VALLEY FORGE SCIENTIFIC CORP
Form 10-Q
February 12, 2004

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 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 December 31, 2003

[ ] 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: 001-10382

VALLEY FORGE SCIENTIFIC CORP.
(Exact name of registrant as specified in its charter)

PENNSYLVANIA	23-2131580
(State or other jurisdiction of incorporation or organization)	(I.R.S. employer identification no.)

136 Green Tree Road, Oaks, Pennsylvania 19456
(Address of principal executive offices and zip code)

Telephone: (610) 666-7500

Indicate by check mark [X] 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 [ ] No [X]

At February 9, 2004 there were 7,913,712 shares outstanding of the Registrant's no par value Common Stock.

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VALLEY FORGE SCIENTIFIC CORP.

INDEX TO FORM 10-Q

December 31, 2003

VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

ASSETS	December 31, 2003 (Unaudited)	September 30, 2003 (Audited)
Current Assets:		
Cash and cash equivalents	$ 2,426,729	$ 2,305,556
Accounts receivable, net	466,335	376,915
Inventory	691,516	775,183
Prepaid items and other current assets	283,730	268,371
Deferred tax assets	52,749	51,431

Total Current Assets	3,921,059	3,777,456
Property, Plant and Equipment, Net	150,842	156,697
Goodwill	153,616	153,616
Intangible Assets, Net	246,606	256,681
Other Assets	25,549	29,963
Total Assets	$ 4,497,672	$ 4,374,413

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities:		
Accounts payable and accrued expenses	$ 245,361	$ 216,457
Deferred revenue	22,310	--
Total Current Liabilities	267,671	216,457
Deferred Tax Liability	19,016	19,950
Total Liabilities	286,687	236,407
Commitments and Contingencies		
Stockholders' Equity:		
Preferred stock	--	--
Common stock (no par, 20,000,000 shares authorized, shares issued and outstanding at December 31, 2003 and September 30, 30, 2003 - 7,913,712)	3,528,530	3,528,530
Retained earnings	682,455	609,476
	4,210,985	4,138,006
Total Liabilities and Stockholders' Equity	$ 4,497,672	$ 4,374,413

See accompanying notes to consolidated financial statements.

VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	For the Three Months Ended December 31,	
	2003	2002

Net Sales	$ 1,199,469	$ 1,019,942
Cost of Sales	555,304	529,272
Gross Profit	644,165	490,670
Other Costs:		
Selling, general and administrative	398,337	330,618
Research and development	113,895	89,338
Amortization	10,075	10,075
Total Other Costs	522,307	430,031
Income from Operations	121,858	60,639
Other Income, Net	5,669	8,989
Income before Income Taxes	127,527	69,628
Provision for Income Taxes	54,548	29,489
Net Income	$ 72,979	$ 40,139
Income per Share:		
Basic income per common share	$ 0.01	$ 0.01
Diluted income per common share	$ 0.01	$ 0.01
Basic weighted average common shares outstanding	7,913,712	8,013,875
Diluted weighted average common shares outstanding	7,965,977	8,043,858

See accompanying notes to consolidated financial statements.

VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	For the Three Months Ended December 31, 2003	2002
Cash Flows from Operating Activities:		
Net income	$ 72,979	$ 40,139
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	17,732	15,190
Interest accrued on loans and advances to employees and related parties	(616)	(583)
Changes in assets and liabilities:		
Increase in accounts receivable, net	(89,420)	(170,822)
Decrease in inventory	83,667	79,203
(Increase) decrease in deferred tax assets	(1,318)	14,115
(Increase) decrease in other assets	4,414	691
Increase in prepaid items and other current assets	(14,743)	(50,067)
Increase (decrease) in accounts payable and accrued expenses and income taxes payable	28,904	(95,096)
Increase in deferred revenue	22,310	--
Decrease in deferred tax liability	(934)	(327)
Net cash provided by (used in) operating activities	122,975	(167,557)
Cash Flows from Investing Activities:		
Proceeds from repayment of employee loans		10,000
Purchases of property, plant and equipment	(1,802)	(4,090)
Net cash provided by (used in) investing activities	(1,802)	5,910
Cash Flows from Financing Activities:		
Repurchase of common stock	--	(81,631)
Net cash used in financing activities	--	(81,631)
Net Increase (Decrease) in Cash and Cash Equivalents	121,173	(243,278)
Cash and Cash Equivalents, beginning of period	2,305,556	2,543,898
Cash and Cash Equivalents, end of period	$ 2,426,729	$ 2,300,620
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for:		
Interest	$ --	$ --
Income taxes	$ --	$ 190,000

See accompanying notes to consolidated financial statements.

VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

DECEMBER 31, 2003

1. DESCRIPTION OF BUSINESS

Valley Forge Scientific Corp. ("VFSC") was incorporated on March 27, 1980 in the Commonwealth of Pennsylvania and is engaged in the business of developing, manufacturing and selling medical devices and products. On August 18, 1994, VFSC formed a wholly-owned subsidiary, Diversified Electronics Company, Inc. ("DEC"), a Pennsylvania corporation, in order to continue the operations of Diversified Electronic Corporation, a company which was merged with and into VFSC on August 31, 1994. Collectively, VFSC and DEC are referred to herein as the "Company".

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Basis of Presentation

The accompanying financial statements consolidate the accounts of VFSC and its wholly-owned subsidiary. All significant intercompany accounts and transactions have been eliminated in consolidation. Certain amounts from prior years have been reclassified to conform to the current year presentation.

The accompanying unaudited consolidated financial statements have been prepared pursuant to rules and regulations of the Securities and Exchange Commission and, therefore, do not include all information and footnote disclosures normally included in audited financial statements. However, in the opinion of management, all adjustments that are of a normal and recurring nature, necessary to present fairly the results of operations, financial position and cash flows have been made. It is suggested that these statements be read in conjunction with the financial statements included in the Company's Annual Report on Form 10-K for the year ended September 30, 2003.

The statements of operations for the three months ended December 31, 2003 and 2002 are not necessarily indicative of results for the full year.

Earnings (Loss) per Share

The Company computes earnings or loss per share in accordance with Statement of Financial Accounting Standards No. 128, "Earnings Per Share" (SFAS 128). Basic earnings per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding. Diluted earnings per share reflects the potential dilution that could occur if securities or other agreements to issue common stock were exercised or converted into common stock. Diluted earnings per share is computed based upon the weighted average number of common shares and dilutive common equivalent shares outstanding, which include convertible debentures, stock options and warrants.

Recently Issued Accounting Standards

In January 2003, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 46, "Consolidation of Variable Interest Entities - an interpretation of ARB No. 51, which provides guidance on the identification of and reporting for variable interest entities. In December 2003, the FASB issued a revised interpretation No. 46, which expands the criteria for consideration in determining whether a variable interest entity should be consolidated. Interpretation No. 46 is effective for the Company in the third quarter of 2004. The Company does not expect adoption of Interpretation No. 46 to have a significant impact on its future results of operations or financial condition.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock-Based Compensation

In December 2002, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure - an amendment of FASB Statement No. 123." SFAS No. 148 amends SFAS 123, "Accounting for Stock-Based Compensation", to provide 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 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS No. 148 is effective for the Company as of January 1, 2003. The Company has not elected a voluntary change in accounting to the fair value based method, and, accordingly, the adoption of SFAS No. 148 did not have a significant impact on the Company's results of operations or financial position.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's stock options have characteristics significantly different from those of traded options, and because changes in subjective input assumptions can materially affect the fair value estimated, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its stock options. In management's opinion existing stock option valuation models do not provide a reliable single measure of the fair value of employee stock options that have vesting provisions and are not transferable. In addition, option pricing models require the input of highly subjective assumptions, including expected stock price volatility.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. In accordance with SFAS 123 and 148, only stock options granted after September 30, 1995 have been included for the Company's pro forma information as follows:

	For the Three Months Ended December 31,	
	2003	2002
Net income, as reported	$ 72,979	$ 40,139
Less: Total stock based compensation expense, determined under fair value based method, net of tax effect	--	13,226
Pro forma net income	$ 72,979	$ 26,913
Pro forma income per share:		
Basic	$ 0.01	$ 0.00
Diluted	$ 0.01	$ 0.00

VALLEY FORGE SCIENTIFIC CORP. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

DECEMBER 31, 2003
(Continued)

3. SUPPLEMENTAL BALANCE SHEET INFORMATION

Accounts Receivable, Net

	December 31, 2003	September 30, 2003
Accounts receivable	$ 472,279	$ 378,786
Less: Allowances	5,944	1,871
	$ 466,335	$ 376,915

Inventory

	December 31, 2003	September 30, 2003
Finished goods	$ 51,283	$ 88,401
Work-in-process	286,776	316,600
Materials and parts	432,575	433,459
Less: Allowance for slow moving and obsolete inventory	79,118	63,277
	$ 691,516	$ 775,183

Property, Plant and Equipment, Net

	Useful Life (Years)	December 31, 2003	September 30, 2003
Land	-	$ 11,953	$ 11,953
Buildings and improvements	15 - 39	94,832	94,832
Furniture and fixtures	5 - 7	17,953	17,953
Laboratory equipment	5 - 10	370,119	370,119
Office equipment	5	183,120	181,318
Leasehold improvements	3 - 5	9,413	9,413
		687,390	685,588
Less: Accumulated depreciation and amortization		536,548	528,891
		$ 150,842	$ 156,697

3. SUPPLEMENTAL BALANCE SHEET INFORMATION (Continued)

Goodwill and Intangible Assets

In accordance with SFAS 142, Goodwill has been reflected on the balance sheet separate from other intangible assets which continue to be amortized. No changes were made to the carrying amount of goodwill for the quarter ended December 31, 2003. The Company completed its transitional impairment test during the quarter ending March 31, 2002, indicating that goodwill was not impaired. An additional annual test was performed during the quarter ending March 31, 2003 and no impairment adjustment was required.

Information regarding the Company's other intangible assets is as follows:

	December 31, 2003			September 30, 2	
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization

Patents, trademarks, licensing agreements	$ 571,617	$ 495,900	$ 75,717	$ 571,617	$ 493,365
Proprietary know-how	452,354	281,465	170,889	452,354	273,925
Acquisition costs	55,969	55,969	--	55,969	55,969
	$ 1,079,940	$ 833,334	$ 246,606	$ 1,079,940	$ 823,259

Amortization expense of intangible assets was $10,075 for the three months ended December 31, 2003 and 2002. Annual amortization expense for intangible assets held as of December 31, 2003, is estimated to be $40,300 for 2004, $40,300 for 2005, $40,300 for 2006, $40,000 for 2007 and $39,000 for 2008.

4. COMMITMENTS AND CONTINGENCIES

On September 19, 2002, the Company was served with a complaint that was filed in the Superior Court of the State of Arizona, County of Maricopa, entitled Jeffrey Turner and Cathryn Turner et al v. Phoenix Children's Hospital, Inc., et al, (CV 2002-010791) in which the Company was named as one of the defendants. The plaintiffs seek an unspecified amount of damages for alleged injuries sustained in a surgery that took place in June 2000. The Company's product liability insurance carrier is providing the Company's defense in this matter. This insurance coverage, which provided a policy limit of $1,000,000 per occurrence at the time of this claim, has a $10,000 deductible that applies to attorney fees and damages, which have been provided for in other costs under selling, general and administrative expense for the year ended September 30, 2002. In an answer that was filed on November 26, 2002, the Company denied any liability. The Company believes the claim is without merit and will vigorously defend itself in this action.

5. EARNINGS PER SHARE

	For the Three Months Ended December 31, 2003	2002
Income available to common shareholders	$ 72,979	$ 40,139
Weighted average common shares outstanding - basic	7,913,712	8,013,875
Net effect of dilutive shares issuable		

in connection with stock plans	52,265	29,983
Weighted average common shares outstanding - diluted	7,965,977	8,043,858
Earnings per share:		
Basic	$ 0.01	$ 0.01
Diluted	$ 0.01	$ 0.01

Options to purchase 477,750 and 527,850 shares of common stock were outstanding at December 31, 2003 and 2002, respectively, and 425,485 and 497,867 of these shares were not included in the computation of diluted earnings per share in accordance with SFAS 128, as the potential shares are considered anti-dilutive.

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

The following is a discussion and analysis of Valley Forge Scientific Corp.'s financial condition and results of operations for the three months ended December 31, 2003 and 2002. This section should be read in conjunction with the financial statements and related notes in Item 1 of this report and Valley Forge Scientific Corp.'s Annual Report on Form 10-K for the year ended September 30, 2003, which has been filed with the Securities and Exchange Commission. Unless the context requires otherwise, references to "we", "us", "our", and "Valley Forge Scientific" refer to Valley Forge Scientific Corp.

Cautionary Note Regarding Forward Looking Statements

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains, in addition to historic information, "forward looking" statements or statements which arguably imply or suggest certain things about our future. Statements which express that we "believe", "anticipate", "expect", or "plan to" as well as other statements which are not historical fact, are forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward looking statements include, but are not limited to statements about: any competitive advantage we may have as a result of our installed base of electrosurgical generators in the neurosurgery market; our belief that our products exceed industry standards or favorably compete with other companies' new technological advancements; the future success of our products and disposable instrumentation in the neurosurgery and dental markets; and our ability, along with the third parties with whom we contract, to distribute and sell our products both in and outside of the neurosurgery market, and the continued acceptance of our products in the neurosurgery market and the acceptance of our products in the dental market and outside of the neurosurgery market. These statements are based on assumptions that we believe are reasonable, but a number of factors could cause our actual results to differ materially from those expressed or implied by these statements. We do not intend to update these forward looking statements after the date of this report. You are advised to review the "Additional Cautionary Statements" section below for more information about risks and uncertainties that could affect the financial results of Valley Forge Scientific.

Overview

We design, develop, manufacture and sell medical and dental devices. Our core business is in our bipolar electrosurgical generators and related

instrumentation, based on our DualWave(TM) technology. Our bipolar systems allow a surgeon or dentist to cut tissue in a manner that minimizes collateral damage to surrounding healthy tissue and to coagulate blood vessels quickly, safely and efficiently. By substantially reducing damage to surrounding healthy tissue, the surgeon or dentist can work safely in close proximity with nerves, blood vessels, bone and metal implants. Our bipolar systems are designed to replace other surgical tools, such as monopolar electrosurgery systems, lasers and conventional instruments, used in soft tissue surgery.

Our DualWave(TM) technology is applicable to many surgical markets. Our bipolar systems are currently used to perform many types of neurosurgery, spine surgery and dental surgery. We have had worldwide exclusive distribution

agreements with Codman & Shurtleff, Inc., a subsidiary of Johnson & Johnson, Inc., to market our neurosurgery bipolar systems since 1983. During the first quarter of fiscal 2004, the term for our current distribution agreement with Codman & Shurtleff, Inc. was extended from December 31, 2003 to March 31, 2004 to allow the parties time to continue to discuss the terms of a new distribution agreement.

Historically, we have derived a significant portion of our sales from our neurosurgery bipolar system. Sales revenue from our Bident(R) Bipolar Tissue Management System for dental applications commenced in the 2000 fiscal year. Our current strategy is to increase sales of our Bident(R) Bipolar Tissue Management System by selling it directly to an expanded base of national dental product dealers, expand the offerings of products in the field of neurosurgery and broaden the market for our products in other clinical and surgical markets that have a need for bipolar electrosurgery. Our strategy also includes using our DualWave(TM) technology and sales of our bipolar generators to drive sales of complementary disposable hand-held instruments and products.

Critical Accounting Policies and Estimates

The following "Management's Discussion and Analysis of Financial Condition and Results of Operations", as well as disclosures included elsewhere in this Form 10-Q, are based upon our unaudited consolidated financial statements, which have been prepared in accordance with accounting principles 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, liabilities, revenues and expenses, and related disclosure of contingencies. On an on-going basis, we evaluate the estimates used, including those related to product returns, bad debts, inventory valuation, impairments of tangible and intangible assets, income taxes, warranty obligations, other accruals, contingencies and litigation. We base our estimates on historical experience, current conditions and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources as well as identifying and assessing our accounting treatment with respect to commitments and contingencies. Actual results may differ from these estimates under different assumptions or conditions. We believe the following critical accounting policies involve more significant judgments and estimates used in the preparation of the consolidated financial statements.

We maintain an allowance for doubtful accounts for estimated losses resulting from the potential inability of our customers to make required payments. 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.

We provide for the estimated cost of product returns based upon historical experience and any known conditions or circumstances. Our warranty obligation is affected primarily by product that does not meet specifications and performance requirements within the applicable warranty period and any related costs of addressing such matters. Should actual incidences of product not meeting specifications and performance requirements differ from our estimates, revisions to the estimated warranty liability may be required.

We value inventory at the lower of cost or market and write down the value of inventory for estimated obsolescence or unmarketable inventory. An inventory reserve is maintained based upon historical data of actual inventory written off and for known conditions and circumstances. Should actual product marketability be affected by conditions that are different from those projected by management, revisions to the estimated inventory reserve may be required.

Our deferred tax assets and liabilities are determined based on the differences between the financial statement and tax based assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Deferred tax assets are reduced by a valuation allowance at the time that a determination can be made that it is more likely than not that a portion or all of the related tax assets will not be realized.

In accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123") and SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure - An Amendment of FASB Statement No. 123" ("SFAS 148"), we have elected to account for stock-based compensation plans in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25"), and related interpretations.

Results of Operations

Results of Operations for the Three Months Ended December 31, 2003 compared to the Three Months Ended December 31, 2002.

Summary

Sales of $1,199,469 for the three months ended December 31, 2003 were 18% greater than sales of $1,019,942 for the three months December 31, 2002. Net income for the three months ended December 31, 2003 of $72,979 was 82% greater than net income of $40,139 for the three months ended December 31, 2002.

Revenues

Sales of $1,199,469 for the three months ended December 31, 2003 reflect an increase in sales volume of our Bident(R) Bipolar Tissue Management System. For the three months ended December 31, 2003, sales of our Bident(R) Bipolar Tissue Management System accounted for $170,049, or 14% of our sales, as compared to no sales for the three months ended December 31, 2002. Sales to Codman & Shurtleff, Inc. for the three months ended December 31, 2003 accounted for $1,025,965, or 85% of our sales, as compared to $1,012,000, or 99% of our sales.

In the first quarter of fiscal 2004, we extended the term of our distribution agreement with Codman & Shurtleff, Inc. from December 31, 2003 to March 31, 2004 in order to provide more time to continue discussions on the terms of a new distribution agreement for both our existing products and the next generation of neurosurgical products and disposable instruments, including

our new irrigation unit and related disposable tubing sets, which began production in the first quarter of fiscal 2004, and our next generation neurosurgical generator and disposable instrumentation which we anticipate having ready for introduction into the market in the first six months of calendar 2004.

In the first quarter of fiscal 2004, we saw a greater contribution from the sales our dental products as leads we received during fiscal 2003 began to turn into sales. We are continuing training the largest dental distributors of our dental products on the uses of the Bident(R) Bipolar Tissue Management System and are providing marketing support to the distributors through print advertisements, active participation in tradeshows and informational CD-ROMs. We expect sales of our dental products in fiscal 2004 to be at greater levels than sales reported in fiscal 2003. Sales, however, may fluctuate from quarter-to-quarter based on the timing of orders we receive from distributors and direct sales.

For the three months ended December 31, 2003, 59% of our sales of neurosurgical products related to sales of bipolar electrosurgical generators, irrigators and accessories as compared to approximately 49% of our sales for the corresponding period in fiscal 2002. Sales of disposable products, primarily cord and tubing sets, accounted for approximately 36% of our sales of neurosurgical products, in the three months ended December 31, 2003 as compared to approximately 42% of our sales for the corresponding period in fiscal 2002.

For the three months ended December 31, 2003, approximately 89% of our sales of dental products related to sales of bipolar electrosurgical generators. Sales of disposable hand-held instruments accounted for approximately 11% of our dental product sales.

Cost of Product Sales

Cost of sales was $555,304, or 46% of sales, for the three months ended December 31, 2003, as compared with $529,272, or 52% of sales, for the three months ended December 31, 2002. Gross margin was 54% for the three months ended December 31, 2003 as compared to 48%, for the three months ended December 31, 2002.

The difference in gross margin as a percentage of sales is attributable to an increase in direct sales of our dental products, changes in product mix and increased sales levels. We cannot be sure that gross margins will remain at current levels or show improvement in the future due to the distribution channels used, product mix, and fluctuation in manufacturing production levels and overhead costs as new products are introduced. In addition, inefficiencies in manufacturing new products and the distribution channels utilized to sell those products may adversely impact gross margin.

Operating Expenses

Selling, general and administrative expenses increased to $398,337, or 33% of sales, for the three months ended December 31, 2003, from $330,618, or 32% of sales, for the three months ended December 31, 2002. Selling, general and administrative expenses reflect increased selling and marketing expenses that we incurred in connection with implementing our sales and marketing efforts for the direct marketing of our Bident(R) Bipolar Tissue Management System to dental product distributors.

Research and development expenses for the three months ended December 31, 2003 were $113,895, or 10% of sales, as compared to $89,338, or 9% of sales, for the three months ended December 31, 2002. We continue to invest in research and development to expand our technological base for use in both existing and additional clinical areas. The increase was primarily related to the development of our next generation neurosurgical generator and instrumentation. We also devoted resources to the final stages of development of a product outside of the neurosurgery and dental markets pursuant to a development agreement we entered into with Stryker Corporation in September 2002. In the first quarter of fiscal 2004, we extended the term of that development agreement until February 28, 2004.

Other Income/Expense, net

Other income and expense, net, decreased slightly to $5,669 for the three months ended December 31, 2003 as compared to $8,989 for the three months ended December 31, 2002. At December 31, 2003, we had $2,426,726 in cash and cash equivalents as compared to $2,300,620 at December 31, 2002.

Income Tax Provision

The provision for income taxes was $54,548 for the three months ended December 31, 2003 as compared to a provision of $29,489 for the three months ended December 31, 2002.

Net Income

As a result of the foregoing, for the three months ended December 31, 2003 our net income was $72,979, or an 82% increase from net income of $40,139 for the three months ended December 31, 2002. Basic and diluted income per share was $.01 for both the three months ended December 31, 2003 and the three months ended December 31, 2002. Due to our operating history and numerous other factors, we cannot be sure that we can sustain profitability or achieve revenue growth.

Liquidity and Capital Resources

At December 31, 2003, we had $3,653,388 in working capital compared to $3,560,999 at September 30, 2003. The primary measures of our liquidity are cash, cash equivalents, accounts receivable and inventory balances, as well as our borrowing ability. The cash equivalents are highly liquid with original maturities of ninety days or less.

Cash provided by operating activities was $122,975 for the three months ended December 31, 2003, as compared to cash used by operating activities of $167,557 for the three months ended December 31, 2002. The cash provided by operating activities for the three months ended December 31, 2003 was mainly attributable to our operating profit net of adjustments for non-cash items of

$72,979, a decrease in inventory of $83,667, an increase in accounts payable, accrued expenses and income taxes payable of $28,904, and an increase in deferred revenue of $22,310. This was partially offset by an increase in accounts receivable of $89,420.

During the three months ended December 31, 2003, inventories decreased by $83,667 to a total of $691,516 at December 31, 2003 compared to $775,183 at September 30, 2003. At December 31, 2002, inventories were $803,629. The

decrease was primarily due to improved inventory management. Inventories were kept at these levels primarily to support anticipated future sales activities.

In the first quarter of fiscal 2004, accounts receivable net of allowances increased by $89,420 to a total of $466,335 at December 31, 2003 as compared to $376,915 at September 30, 2003. At December 31, 2002, our accounts receivable net of allowances was $508,761. The increase in accounts receivable in the first quarter of 2004 was primarily due to timing of sales and an increase in sales of our dental products during the quarter.

During the three months ended December 31, 2003, we purchased property, plant and equipment of $1,802. Net property and equipment increased to $150,842 at December 31, 2003 as compared to $135,106 at December 31, 2002.

At December 31, 2003, we had cash and cash equivalents of $2,426,729. We plan to finance our operating and capital needs principally with cash flows from operations and existing balances of cash and cash equivalents, which we believe will be sufficient to fund our operations in the near future. However, should it be necessary, we believe we could borrow adequate funds at competitive rates and terms. Our future liquidity and capital requirements will depend on numerous factors, including the success in commercializing our existing products, development and commercialization of products in other clinical markets, the ability of our suppliers to continue to meet our demands at current prices, the status of regulatory approvals and competition.

We have a line of credit of $1,000,000 with Wachovia Bank, N.A., which calls for interest to be charged at the bank's national commercial rate. The credit accommodation is unsecured and requires us to have a tangible net worth of no less than $3,000,000. Our tangible net worth at December 31, 2003 was $3,810,763. There was no outstanding balance on this line as of December 31, 2003.

Additional Cautionary Statements

We Face Intense Competition

The markets for our current and potential products are intensely competitive. Some surgical procedures which utilize or could utilize our products could potentially be replaced or reduced in importance by products sold by other companies or alternative medical procedures or new drugs which could render our products obsolete or uncompetitive in the markets which we sell, or in the future may sell, our products.

We are Dependent Upon Sales of Our Neurosurgery System - Substantially All of Our Business Comes From One Customer
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Codman & Shurtleff, Inc., which sells our products in the neurosurgery market, accounted for 85% of our sales in the first quarter of fiscal 2004, and 95% and 90% of our sales in fiscal 2003 and 2002, respectively. Any cancellation, deferral or significant reduction in sales in the neurosurgery market could seriously harm our business, financial condition and results of operations. The term or our current distribution agreement with Codman & Shurtleff, Inc. was recently extended from December 31, 2003 to March 31, 2004 to allow the parties time to continue to discuss the terms of a new distribution agreement. Increased sales in the neurosurgery market are dependent on the acceptance of our new neurosurgical generator and disposable hand-held

instruments in the marketplace.

Commercial Success of our Non-Neurosurgical Products is Uncertain

Our growth depends on the acceptance of our products in the marketplace, the market penetration achieved by the companies that we utilize, sell to, and rely on, to sell and distribute our products, and our ability to introduce new and innovative products that meet the needs of medical professionals. There can be no assurance that we will be able to continue to introduce new and innovative products or that the products we introduce, or have introduced, will be widely accepted, or continue to be accepted, in the marketplace, or that we or the companies, which we may contract with to distribute or sell our products, achieve market penetration. While we have developed several applications for our DualWave(TM) technology outside of neurosurgery and we believe that the products based on our technology offer advantages over other products, we cannot assure you that these advantages will be realized, or if realized, that these products will result in any meaningful benefits to physicians or patients.

We Have Limited Marketing and Sales Experience

We currently have limited experience in marketing and selling our products. To the extent that we have established or will enter into distribution arrangements for the sale of our products, we are and will be dependent upon the efforts of third parties. We have entered into a distribution agreement with Codman & Shurtleff, Inc. to sell our products in the neurosurgery market and we sell our Bident(R) Bipolar Tissue Management System through independent dental product dealers. We cannot assure you that these distributors and dealers will commit the necessary resources to effectively market and sell our neurosurgery and dental product lines, or that they will be successful in selling our products. To the extent our marketing and sales efforts are unsuccessful, our business, financial condition, results of operations and future growth prospects may be materially adversely affected.

Our Products are Extensively Regulated Which Could Delay Product Introduction or Halt Sales

The process of obtaining and maintaining required regulatory approvals is lengthy, expensive and uncertain. Although we have not experienced any substantial regulatory delays to date, there is no assurance that delays will not occur in the future, which could have a significant adverse effect on our

ability to introduce new products on a timely basis. Regulatory agencies periodically inspect our manufacturing facilities to ascertain compliance with "good manufacturing practices" and can subject approved products to additional testing and surveillance programs. Failure to comply with applicable regulatory requirements can, among other things, result in fines, suspensions of regulatory approvals, product recalls, operating restrictions and criminal penalties. While we believe that we are currently in compliance, if we fail to comply with regulatory requirements, it could have an adverse effect on our results of operations and financial condition.

We are Dependent on Key Suppliers

For some of the components we use in our products we rely upon single source suppliers or a single contract manufacturer. For example, we currently subcontract the manufacturer of our disposable cord and tubing sets with a single manufacturer. While we believe there are alternative sources available, we would be required to qualify and validate a new supplier(s) or contractor(s), which could lead to a disruption in our operations and ability to supply product for a period of time.

We Face Uncertainty Over Reimbursement

Failure by physicians, hospitals and other users of our products to obtain sufficient reimbursement from health care payors for procedures in which our products are used or adverse changes in governmental and private third-party payors' policies toward reimbursement for such procedures would have a material adverse effect on our business, financial condition, results of operations and future growth prospects.

We May Be Unable to Effectively Protect Our Intellectual Property

Our ability to compete effectively depends in part on developing and maintaining the proprietary aspects of our bipolar technology. We cannot assure you that the patents we have obtained, or any patents we may obtain, will provide any competitive advantages for our products, or that we will be able to maintain a competitive advantage after our patents expire. We also cannot assure you that those patents will not be successfully challenged, invalidated or circumvented in the future. In addition, we cannot assure you that competitors, many of which have substantial resources and have made substantial investments in competing technologies, have not already applied for or obtained, or will not seek to apply for and obtain, patents that will prevent, limit or interfere with our ability to make, use and sell our products either in the United States or in international markets. Patent applications are maintained in secrecy for a period after filing. We may not be aware of all of the patents and patent applications potentially adverse to our interests.

We May Become Subject to a Patent Litigation

The medical device industry has been characterized by extensive litigation regarding patents and other intellectual property rights, and companies in the medical device industry have employed intellectual property litigation to gain a competitive advantage. We cannot assure you that we will not become subject to patent infringement claims or litigation or interference proceedings declared by the United States Patent and Trademark Office to determine the priority of invention.

We May have Product Liability Claims

Our products involve a risk of product liability claims. Although we maintain product liability insurance at coverage levels, which we believe are adequate, there is no assurance that, if we were to incur substantial liability for product liability claims, insurance would provide adequate coverage against such liability.

Our Operating Results May Fluctuate

We have experienced operating losses at various times since our inception. Our results of operations may fluctuate significantly from quarter to quarter based on numerous factors including the following:

- the introduction of new product lines;
- the level of market acceptance of our products;
- achievement of research and development milestones;
- timing of the receipt of orders from, and product shipments to, distributors and customers;
- timing of expenditures;
- changes in the distribution of our products;
- manufacturing or supply delays;
- the time needed to educate and train a distributor's sales force;
- costs associated with product introduction;
- product returns; and
- receipt of necessary regulation approvals.

The Market Price of Our Stock May be Highly Volatile

During the fiscal year ended September 30, 2003 and the first quarter of fiscal 2004, our common stock has traded in a range of $1.05 and $2.40 per share. The market price of our common stock could continue to fluctuate substantially due to a variety of factors, including:

- Our ability to successfully commercialize our operations;
- The execution of new agreements and material changes in our relationships with companies with whom we contract;
- Quarterly fluctuations in results of operations;
- Announcements regarding technological innovations or new commercial products by us or our competitiors or the results of regulatory approval filings;
- Market reaction to trends in sales, marketing and research and development and reaction to acquisitions;
- Sales of common stock by existing stockholders; and
- Economic and political conditions.

Item 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures (as defined in Securities Exchange Act 1934 Rules 13a-15(c)) that are designed to ensure that the 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 Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures.

As of the end of the quarter ended December 31, 2003, we carried out an evaluation, under the supervision and with the participation of Valley Forge Scientific's management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our

disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report. There have been no significant changes in our internal controls or in other factors that have materially affected, or are reasonably likely to affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

The following is a list of the Exhibits filed as part of this quarterly report on Form 10Q.

Exhibit Number	Exhibit Name
31.1	Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of the Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) Current Reports on Form 8-K

On December 8, 2003, Valley Forge Scientific Corp. filed a report on Form 8-K regarding a press release concerning fourth quarter and year end operating results for fiscal 2003.

VALLEY FORGE SCIENTIFIC CORP.

SIGNATURES

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

VALLEY FORGE SCIENTIFIC CORP.

Date: February 11, 2004

By: /s/ JERRY L. MALIS

Jerry L. Malis, President and Chief Executive Officer (principal financial officer)

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EXHIBIT INDEX

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