

CRITICARE SYSTEMS INC /DE/  
Form 10-Q  
May 11, 2004

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

X 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 1-31943

**CRITICARE SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

Delaware                      39-1501563  
(State or other jurisdiction                      (IRS Employer Identification No.)  
of incorporation or organization)

20925 Crossroads Circle, Suite 100, Waukesha, Wisconsin 53186  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number including area code (262) 798-8282

N/A  
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 \_\_\_\_\_ No X

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Number of shares outstanding of each class of the registrant's classes of common stock as of March 31, 2004: Class A Common Stock 11,436,430 shares.

CRITICARE SYSTEMS, INC.  
CONSOLIDATED BALANCE SHEETS  
MARCH 31, 2004 AND JUNE 30, 2003

(UNAUDITED)

| ASSETS  | March 31,<br>2004    | June 30,<br>2003     |
|---|----------------------|----------------------|
| <b>CURRENT ASSETS:</b>  |                      |                      |
| Cash and cash equivalents   | \$ 3,985,309         | \$ 3,716,446         |
| Accounts receivable, less allowance for doubtful accounts<br>of \$350,000 and \$300,000, respectively | 6,842,557            | 5,627,198            |
| Other receivables   | 496,074              | 553,147              |
| Inventories   | 6,268,064            | 6,347,208            |
| Prepaid expenses  | 311,995              | 340,934              |
| <b>Total current assets</b>   | <b>17,903,999</b>    | <b>16,584,933</b>    |
| Property, plant and equipment net   | 2,358,864            | 2,093,408            |
| License rights and patents net  | 78,735               | 83,986               |
| <b>TOTAL ASSETS</b>   | <b>\$ 20,341,598</b> | <b>\$ 18,762,327</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                      |                      |
| <b>CURRENT LIABILITIES:</b>   |                      |                      |
| Accounts payable  | \$ 2,968,682         | \$ 2,272,953         |
| Accrued liabilities:  |                      |                      |
| Compensation and commissions  | 854,175              | 850,034              |
| Product warranties  | 444,000              | 312,000              |
| Other   | 246,283              | 254,470              |
| <b>Total current liabilities</b>  | <b>4,513,140</b>     | <b>3,689,457</b>     |
| <b>LONG-TERM LIABILITIES:</b>   |                      |                      |
| Obligations under capital lease   | 333,840              |                      |
| Other long-term obligations   | 25,263               | 38,662               |
| <b>Total long-term liabilities</b>  | <b>359,103</b>       | <b>38,662</b>        |
| <b>TOTAL LIABILITIES</b>  | <b>4,872,243</b>     | <b>3,728,119</b>     |

## STOCKHOLDERS' EQUITY:

|  |                             |                             |
|--|-----------------------------|-----------------------------|
| Preferred stock - \$.04 par value, 500,000 shares authorized,<br>no shares issued or outstanding   |                             |                             |
| Common stock - \$.04 par value, 15,000,000 shares authorized,<br>11,562,749 and 11,204,024 shares issued, and<br>11,436,430 and 11,073,832 outstanding, respectively | 462,510                     | 448,161                     |
| Additional paid-in capital   | 23,940,739                  | 23,360,244                  |
| Common stock held in treasury (126,319 and 130,192 shares, respectively)   | (412,403)                   | (419,618)                   |
| Subscriptions receivable   |                             | (225,000)                   |
| Retained earnings (accumulated deficit)  | (8,518,009)                 | (8,126,097)                 |
| Cumulative translation adjustment  | (3,482)                     | (3,482)                     |
|  | <u>                    </u> | <u>                    </u> |
| Total stockholders' equity   | 15,469,355                  | 15,034,208                  |
|  | <u>                    </u> | <u>                    </u> |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY   | \$ 20,341,598               | \$ 18,762,327               |
|  | <u>                    </u> | <u>                    </u> |

See notes to consolidated financial statements.

2

CRITICARE SYSTEMS, INC.  
CONSOLIDATED INCOME STATEMENTS  
NINE MONTHS ENDED MARCH 31, 2004 AND 2003

(UNAUDITED)

|                                       | 2004              | 2003              |
|---------------------------------------|-------------------|-------------------|
| NET SALES                             | \$ 21,923,864     | \$ 21,857,740     |
| COST OF GOODS SOLD                    | <u>12,855,828</u> | <u>13,041,237</u> |
| GROSS PROFIT                          | 9,068,036         | 8,816,503         |
| OPERATING EXPENSES:                   |                   |                   |
| Sales and marketing                   | 5,316,293         | 4,875,229         |
| Research, development and engineering | 1,810,732         | 2,078,572         |
| Administrative                        | <u>2,484,791</u>  | <u>2,977,022</u>  |
| Total                                 | 9,611,816         | 9,930,823         |
| LOSS FROM OPERATIONS                  | (543,780)         | (1,114,320)       |
| OTHER INCOME (EXPENSE):               |                   |                   |
| Interest expense                      |                   | (91,533)          |
| Interest income                       | 29,496            | 40,544            |
| Other                                 | 122,371           | 1,513,513         |

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|   |              |            |
|---|--------------|------------|
| Total   | 151,867      | 1,462,524  |
| (LOSS) INCOME BEFORE INCOME TAXES                     | (391,913)    | 348,204    |
| INCOME TAX PROVISION                                  |              |            |
| NET (LOSS) INCOME                                     | \$ (391,913) | \$ 348,204 |
| NET (LOSS) INCOME PER COMMON SHARE:                   |              |            |
| Basic   | \$ (0.04)    | \$ 0.03    |
| Diluted   | \$ (0.04)    | \$ 0.03    |
| WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING: |              |            |
| Basic   | 11,173,768   | 11,071,267 |
| Diluted   | 11,173,768   | 11,423,100 |

See notes to consolidated financial statements.

3

CRITICARE SYSTEMS, INC.  
CONSOLIDATED INCOME STATEMENTS  
THREE MONTHS ENDED MARCH 31, 2004 AND 2003

(UNAUDITED)

|                                       | 2004         | 2003         |
|---------------------------------------|--------------|--------------|
| NET SALES                             | \$ 6,571,171 | \$ 6,503,787 |
| COST OF GOODS SOLD                    | 3,762,149    | 4,022,771    |
| GROSS PROFIT                          | 2,809,022    | 2,481,016    |
| OPERATING EXPENSES:                   |              |              |
| Sales and marketing                   | 1,944,077    | 1,533,931    |
| Research, development and engineering | 586,419      | 692,917      |
| Administrative                        | 759,740      | 888,261      |
| Total                                 | 3,290,236    | 3,115,109    |
| LOSS FROM OPERATIONS                  | (481,214)    | (634,093)    |
| OTHER INCOME (EXPENSE):               |              |              |
| Interest expense                      |              |              |

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|  |                     |                   |
|--|---------------------|-------------------|
| Interest income  | 8,748               | 12,016            |
| Other  | 59,859              | 1,081,761         |
| <b>Total</b>   | <b>68,607</b>       | <b>1,093,777</b>  |
| <b>(LOSS) INCOME BEFORE INCOME TAXES</b>                     | <b>(412,607)</b>    | <b>459,684</b>    |
| <b>INCOME TAX PROVISION</b>                                  |                     |                   |
| <b>NET (LOSS) INCOME</b>                                     | <b>\$ (412,607)</b> | <b>\$ 459,684</b> |
| <b>NET (LOSS) INCOME PER COMMON SHARE:</b>                   |                     |                   |
| Basic  | \$ (0.04)           | \$ 0.04           |
| Diluted  | \$ (0.04)           | \$ 0.04           |
| <b>WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING:</b> |                     |                   |
| Basic  | 11,326,283          | 11,071,273        |
| Diluted  | 11,326,283          | 11,370,087        |

See notes to consolidated financial statements.

4

CRITICARE SYSTEMS, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
NINE MONTHS ENDED MARCH 31, 2004 AND 2003

(UNAUDITED)

|  | 2004         | 2003        |
|--|--------------|-------------|
| <b>OPERATING ACTIVITIES:</b>   |              |             |
| Net (loss) income  | \$ (391,913) | \$ 348,204  |
| Adjustments to reconcile net (loss) income to net cash provided by operating activities: |              |             |
| Depreciation   | 442,910      | 713,839     |
| Amortization   | 5,251        | 5,251       |
| Provision for doubtful accounts  | 80,602       |             |
| Provision for obsolete inventory   | 429,073      | 184,225     |
| Gain on sale of Immtech stock  |              | (1,290,252) |
| Gain on sale of building   |              | (41,208)    |
| Changes in assets and liabilities:   |              |             |
| Accounts receivable  | (1,295,961)  | 57,132      |
| Other receivables  | 57,073       | 211,149     |
| Inventories  | (400,094)    | (473,197)   |
| Prepaid expenses   | 28,939       | 120,979     |
| Accounts payable   | 695,729      | 822,633     |
| Accrued liabilities  | 114,555      | (127,827)   |

|   |              |              |
|---|--------------|--------------|
| Net cash (used in) provided by operating activities | (233,836)    | 530,928      |
| <b>INVESTING ACTIVITIES:</b>                        |              |              |
| Purchases of property, plant and equipment, net     | (324,360)    | (674,757)    |
| Proceeds from sale of Immtech stock                 |              | 1,290,252    |
| Proceeds from sale of building                      |              | 3,795,164    |
| Net cash (used in) provided by investing activities | (324,360)    | 4,410,659    |
| <b>FINANCING ACTIVITIES:</b>                        |              |              |
| Retirement of long-term debt                        |              | (3,197,125)  |
| Repurchase of Company common stock                  |              | (121,359)    |
| Proceeds from issuance of common stock              | 827,059      | 17,368       |
| Net cash provided by (used in) financing activities | 827,059      | (3,301,116)  |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH             |              | 268          |
| NET INCREASE IN CASH AND CASH EQUIVALENTS           | 268,863      | 1,640,739    |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD      | 3,716,446    | 3,523,070    |
| CASH AND CASH EQUIVALENTS, END OF PERIOD            | \$ 3,985,309 | \$ 5,163,809 |

See notes to consolidated financial statements.

CRITICARE SYSTEMS, INC.  
Condensed Notes to Consolidated Financial Statements  
(Unaudited)

### 1. Basis of Presentation

The accompanying unaudited financial statements have been prepared by Criticare Systems, Inc. (the "Company") pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") and, in the opinion of the Company, include all adjustments necessary for a fair statement of results for each period shown. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such SEC rules and regulations. The Company believes that the disclosures made are adequate to prevent the financial information given from being misleading. It is suggested that these financial statements be read in conjunction with the financial statements and notes thereto included in the Company's latest annual report and previously filed Form 10-K. Certain amounts from the fiscal 2003 financial statements have been reclassified to conform to the 2004 presentation.

### 2. Inventory Valuation

Inventory is stated at the lower of cost or market, with cost determined on the first-in, first-out method. Components of inventory consisted of the following at March 31, 2004 and June 30, 2003, respectively:

|                                | March 31, 2004 | June 30, 2003 |
|--------------------------------|----------------|---------------|
| Component parts                | \$ 2,198,612   | \$ 2,762,803  |
| Work in process                | 693,622        | 811,906       |
| Finished units                 | 4,247,694      | 4,172,499     |
| Total inventories              | 7,139,928      | 7,747,208     |
| Less: reserve for obsolescence | 871,864        | 1,400,000     |
| Net inventory                  | \$ 6,268,064   | \$ 6,347,208  |

### 3. Investments

During fiscal 2003, the Company completely liquidated its position in its Immtech International, Inc. ( Immtech ) common stock. In the first three quarters of fiscal 2003 ended March 31, 2003 the Company sold all 456,374 shares of its Immtech stock and realized the following gains:

|  | Shares Sold | Realized Gain |
|--|-------------|---------------|
| 1 <sup>st</sup> quarter ended September 30, 2002 | 50,000      | \$ 241,746    |
| 2 <sup>nd</sup> quarter ended December 31, 2002  | 4,000       | 14,097        |
| 3rd quarter ended March 31, 2003                 | 402,374     | 1,034,410     |
| Total  | 456,374     | \$ 1,290,252  |

6

### 4. Property, Plant and Equipment

Property, plant and equipment consist of the following:

|                                      | March 31, 2004 | June 30, 2003 |
|--------------------------------------|----------------|---------------|
| Machinery and equipment              | \$ 2,678,300   | \$ 2,264,697  |
| Furniture and fixtures               | 932,381        | 919,077       |
| Leasehold improvements               | 218,423        | 212,229       |
| Demonstration and loaner monitors    | 1,133,979      | 1,346,459     |
| Production tooling                   | 1,944,233      | 3,617,345     |
| Property, plant and equipment - cost | 6,907,316      | 8,359,807     |

|                                     |              |              |
|-------------------------------------|--------------|--------------|
| Less: accumulated depreciation      | 4,548,452    | 6,266,399    |
| Property, plant and equipment - net | \$ 2,358,864 | \$ 2,093,408 |

## 5. Contingencies

The import and export rules applicable to all United States companies engaged in international business transactions contain compliance guidelines. Violations may result in civil or criminal penalties, or both, as well as the potential loss of export privileges.

On August 6, 2002, in part due to the new regulations imposed under the Sarbanes-Oxley Act, the Company initiated an internal review of its import and export procedures. On August 28, 2002, senior management of the Company became aware of previous events that may have violated United States import/export laws and regulations. Senior management of the Company immediately authorized an internal audit of these possible violations, focusing on the sale of medical equipment directly or indirectly into an embargoed country and possible marking issues.

The factual investigation pursuant to the internal audit is complete, no additional compliance issues arose, and no material marking issues were identified as a result of the investigation.

Subsequently, the Company has taken action to adopt and implement a written compliance program with respect to applicable import/export rules. The Company has also undertaken a voluntary disclosure with the relevant government agencies and has filed its completed internal audit report and all requested documents. Although there is no assurance, based upon the results of the completed internal audit and precedents, the Company believes a negotiated settlement of any violations will not have a material adverse effect on the Company. In addition, the Company does not believe that the audit result supports the denial of export privileges; however, any such penalty would have a material adverse effect on the Company's business. The Company further believes that the voluntary disclosure, along with other internal actions taken, will serve to mitigate any potential adverse consequences that otherwise might accrue.

## 6. Guarantees

Criticare Integration, Inc., a wholly owned U.S. subsidiary of the Company, was incorporated on April 8, 2003 to supply medical equipment and supplies to medical

7

facilities in countries in the Black Sea Economic Zone (Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Romania, and the Ukraine). The Company had set up a standby letter of credit for \$300,000 on behalf of a Romanian company it is working with in connection with this new venture. The standby letter of credit served as a guarantee for a \$2,000,000 line of credit that had been extended by a large Austrian bank to the Romanian company to fund this project. The standby letter of credit was to expire on November 15, 2003. The line of credit was no longer deemed necessary to fund the project and was therefore cancelled prior to expiration. The related standby letter of credit from the Company guaranteeing the line of credit was also cancelled on October 20, 2003.

The Company also maintained a second standby letter of credit (SBLC) for \$300,000 on behalf of the Romanian company that served as a guarantee to fund borrowings by the Romanian company used to set up and market this project. This SBLC was to expire on November 1, 2003, but was renewed through November 1, 2004 on October 16, 2003. Due mainly to more favorable credit terms obtained from another bank, on December 24, 2003 this \$300,000 SBLC was cancelled and replaced by a \$400,000 SBLC from another bank that expires on December 31, 2004. This



standby letter of credit would only be called if the cash flows from the project were not adequate to fund the costs to support the project and the Romanian company would not be able to retire the debt.

In the fiscal second quarter ended December 31, 2003, the Company also set up two new standby letters of credit to two suppliers of medical equipment for the project totaling \$100,000. These two SBLC's were set up to secure payment for the suppliers and would only be called if the cash flows from the project were not adequate to fund equipment purchases from these suppliers. The value of these three guarantees were not material to the Company's financial statements.

## 7. Stock Options

The Company has adopted the disclosure-only provisions of SFAS No. 123, Accounting for Stock-Based Compensation and SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. If the Company had elected to recognize compensation cost for the options granted for the three months and nine months ended March 31, 2004 and 2003, consistent with the method prescribed by SFAS No. 123, net (loss) income and net (loss) income per share would have been changed to the pro forma amounts indicated below:

|   | Three Months Ended |            | Nine Months Ended |            |
|---|--------------------|------------|-------------------|------------|
|   | 2004               | 2003       | 2004              | 2003       |
| Net (loss) income as reported                             | \$ (412,607)       | \$ 459,684 | \$ (391,913)      | \$ 348,204 |
| Net (loss) income pro forma                               | \$ (419,855)       | \$ 413,009 | \$ (405,805)      | \$ 208,178 |
| Basic and diluted net (loss) income per share as reported | \$ (0.04)          | \$ 0.04    | \$ (0.04)         | \$ 0.03    |
| Basic and diluted net (loss) income per share pro forma   | \$ (0.04)          | \$ 0.04    | \$ (0.04)         | \$ 0.02    |

The fair value of stock options used to compute pro forma net (loss) income and net (loss) income per share is the estimated present value at the grant date using the Black-Scholes option-pricing model.

## 8. Income Taxes

No income tax provision has been made in the consolidated income statements due to federal and state net operating loss carry forwards that will be utilized to offset taxable income earned. At March 31, 2004, the Company had federal net operating loss carry forwards of approximately \$13,361,000 (which expire from 2008 through 2023) and state net operating loss carry forwards of approximately \$10,037,000 (which expire from 2004 through 2018) available to offset future taxable income. The Company has recorded a valuation allowance to offset the related deferred income tax assets arising from these net loss carry forwards due to the uncertainty of realizing the benefits of these assets in future years.

## 9. Commitments

On January 19, 2004 the Company entered into a lease agreement for the hardware and software for a new business system. This lease has been accounted for as a capital lease in accordance with SFAS No. 13, Accounting for Leases. The following is an analysis of this capital lease:

|                               | March 31, 2004 | June 30, 2003 |
|-------------------------------|----------------|---------------|
| Machinery and equipment       | \$ 333,840     | \$ ---        |
| Less accumulated depreciation | (9,538)        | ---           |
| Net                           | \$ 324,302     | \$ ---        |

The future minimum lease payments under this capital lease, together with the present value of the net minimum lease payments were as follows:

| Fiscal year ending June 30                  | Capital Lease |
|---|---------------|
| 2004  | \$ 20,640     |
| 2005  | 82,560        |
| 2006  | 82,560        |
| 2007  | 82,560        |
| 2008 and thereafter                         | 145,200       |
| Total minimum lease payments                | \$413,520     |
| Less amount representing interest           | (79,680)      |
| Present value of net minimum lease payments | \$333,840     |
| Less current portion at March 31, 2004      | 54,186        |
| Long-term portion at March 31, 2004         | \$279,654     |

CRITICARE SYSTEMS, INC.  
 Management's Discussion and Analysis of  
 Results of Operations and Financial Condition  
 Nine Months Ended March 31, 2004 and 2003

**Results of Operations**

Net sales of \$21,923,864 for the nine months ended March 31, 2004 were up slightly from the \$21,857,740 generated for the same period in the prior year. A 13.3% increase in the number of units shipped was partially offset by a 9.7%

reduction in the average sales price per unit and an 11.4% decrease in accessory sales in the current period. The higher unit sales and lower average sales price per unit were driven by a large shipment of the Company's 504DX pulse oximeters to supply a large government tender in Mexico. These units monitor pulse oximetry only and therefore carry a much lower average selling price than the Company's equipment that monitors multiple vital signs parameters.

The gross profit percentage of 41.4% for the nine months ended March 31, 2004 improved from 40.3% for the same period in the prior year. The higher margins, combined with a \$319,007 reduction in operating expenses, resulted in a loss from operations of \$543,780 that was \$570,540 better than the \$1,114,320 loss from operations for the same period in the prior year.

The reduction in operating expenses was driven by a \$492,231 decrease in administrative expenses and a \$267,840 decrease in research, development and engineering expenses that was partially offset by a \$441,064 increase in sales and marketing expenses. A \$305,515 reduction in legal and consulting fees primarily related to the internal review conducted in the prior year by the Company of its import and export procedures was the main contributor to the lower administrative expenses. In addition, a final payment in the prior year of \$150,000 made to the Company's former CEO and founder to satisfy past severance obligation issues increased expenses in the prior year period compared to the current year period. The lower research, development and engineering expenses were mainly due to funding received from an OEM business partner to jointly develop a new line of MRI compatible medical monitors. The higher sales and marketing expenses were mainly driven by increased spending to promote the Company's new line of anesthesia monitoring products, to enter the veterinary market, and to conduct clinical trials to test enhancements made to one of the Company's vital signs parameters.

Total other income of \$151,867 for the nine months ended March 31, 2004 decreased \$1,310,657 from the same period in the prior year. Total other income in the prior year period included the recognition of a \$1,290,252 gain on the sale of the Company's Immtech International, Inc. stock, \$93,000 in profits recognized on the completion of a medical equipment integration project in Romania, and a \$41,208 gain on the sale of the Company's building. These gains were partially offset by the elimination of \$91,533 in interest expense in the current period due to the retirement of the long-term debt on the Company's facility from the August 30, 2002 sale of its building.

The improved margins and the \$319,077 reduction in operating expenses partially offset the \$1,310,657 decrease in other income for the nine months ended March 31, 2004, resulting in a net loss of \$391,913 that was down from the \$348,204 of net income for the same period in the prior year.

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CRITICARE SYSTEMS, INC.  
Management's Discussion and Analysis of  
Results of Operations and Financial Condition  
Three Months Ended March 31, 2004 and 2003

**Results of Operations**

Net sales of \$6,571,171 for the three months ended March 31, 2004 were up slightly from \$6,503,787 for the same period in fiscal 2003. A 6.7% increase in the number of units shipped more than offset a 4.1% reduction in the average sales price per unit in the current period. A \$677,808 increase in domestic sales during the quarter more than offset lower sales in the Company's international and OEM markets.

The gross profit percentage of 42.7% for the three months ended March 31, 2004 increased from 38.1% produced in the same period in the prior year. A combination of lower per unit costs on two of the Company's core multiple

parameter vital signs monitors and improved margins on accessory sales drove the higher margins in the current quarter.

A \$175,127 increase in operating expenses partially offset the higher margins, resulting in a loss from operations for the three months ended March 31, 2004 of \$481,214 that was \$152,879 better than the same period in the prior year. A \$410,146 increase in sales and marketing expenses more than offset a \$128,521 reduction in administrative expenses and a \$106,498 decrease in research, development and engineering expenses. The higher sales and marketing expenses were mainly driven by increased spending to promote the Company's new line of anesthesia monitoring products, to enter the veterinary market, and to conduct clinical trials to test enhancements made to one of the Company's vital signs parameters. Domestic employee and dealer commissions also increased 17.5% to support higher sales that improved 26.4% during the period. A \$72,262 reduction in legal fees primarily related to the internal review conducted in the prior year by the Company of its import and export procedures, along with a \$35,983 decrease in wages and related fringe benefits, were the major contributors to the lower administrative expenses. The lower research, development and engineering expenses were mainly due to funding received from an OEM business partner in the current period to jointly develop a new line of MRI compatible medical monitors.

Total other income for the three months ended March 31, 2004 decreased \$1,025,170 from the same period in the prior year, due mainly to the recognition of a \$1,034,410 gain on the sale of 402,374 shares of the Company's Immtech International, Inc. stock in the prior year period. This large gain in the prior year period resulted in net income of \$459,684 for the three months ended March 31, 2003 compared to a \$412,607 net loss in the current year period.

11

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CRITICARE SYSTEMS, INC.  
Management's Discussion and Analysis of  
Results of Operations and Financial Condition

**Liquidity and Capital Resources**

As of March 31, 2004, the Company had a cash balance of \$3,985,309 that was \$268,863 higher than its fiscal 2003 year-end balance at June 30, 2003 of \$3,716,446. The Company continues to maintain a long-term bank debt free balance sheet since August 30, 2002 when it sold its building and used the proceeds from the sale to retire the long-term bank debt on the facility.

The Company increased its cash position by \$268,863 for the nine months ended March 31, 2004 as \$827,059 of cash provided from the exercise of 458,725 shares under expiring stock options more than offset \$324,360 of capital spending and \$233,836 of cash used in operations.

On January 19, 2004 the Company entered into a lease agreement for the hardware and software for a new business system. The lease term is 54 months and requires monthly payments of \$6,880 with an option to purchase the system at the end of the lease at its then estimated fair market value of \$42,000. This fair market value can be paid in a lump sum at the termination date of the lease or paid in twelve equal monthly installments beginning in the month immediately following the last month of the initial lease term. If the Company elects not to purchase the system at the end of the lease, the terms of the lease will be extended for an additional six months at the same monthly rental payment called for during the initial lease term. This lease has been accounted for as a capital lease in accordance with SFAS No. 13, *Accounting for Leases*. Therefore, the Company has recorded in its consolidated balance sheet at March 31, 2004 an asset and an obligation at an amount equal to the present value at the beginning of the lease term of the minimum lease payments to be made during the lease term.

The Company believes all capital and liquidity requirements for the remainder of calendar year 2004 will be satisfied by cash generated from operations and its current cash balances. No major capital equipment expenditures are expected for the remainder of calendar year 2004. The Company also has a \$2,500,000 line of credit currently in place that expires in November 2004. The Company does not expect to utilize this credit facility during its term, but it is available if necessary. At March 31, 2004, there were no borrowings outstanding under this line of credit. The Company was not in compliance with a quarterly profitability covenant of this credit facility at March 31, 2004. This non-compliance was waived by the lending institution.

### **Forward Looking Statements**

A number of the matters and subject areas discussed herein that are not historical or current facts deal with potential future circumstances and developments. These include anticipated product introductions, expected future financial results, liquidity needs, financing ability, management's or the Company's expectations and beliefs and similar matters discussed in Management's Discussion and Analysis or elsewhere herein. The discussions of such matters and subject areas are qualified by the inherent risk and

12

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uncertainties surrounding future expectations generally, and also may materially differ from the Company's actual future experience.

The Company's business, operations and financial performance are subject to certain risks and uncertainties which could result in material differences in actual results from management's or the Company's current expectations. These risks and uncertainties include, but are not limited to, general economic conditions, demand for the Company's products, costs of operations, the development of new products, the reliance on single sources of supply for certain components in the Company's products, government regulation, health care cost containment programs, the effectiveness of the Company's programs to manage working capital and reduce costs, competition in the Company's markets, compliance with product safety regulations and product liability and product recall risks, risks relating to international sales and compliance with U.S. export regulations, unanticipated difficulties in outsourcing the manufacturing of the majority of its products to foreign manufacturers and risks related to foreign manufacturing, including economic and political instability, trade and foreign tax laws, production delays and cost overruns and quality control.

### **Quantitative and Qualitative Disclosures about Market Risk**

The Company has a demand line of credit facility with a commercial bank with interest payable monthly at 25 basis points above the bank's reference rate. The Company had no borrowings outstanding under this bank facility at March 31, 2004 and June 30, 2003. Due historically to the lack of need to borrow from this credit facility and due to the Company's current cash position, the Company is not subject to financial risk on this obligation if interest rates in the market change significantly.

The Company's net sales are primarily denominated in United States dollars, except for a small amount of net sales from the Company's operation in India denominated in Indian rupees. As a result, part of the Company's accounts receivable are denominated in rupees and translated into U.S. dollars for financial reporting purposes. A 10% change in the exchange rate of the U.S. dollar with respect to the Indian rupee would not have a material adverse effect on the Company's financial condition or results of operations. The Company does not use any hedges or other derivative financial instruments to manage or reduce exchange rate risk.

### **Controls and Procedures**

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Company's Vice President - Finance, of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended). Based on this evaluation, the Company's Chief Executive Officer and Vice President - Finance concluded that the Company's disclosure controls and procedures were effective in timely alerting them to material information relating to the Company required to be included in the Company's periodic filings with the Securities and Exchange Commission. It should be noted that in designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how

13

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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. The Company has designed its disclosure controls and procedures to reach a level of reasonable assurance of achieving the desired control objectives and based upon the evaluation described above, the Company's Chief Executive Officer and Vice President - Finance concluded that the Company's disclosure controls and procedures were effective at reaching that level of reasonable assurance.

There was no change in the Company's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended) during the Company's most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

14

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## PART II - OTHER INFORMATION

### Item 6. Exhibits and Reports on Form 8-K.

#### (a) Exhibits:

3.1 Restated Certificate of Incorporation of the Company (incorporated by reference to the Registration Statement filed on Form S-1, Registration No. 33-13050).

3.2 By-Laws of the Company (incorporated by reference to the Registration Statement filed on Form S-1, Registration No. 33-13050).

4.1 Specimen Common Stock certificate (incorporated by reference to the Registration Statement filed on Form S-1, Registration No. 33-13050).

4.2 Rights Agreement (incorporated by reference to the Company's Current Report on Form 8-K filed on April 18, 1997).

31.1 Certification of Emil H. Soika, President and Chief Executive Officer (Principal Executive Officer) pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Michael J. Sallmann, Vice President - Finance and Secretary (Principal Financial Officer) pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32\* Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350.

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\* This Certification is not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended.

(b) Reports on Form 8-K: None in the quarter ended March 31, 2004.

15

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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.

CRITICARE SYSTEMS, INC.  
(Registrant)

Date: May 11, 2004      BY /s/ Michael J. Sallmann  
Michael J. Sallmann  
Vice President - Finance  
(Chief Accounting Officer and  
Duly Authorized Officer)

16

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