

CRITICARE SYSTEMS INC /DE/  
Form 10-Q  
February 05, 2007

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 December 31, 2006

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  
(State or other jurisdiction of incorporation or organization)

39-1501563  
(IRS Employer Identification No.)

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

53186  
(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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer \_\_\_\_\_ Accelerated filer \_\_\_\_\_ Non-accelerated filer X

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

Number of shares outstanding of each class of the registrant's classes of common stock as of December 31, 2006:  
Voting Common Stock, 12,298,073 shares.

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CRITICARE SYSTEMS, INC.  
CONSOLIDATED BALANCE SHEETS  
DECEMBER 31, 2006 AND JUNE 30, 2006

(UNAUDITED)

| ASSETS   | December 31,<br>2006 | June 30,<br>2006     |
|--|----------------------|----------------------|
| <b>CURRENT ASSETS:</b>   |                      |                      |
| Cash and cash equivalents  | \$ 3,947,297         | \$ 3,793,781         |
| Accounts receivable, less allowance for doubtful accounts<br>of \$698,372 and \$829,700, respectively  | 6,161,894            | 6,187,351            |
| Other receivables  | 420,843              | 591,008              |
| Short-term note receivable   | 50,000               | 50,000               |
| Inventories  | 8,077,732            | 9,464,037            |
| Prepaid expenses   | 119,288              | 227,606              |
| <b>Total current assets</b>  | <b>18,777,054</b>    | <b>20,313,783</b>    |
| Property, plant and equipment - net  | 2,401,237            | 2,452,314            |
| License rights and patents - net   | 59,480               | 62,981               |
| Long-term note receivable  | 100,000              | 150,000              |
| <b>Total other assets</b>  | <b>159,480</b>       | <b>212,981</b>       |
| <b>TOTAL ASSETS</b>  | <b>\$ 21,337,771</b> | <b>\$ 22,979,078</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                      |                      |
| <b>CURRENT LIABILITIES:</b>  |                      |                      |
| Accounts payable   | \$ 3,148,887         | \$ 5,408,746         |
| <b>Accrued liabilities:</b>  |                      |                      |
| Compensation and commissions   | 937,699              | 914,889              |
| Product warranties   | 388,000              | 425,000              |
| Obligations under capital lease  | 71,114               | 68,205               |
| Other  | 112,774              | 174,667              |
| <b>Total current liabilities</b>   | <b>4,658,474</b>     | <b>6,991,507</b>     |
| <b>LONG-TERM LIABILITIES:</b>  |                      |                      |
| Obligations under capital lease  | 97,526               | 133,826              |
| Other long-term obligations  | —                    | 659                  |
| <b>Total long-term liabilities</b>   | <b>97,526</b>        | <b>134,485</b>       |
| <b>TOTAL LIABILITIES</b>   | <b>4,756,000</b>     | <b>7,125,992</b>     |
| <b>STOCKHOLDERS' EQUITY:</b>   |                      |                      |
| 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, 12,399,631<br>and<br>12,398,131 shares issued, and 12,298,073 and 12,291,454 shares<br>outstanding, respectively | 495,985              | 495,925              |

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|  |                      |                      |
|--|----------------------|----------------------|
| Additional paid-in capital   | 26,223,139           | 26,156,864           |
| Common stock held in treasury at cost (101,558 and 106,677 shares, respectively) | (366,278)            | (375,813)            |
| Retained earnings (accumulated deficit)  | (9,753,186)          | (10,436,794)         |
| Other comprehensive income (loss)  | (17,889)             | 12,904               |
| Total stockholders' equity   | 16,581,771           | 15,853,086           |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                | <b>\$ 21,337,771</b> | <b>\$ 22,979,078</b> |

See notes to consolidated financial statements.

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CRITICARE SYSTEMS, INC.  
CONSOLIDATED STATEMENTS OF INCOME  
SIX MONTHS ENDED DECEMBER 31, 2006 AND 2005

(UNAUDITED)

|  | 2006          | 2005          |
|--|---------------|---------------|
| NET SALES  | \$ 16,669,334 | \$ 16,443,126 |
| COST OF GOODS SOLD                                       | 10,132,140    | 9,931,378     |
| GROSS PROFIT   | 6,537,194     | 6,511,748     |
| OPERATING EXPENSES:                                      |               |               |
| Sales and marketing                                      | 2,813,618     | 3,292,693     |
| Research, development and engineering                    | 1,199,694     | 1,299,666     |
| Administrative   | 1,882,345     | 1,613,900     |
| Total  | 5,895,657     | 6,206,259     |
| INCOME FROM OPERATIONS                                   | 641,537       | 305,489       |
| OTHER INCOME (EXPENSE):                                  |               |               |
| Interest expense   | (7,889)       | (10,565)      |
| Interest income  | 62,661        | 41,974        |
| Other (expense) income                                   | (12,700)      | 407,417       |
| Total  | 42,072        | 438,826       |
| INCOME BEFORE INCOME TAXES                               | 683,609       | 744,315       |
| INCOME TAX PROVISION                                     | —             | —             |
| NET INCOME   | \$ 683,609    | \$ 744,315    |
| NET INCOME PER COMMON SHARE:                             |               |               |
| Basic  | \$ 0.06       | \$ 0.06       |
| Diluted  | \$ 0.06       | \$ 0.06       |
| WEIGHTED AVERAGE NUMBER OF COMMON<br>SHARES OUTSTANDING: |               |               |
| Basic  | 12,295,483    | 11,935,933    |
| Diluted  | 12,362,820    | 12,241,949    |

See notes to consolidated financial statements.

CRITICARE SYSTEMS, INC.  
CONSOLIDATED STATEMENTS OF INCOME  
THREE MONTHS ENDED DECEMBER 31, 2006 AND 2005

(UNAUDITED)

|   | 2006         | 2005         |
|---|--------------|--------------|
| NET SALES   | \$ 8,462,740 | \$ 8,770,813 |
| COST OF GOODS SOLD                                    | 5,046,620    | 5,194,365    |
| GROSS PROFIT  | 3,416,120    | 3,576,448    |
| OPERATING EXPENSES:                                   |              |              |
| Sales and marketing                                   | 1,517,496    | 1,805,862    |
| Research, development and engineering                 | 557,411      | 673,015      |
| Administrative  | 1,026,117    | 849,153      |
| Total   | 3,101,024    | 3,328,030    |
| INCOME FROM OPERATIONS                                | 315,096      | 248,418      |
| OTHER INCOME (EXPENSE):                               |              |              |
| Interest expense                                      | (3,770)      | (5,122)      |
| Interest income                                       | 28,936       | 21,718       |
| Other income  | 10,471       | 341,923      |
| Total   | 35,637       | 358,519      |
| INCOME BEFORE INCOME TAXES                            | 350,733      | 606,937      |
| INCOME TAX PROVISION                                  | —            | —            |
| NET INCOME  | \$ 350,733   | \$ 606,937   |
| NET INCOME PER COMMON SHARE:                          |              |              |
| Basic   | \$ 0.03      | \$ 0.05      |
| Diluted   | \$ 0.03      | \$ 0.05      |
| WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING: |              |              |
| Basic   | 12,297,193   | 12,027,943   |
| Diluted   | 12,357,641   | 12,334,894   |

See notes to consolidated financial statements.

CRITICARE SYSTEMS, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
SIX MONTHS ENDED DECEMBER 31, 2006 AND 2005

(UNAUDITED)

|   | 2006                | 2005                |
|---|---------------------|---------------------|
| <b>OPERATING ACTIVITIES:</b>  |                     |                     |
| Net income  | \$ 683,609          | \$ 744,315          |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                     |                     |
| Depreciation  | 253,126             | 288,902             |
| Amortization  | 3,501               | 3,500               |
| Share based compensation  | 56,545              | 81,140              |
| Provision for doubtful accounts   | 1,674               | —                   |
| Provision for obsolete inventory  | 102,000             | (132,300)           |
| Changes in assets and liabilities:  |                     |                     |
| Accounts receivable   | (9,323)             | (587,076)           |
| Note receivable   | 50,000              | —                   |
| Other receivables   | 170,165             | 25,047              |
| Inventories   | 1,198,237           | (1,651,915)         |
| Prepaid expenses  | 108,318             | 72,421              |
| Accounts payable  | (2,259,859)         | 1,020,836           |
| Accrued liabilities   | (76,742)            | 5,952               |
| Net cash provided by (used in) operating activities   | 281,251             | (129,178)           |
| <b>INVESTING ACTIVITIES:</b>  |                     |                     |
| Purchases of property, plant and equipment, net   | (115,982)           | (383,358)           |
| Net cash used in investing activities   | (115,982)           | (383,358)           |
| <b>FINANCING ACTIVITIES:</b>  |                     |                     |
| Retirement of obligations under capital lease   | (33,391)            | (30,715)            |
| Proceeds from issuance of common stock  | 19,325              | 542,940             |
| Net cash (used in) provided by financing activities   | (14,066)            | 512,225             |
| <b>EFFECT OF EXCHANGE RATE CHANGES ON CASH</b>  | <b>2,313</b>        | <b>(3,691)</b>      |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                                 | <b>153,516</b>      | <b>(4,002)</b>      |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>                                       | <b>3,793,781</b>    | <b>3,680,965</b>    |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>   | <b>\$ 3,947,297</b> | <b>\$ 3,676,963</b> |
| <b>SUPPLEMENTAL CASH FLOW INFORMATION:</b>  |                     |                     |
| Cash paid for:  |                     |                     |
| Income taxes paid-net   | \$ 9,325            | —                   |
| Interest  | \$ 7,889            | \$ 10,565           |

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. The three and six month results represent past performance, and are not necessarily indicative of results for an entire year. Certain amounts from the fiscal 2006 financial statements have been reclassified to conform to the 2007 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 December 31, 2006 and June 30, 2006, respectively:

|                                | December 31,<br>2006 | June 30,<br>2006 |
|--------------------------------|----------------------|------------------|
| Component parts                | \$ 2,826,505         | \$ 2,605,751     |
| Work in process                | 1,591,424            | 1,470,893        |
| Finished units                 | 4,121,803            | 5,747,393        |
| Total inventories              | 8,539,732            | 9,824,037        |
| Less: reserve for obsolescence | 462,000              | 360,000          |
| Net inventory                  | \$ 8,077,732         | \$ 9,464,037     |

### 3. Property, Plant and Equipment

Property, plant and equipment consist of the following:

|                                      | December 31,<br>2006 | June 30,<br>2006 |
|--------------------------------------|----------------------|------------------|
| Machinery and equipment              | \$ 3,226,702         | \$ 3,157,328     |
| Furniture and fixtures               | 942,215              | 952,193          |
| Leasehold improvements               | 243,604              | 243,604          |
| Production tooling                   | 2,335,132            | 2,294,360        |
| Demonstration and loaner monitors    | 2,101,645            | 1,997,844        |
| Property, plant and equipment - cost | 8,849,298            | 8,645,329        |
| Less: accumulated depreciation       | (6,448,061)          | (6,193,015)      |
| Property, plant and equipment - net  | \$ 2,401,237         | \$ 2,452,314     |



#### **4. Stock Options**

The Company has adopted the fair value recognition provisions of SFAS No. 123 (R), "Share-Based Payment". Under the modified prospective method of adoption selected by the Company, compensation cost recognized is the same as that which would have been recognized had the recognition provisions of SFAS No. 123 been applied from its original effective date. Stock-based employee compensation expense included in reported net income totaled \$27,078 and \$41,123 for the three months ended December 31, 2006 and 2005, respectively. Stock-based employee compensation expense included in reported net income totaled \$56,545 and \$81,140 for the six months ended December 31, 2006 and 2005, respectively.

The Company did not grant any options for the three and six months ended December 31, 2006. The fair value of stock options used to compute net income per share is the estimated fair value at the grant date using the Black-Scholes option-pricing model. The assumptions used when calculating the option-pricing model include the expected volatility of Criticare's common stock at 45.0%, the risk-free interest rate of 4.29%, the expected option life of 8.88 years and the forfeiture rate of option grants at 0%.

#### **5. Income Taxes**

No income tax provision has been made in the consolidated statements of income due to federal and state net operating loss carry forwards that will be utilized to offset taxable income earned. At December 31, 2006, the Company had federal net operating loss carry forwards of approximately \$17,706,000 (which expire from 2008 through 2026) and state net operating loss carry forwards of approximately \$11,930,000 (which expire from 2007 through 2021) 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 operating loss carry forwards due to the uncertainty of realizing the benefits of these assets in future years.

#### **6. Line of Credit Facility**

At December 31, 2006, the Company had a \$2,000,000 demand line of credit facility with a commercial bank to meet its short-term borrowing needs. Borrowings against the line were payable on demand with interest payable monthly at the bank's reference rate, less 0.25% (8.00% as of December 31, 2006). As of December 31, 2006 and June 30, 2006, there were no borrowings against the line. Borrowings under the line of credit facility are collateralized by substantially all assets of the Company. The credit facility has covenants, which require minimum income or liquidity levels. The Company was in compliance with the covenants at December 31, 2006.

#### **7. Net Income Per Common Share**

Basic net income per share is computed using the weighted average number of common shares outstanding during the periods. Diluted net income per share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the periods. Additionally, antidilution occurs when the exercise price of the option is higher than the average market price of the common stock. The diluted weighted average common shares outstanding would be higher by 80,000 shares for the three and six months ended December 31, 2006 and by 28,000 shares for the three and six months ended December 31, 2005 without this anti-dilutive impact.

CRITICARE SYSTEMS, INC.  
Management's Discussion and Analysis of  
Results of Operations and Financial Condition  
Six Months Ended December 31, 2006 and 2005

**Results of Operations**

Net sales of \$16,669,334 for the six months ended December 31, 2006 increased 1.4% from \$16,443,126 for the same period in fiscal 2006. A 5.2% increase in the number of units shipped and a 4.9% increase in the accessory sales were partially offset by a 5.0% reduction in average sales price, due to variations in the product mix, in the current period. The increased sales were the result of a \$715,255 increase in domestic alternate care sales and a \$269,782 increase in domestic acute care sales, which were partially offset by a \$622,246 decrease in international sales.

The gross profit percentage of 39.2% for the six months ended December 31, 2006 decreased slightly from 39.6% for the same period in fiscal 2006. The decreased margins in the current period were mainly due to the small variations in the product mix.

Operating expenses for the six months ended December 31, 2006 decreased \$310,602 from the same period in fiscal 2006, despite the increase of \$268,445 in administrative expenses due to the \$362,693 of expenses incurred during the year in connection with the two consent solicitation actions initiated by BlueLine Partners. The decrease of \$479,075 in sales and marketing expenses was due mainly to a \$209,032 decrease in India operation expenses, a \$107,537 decrease in operating supplies expenses and a \$30,364 decrease in commissions earned for the six months ended December 31, 2006. There will be additional expenses incurred in connection with the second BlueLine consent solicitation, which will increase the administrative expenses in the third quarter of fiscal 2007.

Total other income for the six months ended December 31, 2006 decreased \$396,754 from the same period in fiscal 2006. This decrease was mainly due to the \$300,000 received pursuant to a patent license agreement in fiscal 2006 with no corresponding income in fiscal 2007 and a decrease of \$94,200 in royalty income received during the first six months of fiscal 2007.

Income from operations of \$641,537 for the six months ended December 31, 2006 increased \$336,048 as compared to income from operations of \$305,489 for the same period in fiscal 2006, which was the result of a \$25,446 increase in gross profit combined with the decreased operating expenses of \$310,602. Income from operations was offset by the decrease in other income of \$396,754, resulting in net income of \$683,609 for the six months ended December 31, 2006 as compared to net income of \$744,315 for the same period in fiscal 2006.

CRITICARE SYSTEMS, INC.  
Management's Discussion and Analysis of  
Results of Operations and Financial Condition  
Three Months Ended December 31, 2006 and 2005

**Results of Operations**

Net sales of \$8,462,740 for the three months ended December 31, 2006 decreased 3.5% from \$8,770,813 for the same period in fiscal 2006. A 2.6% increase in the number of units shipped and a 1.3% increase in the accessory sales were offset by a 6.3% reduction in average sales price, due to variations in the product mix, in the current period. The small decrease in sales were the result of a \$116,564 increase in domestic alternate care sales, which was offset by a \$291,179 decrease in OEM sales and \$107,324 in international sales.

The gross profit percentage of 40.4% for the three months ended December 31, 2006 decreased slightly from 40.8% for the same period in fiscal 2006. The decreased margins in the current period were mainly due to the small variations in the product mix.

Operating expenses for the three months ended December 31, 2006 decreased \$227,006 from the same period in fiscal 2006, despite the increase of \$176,964 in administrative expenses due to the \$271,153 of expenses incurred during the quarter in connection with the two consent solicitation actions initiated by BlueLine Partners. The decrease of \$288,366 in sales and marketing expenses was due mainly to a \$134,978 decrease in India operation expenses, a \$65,163 decrease in commissions earned and a \$25,848 decrease in operating supplies expenses for the three months ended December 31, 2006. There will be additional expenses incurred in connection with the second BlueLine consent solicitation, which will increase the administrative expenses in the third quarter of fiscal 2007.

Total other income for the three months ended December 31, 2006 decreased \$322,882 from the same period in fiscal 2006. This decrease was driven by the \$300,000 received pursuant to a patent license agreement in fiscal 2006 with no corresponding income in fiscal 2007.

Income from operations of \$315,096 for the three months ended December 31, 2006 increased \$66,678 as compared to income from operations of \$248,418 for the same period in fiscal 2006, which was the result of the decreased operating expenses of \$227,006, partially offset by a \$160,328 decrease in gross profit. Income from operations was offset by the decrease in other income of \$322,882, resulting in net income of \$350,733 for the three months ended December 31, 2006 as compared to net income of \$606,937 for the same period in fiscal 2006.

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

**Liquidity and Capital Resources**

As of December 31, 2006, the Company had a cash balance of \$3,947,297, which was \$1,271,847 higher than its balance at September 30, 2006 of \$2,675,450 and \$153,516 higher than its balance at June 30, 2006 of \$3,793,781. 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's cash position increased by \$153,516 for the six months ended December 31, 2006 mainly due to \$314,357 of cash provided by operating activities, which was partially offset by \$115,982 of capital expenditures. Cash provided by operations was \$314,357 for the six months ended December 31, 2006 as a decrease of \$2,259,859 in accounts payable was offset by a \$1,198,237 decrease in inventory, depreciation of \$253,126 and net income of \$683,609.

The Company believes all future capital and liquidity requirements will be satisfied by cash generated from operations, proceeds received from the issuance of common stock related to the exercise of stock options, and its current cash balances. No major capital equipment expenditures are expected in the Company's current fiscal year ending June 30, 2007. The Company also has a \$2,000,000 line of credit currently in place that could be utilized, if necessary. At both December 31, 2006 and June 30, 2006, there were no borrowings outstanding under this line of credit. The credit facility has covenants that require minimum income or liquidity levels. The Company was in compliance with the covenants at December 31, 2006. This line expires in June 2007.

**Recently Issued Accounting Pronouncements**

FASB Interpretation No. 48 ("FIN 48"), Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109, clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement 109 (Accounting for Income Taxes). FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the pronouncement and the potential impact of this accounting change on the financial statements.

### **Forward Looking Statements**

A number of the matters and subject areas discussed in this report 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 in this report. These statements may be identified by the use of forward-looking words or phrases such as "anticipate," "believe," "could," "expect," "intend," "may," "hope," "plan," "potential," "should," "estimate," "predict," "continue," "future," "will," "would" or the negative of these terms or other words of similar meaning.

Such forward-looking statements are inherently subject to known and unknown risks and uncertainties. The Company's actual results and future developments could differ materially from the results or developments expressed in, or implied by, these forward-looking statements. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements 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. Such uncertainties and other risks that may affect the Company's performance are discussed further in Part I, Item 1A, "Risk Factors," in the Company's Form 10-K for the year ended June 30, 2006. The Company undertakes no obligation to make any revisions to the forward-looking statements contained in this report or to update them to reflect events or circumstances occurring after the date of this report.

### **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 below the bank's reference rate. The Company had no borrowings outstanding under this bank facility at December 31, 2006 and June 30, 2006. 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 for the quarter ended December 31, 2006. 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, as of the end of such period, the Company's disclosure controls and procedures were effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in reports that the Company files with or submits to 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 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.

PART II - OTHER INFORMATION

Item 1A. Risk Factors.

There have been no material changes from the risk factors previously disclosed in Part I, Item 1A, "Risk Factors," of the Company's Form 10-K for the year ended June 30, 2006. Please refer to that section for disclosures regarding the risks and uncertainties relating to the Company's business.

Item 4. Submission of Matters to a Vote of Security Holders.

The annual meeting of stockholders of the Company was held on December 19, 2006. The matters voted upon, including the number of votes cast for, against or withheld, as well as the number of abstentions and broker non-votes, as to each such matter were as follows:

Proposal 1: Election of two directors to serve for a term ending at the 2009 annual meeting of stockholders.

|                       | For        | Withheld  |
|-----------------------|------------|-----------|
| Stephen K. Tannenbaum | 8,626,613  | 2,545,614 |
| Emil H. Soika         | 10,024,438 | 1,147,789 |

The Company's other directors consist of Higgins D. Bailey and Sam B. Humphries (whose terms end at the 2007 annual meeting of stockholders) and Jeffrey T. Barnes and Dr. N.C. Joseph Lai (whose terms end at the 2008 annual meeting of stockholders).

Proposal 2: Ratification of appointment of BDO Seidman, LLP as independent auditors of the Company.

| For       | Against | Abstain   | Broker Non-Votes |
|-----------|---------|-----------|------------------|
| 9,521,722 | 121,025 | 1,529,480 | 0                |

Item 6. 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 Joel D. Knudson, 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 Exhibit 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.



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: February 5, 2007

BY /s/ Joel D. Knudson

Joel D. Knudson

Vice President - Finance

(Chief Accounting Officer and

Duly Authorized Officer)