. Actual results could vary from these estimates under different assumptions or conditions.

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We believe that the following critical accounting principles affect the more significant judgments and estimates used in the preparation of our consolidated financial statements:

- o Through September 30, 2001, we amortized goodwill and intangibles on a straight-line basis over their estimated lives. Upon our adoption of SFAS No. 142 on October 1, 2001, we ceased amortizing goodwill and we perform an annual impairment analysis based upon discounted cash flows to assess the recoverability of the goodwill, in accordance with the provisions of SFAS No. 142. We completed this impairment test during the three month period ended March 31, 2004 and found no impairment. If we are required to record impairment charges in the future, it would have an adverse impact on our results of operations and financial condition.
- o We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments, which results in bad debt expense. Our allowance for doubtful accounts was \$708,000 at March 31, 2004 and \$919,000 at September 30, 2003. We determine the adequacy of this allowance by evaluating individual customer receivables, considering the customer's financial condition and credit history and analyzing current economic conditions. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.
- o Our sales to distributors are made at our established price. Each distributor subsequently provides us with documentation that our

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products have been shipped to particular end-users (i.e.. particular hospitals). In general, the end-user is entitled, on a case by case basis, to a price lower than our established price. Accordingly, we owe the distributor a rebate - the difference between the established price and the lower price to which the end-user is entitled - upon our receipt of the documentation from the distributor. At the time that the distributor remits payment to us for the products purchased, the distributor deducts an amount for the related rebates.

The allowance for rebates is recorded at the time we record the revenue for the product shipped to the distributor. The rebate is recorded as sales allowance reducing gross revenue.

We had, for several years, utilized an historical moving average to estimate the allowance for rebates. Based upon our review during the second quarter of fiscal 2003, we concluded that the moving average estimate did not necessarily result in the appropriate liability due to the distributor. Accordingly, we changed our method of estimating rebate claims in the second quarter of fiscal 2003, to record the allowance for rebates based upon the documentation provided by the distributor of the shipments to the end-user as well as estimates for inventory not yet sold by the distributor, adjusting from estimate to actual at the time of remittance. The allowance for rebates was \$7,865,000 and \$6,156,000 at March 31, 2004 and September 30, 2003, respectively. Rebate expense was \$11,669,000 and \$12,484,000 for the three months ended March 31, 2004 and March 31, 2003, and was \$22,754,000 and \$22,525,000 for the six months ended March 31, 2004 and March 31, 2003.

- o We have established an allowance for inventory obsolescence. The allowance was determined by performing an aging analysis of the inventory; based upon this review, inventory is stated at the lower of cost (first in, first out method) or its net realizable value. In the quarter ended March 31, 2004, the Company wrote-off certain Breas inventory amounting to \$363,000. Our inventory allowance for obsolescence was \$1,147,000 at March 31, 2004 and \$981,000 at September 30, 2003.

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- o We are subject to various claims and legal actions in the ordinary course of our business. These matters frequently arise in disputes regarding the rights to intellectual property, where it is difficult to assess the likelihood of success and even more difficult to assess the probable ranges of recovery. Although we currently are not aware of any legal proceeding that is reasonably likely to have a material adverse effect on our financial position and results of operations, if we become aware of any such claims against us, we will evaluate the probability of an adverse outcome and provide accruals for such contingencies as necessary.

Accounting Principles. For information regarding new accounting

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principles, see Note 16 of our notes to consolidated financial statements.

ITEM 3.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risks, including the impact of material price changes and changes in the market value of our investments and, to a lesser extent, interest rate changes and foreign currency fluctuations. In the normal course of business as described below, we employ policies and procedures with the objective of limiting the impact of market risks on earnings and cash flows and to lower our overall borrowing costs.

The impact of interest rate changes is not material to our financial condition. We do not enter into interest rate transactions for speculative purposes.

Our international net revenue represents approximately 27.2% of our total net revenues. Our Breas subsidiary, located in Sweden, represents 59.8% of our total international net revenues. We do not enter into any derivative transactions, including foreign currency transactions, for speculative purposes. The Company has not entered into any derivative instruments (i.e. foreign exchange forward or option contracts) as of March 31, 2004.

Our risk involving price changes relate to raw materials used in our operations. We are exposed to changes in the prices of resins and latex for the manufacture of our products. We do not enter into commodity futures or derivative instrument transactions. Except with respect to our single source of supply for facemasks, it is our policy to maintain commercial relations with multiple suppliers and when prices for raw materials rise to attempt to source alternative supplies.

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ITEM 4.

CONTROLS AND PROCEDURES

(a) Disclosure controls and procedures. As of the end of the Company's most recently completed fiscal quarter covered by this report, the Company carried out an evaluation, with the participation of the Company's management, including the Company's Chief Executive Officer and Interim Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures pursuant to Securities Exchange Act Rule 13a-15. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported, within the time periods

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specified in the SEC's rules and forms.

(b) Changes in internal controls over financial reporting. There have been no changes in the Company's internal controls over financial reporting that occurred during the Company's last fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. Other Information

ITEM 1.

Legal Proceedings:

- (a) On December 8, 1999, a complaint was filed against us on behalf of the former shareholders of our Vital Pharma subsidiary alleging breach of contract for failure to pay earnout payments allegedly due under the stock purchase agreement executed in connection with our purchase of Vital Pharma in December 1995. We have answered the complaint, filed counter-claims and moved to transfer the case to arbitration. In August 2000, the court ordered the plaintiff to submit such claims to binding arbitration and stayed all other proceedings pending the outcome of the arbitration. The arbitration hearing commenced on January 26, 2004. The hearing is being held on an intermittent schedule with the next hearing date scheduled in May 2004. Due to the introduction of new witnesses, the Arbitrator has permitted additional discovery during the course of the arbitration proceedings, resulting in delays in concluding the case.
- (b) On May 7, 2003 a complaint was filed against the Company and two of its officers by Joseph Bourgart, a former chief financial officer of the Company. A detailed description of this litigation is set forth in Item 3, Legal Proceedings, of the Company's Annual Report on Form 10-K for the year ended September 30, 2003. The Company strongly denies all of Plaintiff's allegations, that it had engaged in improper conduct both as regards its accounting practices and with regard to its treatment of the Plaintiff. The Company and the individual defendants filed a Motion for Summary Judgment that has been pending since September 2003.
- (c) A first amended complaint was filed against the Company's Vital Pharma subsidiary on September 8, 2003 in the U.S. District Court for the Northern District of California related to the packaging services it provides to Lifecore Biomedical, Inc. ("Lifecore"). The complaint also names Lifecore and Ethicon, Inc. (a subsidiary of Johnson and Johnson) as defendants. The complaint asserts multiple theories of negligence and product liability claims against the defendants for injuries allegedly sustained through the use of Lifecore's Gynecare Intergel ("Intergel") product during surgery. Lifecore manufactures the product, which is approved for the purpose of reducing post-surgical

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adhesions. The Company's insurance carrier has responded and has also notified Lifecore of its obligation under its agreement with Vital Pharma to indemnify it for complaints related to product defects.

On January 28, 2004 plaintiff filed a nearly identical lawsuit in California state court on her own behalf and on behalf of the general public alleging violation of the California Business and Professions Code based upon the facts underlying the federal court action. Our insurance carrier has denied coverage for this matter and we have begun a dialogue with our insurance carrier over this issue. We have notified our carrier that the Company believes coverage should be provided. If our insurance carrier does not provide coverage, we intend to take legal action to enforce our rights.

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On May 4, 2004, counsel for Vital Pharma received a copy of a complaint filed in Florida State Court (Circuit Court, Palm Beach County) alleging products liability claims against Vital Pharma, Lifecore, Ethicon and Johnson & Johnson for injuries alleged to have been caused by the Intergel product. We have not yet been served with the complaint. Our insurance carrier has been notified of the matter. We have been informed by counsel for Johnson & Johnson that a total of seven cases related to the Intergel product have already been filed in other jurisdictions and that there may be as many as twenty five lawsuits filed in total.

- (d) A detailed description of litigation involving the Company is set forth in Item 3, Legal Proceedings, of the Company's Annual Report on Form 10-K for the year ended September 30, 2003. We are also involved in other legal proceedings arising in the ordinary course of business. We cannot predict the outcome of our legal proceedings with certainty. However, based upon our review of pending legal proceedings, we do not believe the ultimate disposition of our pending legal proceedings will be material to our financial condition. Predictions regarding the impact of pending legal proceedings constitute forward-looking statements. The actual results and impact of such proceedings could differ materially from the impact anticipated, primarily as a result of uncertainties involved in the proof of facts in legal proceedings.

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ITEM 2.

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Changes in Securities and Use of Proceeds:

The following table provides information about purchases made by the Company during the quarter ended March 31, 2004 of equity securities that are registered by the Company pursuant to Section 12 of the Exchange Act

| PERIOD | (a) TOTAL NUMBER OF SHARES PURCHASED | (b) AVERAGE PRICE PAID PER SHARE | (c) (1) TOTAL NUMBER OF SHARES PURCHASED AS PART OF PUBLICLY ANNOUNCED PLANS OR PROGRAMS | (d) (1) MAXIMUM DOLLAR AMOUNT THAT MAY YET BE PURCHAED UNDER THE PLANS OR PROGRAMS |
|------------------------|---|---|---|--|
| ----- | ----- | ----- | ----- | ----- |
| 1/1/2004- 1/31/2004 | 16,000 | \$ 32.75 | 16,000 | \$ 16,432,663 |
| 2/1/2004- 2/29/2004 | 46,900 | \$ 32.22 | 46,900 | \$ 14,919,880 |
| 3/1/2004- 3/31/2004 | 40,200 | \$ 31.96 | 40,200 | \$ 13,633,564 |
| Total | 103,100 ===== | \$ 32.20 ===== | 103,100 ===== | \$ 13,633,564 ===== |

(1) In May 2003, our Board of Directors authorized the expenditure of up to \$20 million for the repurchase of Vital Signs' stock. From November 14, 2003 to March 31, 2004, we had repurchased 217,600 shares for \$6.4 million, including commissions of \$8,700, at an average price of \$29.22. Any purchases under Vital Signs' stock repurchase program may be made from time-to-time in the open market, through block trades or otherwise. Depending on market conditions and other factors, these purchases may be commenced or suspended at any time or from time-to-time without prior notice.

ITEM 3 THROUGH 5

Not applicable.

ITEM 6.

Reports on Form 8-K (excluding reports furnished to, but not deemed filed with, the Commission)

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A Current Report on Form 8-K was filed on February 19, 2004, disclosing (under Item 5) the resignation of Anthony Dimun from the Company's Board of Directors

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EXHIBITS

- 31.1 Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Interim Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Chief Executive Officer Pursuant to [p] U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of the Interim Chief Financial Officer Pursuant to [p] U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

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

VITAL SIGNS, INC.

By: /s/ Richard T. Feigel

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Richard T. Feigel
Corporate Controller and
Interim Chief Financial Officer

Date: May 14, 2004

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STATEMENT OF DIFFERENCES

The trademark symbol shall be expressed as..... 'TM'
The paragraph symbol shall be expressed as..... [p]
The Greek letter theta shall be expressed as..... [th]