SYNBIOTICS CORP
Form PRER14A
June 15, 2005
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE 14A

Amendment No. 1

Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934

Filed by the Registrant x

Filed by a Party other than the Registrant ¨

Check the appropriate box:

x Preliminary Proxy Statement
¨ **Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**
¨ Definitive Proxy Statement
¨ Definitive Additional Materials
¨ Soliciting Material Pursuant to §240.14a-12

SYNBIOTICS CORPORATION

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if Other Than the Registrant)

Payment of Filing Fee (Check the appropriate box):

x No fee required.
¨ Fee computed on table below per Exchange Act Rules 14a-6(i)(4) and 0-11.

1) Title of each class of securities to which transaction applies:

2) Aggregate number of securities to which transaction applies:

3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11:

4) Proposed maximum aggregate value of transaction:

5) Total fee paid:

¨ Fee paid previously with preliminary materials.

¨ Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

1) Amount Previously Paid:

2) Form, Schedule or Registration Statement No.:

3) Filing Party:

4) Date Filed:

Table of Contents

THIS TRANSACTION HAS NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION. NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY STATE SECURITIES COMMISSION HAS PASSED UPON THE FAIRNESS OR MERITS OF THIS TRANSACTION OR UPON THE ACCURACY OR ADEQUACY OF THE DISCLOSURE CONTAINED IN THIS DOCUMENT. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

SYNBIOTICS CORPORATION

PROXY STATEMENT

WRITTEN CONSENT SOLICITATION OF SHAREHOLDERS

June , 2005

INTRODUCTION

These proxy materials and the enclosed consent are being mailed in connection with the solicitation of written consents by the board of directors of Synbiotics Corporation, a California corporation (the Company). The mailing address of our principal executive offices is 11011 Via Frontera, San Diego, California 92127.

Shareholders are being asked to consider and vote upon two proposals to amend our Articles of Incorporation, as amended. The first is to effect a reverse split of our outstanding common stock pursuant to which each 2,000 outstanding shares of common stock will be combined into one whole share and, in lieu of us issuing any fractional shares resulting from the combination, we will pay $0.13 cash for each pre-reverse split share traceable to a fractional share (the Reverse Split). The second proposal is to effect a 2,000-for-1 forward split of the resulting whole shares of common stock (the Forward Split), contingent upon, and effective after completion of, the Reverse Split.

If the Reverse Split and the Forward Split (together, the Split Transaction) are approved as described below, holders of less than 2,000 shares of common stock immediately before the Reverse Split no longer will be shareholders of the Company, and will be entitled only to receive payment of $0.13 per share of common stock held immediately before the Reverse Split (Pre-Split Shares). Shareholders holding 2,000 or more Pre-Split Shares will remain shareholders of the Company, but any fractional shares indicated for them in the Reverse Split will also be cashed out. As a result of the reverse split and a contemplated private financing, we expect that the continuing shareholders percentage interest in the Company will remain approximately the same as before the Split Transaction, except for an increase in the percentage ownership of Redwood Holdings, LLC and its affiliates. We intend to terminate our registration and further reporting obligations under the Securities Exchange Act of 1934, as amended (the 1934 Act), as soon as possible following the Split Transaction.

Our board of directors has considered the Split Transaction and the related transactions. In connection with its evaluation, our board of directors did not retain any advisors to render an opinion as to the fairness, from a financial point of view, to our shareholders of the consideration to be received by them in connection with the transaction. Two of our directors, Thomas A. Donelan and Christopher P. Hendy, are affiliates of Redwood Holdings, LLC, which is affiliated with our controlling shareholder. In order to finance the Split Transaction, Redwood Holdings, LLC will purchase shares of Series C preferred stock to be newly issued by the Company, thereby increasing its percentage ownership of the Company following the Split Transaction. Our other director, Paul R. Hays, currently is and will remain our President and Chief Executive Officer following the Split Transaction.

Our board of directors has fixed April 7, 2005, as the record date for determining the shareholders entitled to give consents. At the close of business on the record date, we had 33,822,033 shares of common stock outstanding and entitled to vote, and 1,531 shares of Series C preferred stock outstanding and entitled to vote.

Table of Contents

Any shareholder executing a consent has the power to revoke it at any time before , 2005 (or if earlier, the date on which at least the minimum number of shares have consented in order to approve the Split Transaction) by delivering written notice of such revocation to our Secretary at our offices.

We will pay the expenses of soliciting consents, including the charges and expenses of brokerage firms and others for forwarding solicitation material to beneficial owners of shares. In addition to the use of the mails, some of our directors, officers and regular employees, without extra compensation, may solicit consents by telephone, fax, e-mail and in person.

These proxy materials will be first mailed to shareholders of record beginning on approximately June , 2005.

Consents are to be submitted by no later than , 2005 to our consent tabulator, Mellon Investor Services LLC, at Mellon Investor Services, Proxy Processing, PO Box 3510, S. Hackensack, New Jersey 07606-9210.

Our Annual Report on Form 10-K for the year ended December 31, 2004 is included as Exhibit A to this proxy statement, and our Quarterly Report on Form 10-Q for the quarter ended March 31, 2005 is included as Exhibit B to this proxy statement. The Form 10-K and Form 10-Q exhibits are not included, but they can be viewed on EDGAR at www.sec.gov or, if you request us in writing, we will send copies of them to you free of charge.

Approval of each of the proposals described in this proxy statement requires the affirmative vote of the holders of the majority of the outstanding shares of common stock (voting as a separate class), the affirmative vote of the holders of the majority of the outstanding shares of Series C preferred stock (voting as a separate class), and also the affirmative vote of the holders of the majority of the voting power of all stock entitled to vote. Abstentions (including failures to return consents) and broker nonvotes have the same effect as negative votes. In determining whether the holders of the majority of the voting power of all stock entitled to vote have approved, the shares of Series C preferred stock are entitled to 7,784.52 votes each.

Our board of directors, executive officers and other affiliates of our major shareholder Redwood West Coast, LLC, beneficially own approximately 49.7% of the outstanding shares of our common stock and 93.5% of the outstanding shares of our Series C preferred stock. If all such shares are voted for the Split Transaction, an additional affirmative vote of only 115,972 shares, or 0.3%, of the outstanding common stock will be required in order for the Split Transaction to be approved.

SUMMARY TERM SHEET

This summary highlights the material information about the Split Transaction and the related transactions. You should read this entire proxy statement and its exhibits before deciding whether to sign and return your consent.

The following summary briefly describes the material terms of the Split Transaction. The proxy statement contains a more detailed description of such terms.

If the Split Transaction is completed, our board of directors has determined that in lieu of issuing any fractional shares resulting from the Reverse Split, we will make a cash payment of $0.13 per Pre-Split Share traceable to a fractional share. Accordingly, if the Reverse Split is completed, shareholders with less than 2,000 Pre-Split Shares will have no further interest in the Company and will become entitled only to payment for their Pre-Split Shares. Also, even for holders of at least one whole share as of immediately after the Reverse Split, we will not issue any fractional shares in the Reverse Split, but instead will pay cash in lieu of fractional shares at the rate of $0.13 for each Pre-Split Share. We expect to pay approximately $137,000 in the aggregate, and no shareholder with a single account could receive more than $259.87 as a result of the payout for their Pre-Split Shares. After the Reverse Split is completed and we identify those shareholders entitled to payment for their Pre-Split Shares, we will effect the Forward Split such that each post-Reverse Split whole share of common stock will be converted into 2,000 shares of common stock after the Forward Split. Shareholders who hold a number of Pre-Split Shares that is exactly divisible by 2,000 will after the Split Transaction have the same number of shares of common stock as before the Split Transaction. Other shareholders, who held at least 2,000 Pre-Split Shares, will have after the Split Transaction slightly fewer shares of common stock than before the Split Transaction. For example, a holder of 20,500 Pre-Split Shares would, after the Split Transaction, have 20,000 shares of common stock and be entitled to $65.00 cash (see Special Factors Structure of the Split Transaction beginning on page 8).

The primary practical effect of the Split Transaction will be to reduce the number of shareholders of record to less than 300, thereby allowing us to elect to deregister our common stock and our poison pill preferred stock purchase rights under the 1934 Act and go private, which we would then promptly do (see Special Factors Effect of the Split Transaction on the Company beginning on page 10).

All of the members of our board of directors and our controlling shareholder, Redwood West Coast, LLC and its affiliates, believe that the Split Transaction is fair, both procedurally and substantively, to the Company and its unaffiliated shareholders. Our board of directors has determined that the Split Transaction, including the payment of $0.13 in cash in lieu of any fractional shares resulting from the Reverse Split, is advisable and in the best interests of the Company and its unaffiliated shareholders and recommends that you vote FOR both proposals in connection with the Split Transaction (see Special Factors Factors Considered By the Board of Directors beginning on page 6, Proposal No. 1 Recommendation of the Board of Directors beginning on page 15 and Proposal No. 2 Recommendation of the Board of Directors beginning on page 15).

Our board of directors did not retain any advisors to render an opinion as to the fairness, from a financial point of view, to our shareholders of the consideration to be received by them in connection with the transaction (see Special Factors No Opinion of Financial Advisor beginning on page 11).

Each of the proposals requires the affirmative vote of a majority of the outstanding common stock, the affirmative vote of a majority of the outstanding preferred stock and also the affirmative vote of the holders of the majority of the voting power of all stock entitled to vote. Even if both proposals are approved, the board of directors may, in its discretion, abandon the Split Transaction (see Proposal No. 1 Vote Required beginning on page 14, Proposal No. 2 Recommendation of the Board of Directors beginning on page 15 and Special Factors Factors Considered By the Board of Directors beginning on page 6).

All of our directors and our controlling shareholder and its affiliates have interests in the Split Transaction that may potentially be different from the interests of our unaffiliated shareholders. Our controlling shareholder and its affiliates own 48.5% of our outstanding common stock, and, along with our directors and officers, control 49.7% of our outstanding common stock. Our controlling shareholder and its affiliates also own 86.9% of our outstanding preferred stock, and, along with our directors and officers, control 93.5% of our outstanding preferred stock. Following the completion of the Split Transaction, each of our remaining shareholders, including affiliates and members of management owning common shares, will own a slightly increased or slightly decreased (depending upon the size of the indicated fraction of a share post-Reverse Split) percentage of the outstanding common stock and a slightly decreased percentage of the fully-diluted common stock (except that Redwood Holdings, LLC, which will be buying new shares of Series C preferred stock from us to finance the cash payments to the holders of post-Reverse Split fractional shares, will have an increase in its percentage of fully-diluted common stock). We do not anticipate any changes in the Company s board of directors or management following the Split Transaction (see Security Ownership of Certain Beneficial Owners and Management beginning on page 18, Other Issues Related to the Split Transaction Conduct of the

Table of Contents

Company s Business After the Split Transaction beginning on page 16 and Other Issues Related to the Split Transaction Source of Funds and Financial Effect of the Split Transaction beginning on page 15).

Under California law, our shareholders are not entitled to dissenter s or appraisal rights with respect to the Split Transaction (see Other Issues Related to the Split Transaction Dissenters Rights beginning on page 18).

Under state escheat laws, any payment for fractional interests not claimed by the shareholder entitled to such payment may be claimed by various states (see Other Issues Related to the Split Transaction Escheat Laws beginning on page 17).

Any receipt of cash in the Split Transaction by shareholders holding Pre-Split Shares will be a taxable transaction in the same way as if they sold their shares in the market for $0.13 per share (see Special Factors Material Federal Income Tax Consequences beginning on page 11).

If the Split Transaction is approved by our shareholders, each shareholder holding fewer than 2,000 Pre-Split Shares or holding a number of Pre-Split Shares not exactly divisible by 2,000 will receive a letter from our exchange agent following the effective date of the Split Transaction. This letter will indicate the procedures to be followed for surrendering your stock certificates (see Other Issues Related to the Split Transaction Exchange of Stock Certificates beginning on page 17). All other shareholders will continue to hold their current share certificates.

There are risks associated with the Split Transaction, including risks associated with remaining a shareholder following the Split Transaction, such as the lack of liquidity for shares of a privately held company, the loss of the informational benefits of the 1934 Act and the operation risks of maintaining an investment in the Company; as well as risks associated with being cashed out in the Split Transaction, such as loss of the opportunity to participate in the Company s future growth and the possibility that the fair value of the shares may exceed the cash-out price (see Risk Factors beginning on page 12).

SPECIAL FACTORS

Background

On January 7, 2005, our board of directors began considering whether, in light of the costs and related burdens of being a public company in the current market, remaining a public company was in the best interests of the Company and its shareholders. As a result, on April 5, 2005, our board of directors adopted a resolution to solicit shareholder approval, via written consent, of the Split Transaction. On April 19, 2005, our board of directors adopted resolutions to: 1) authorize amendments to our Articles of Incorporation to effect the Split Transaction; and 2) authorize a Series C purchase agreement whereby, to finance the cash-out of any fractional shares resulting from the Reverse Split, Redwood Holdings, LLC, upon approval of the Split Transaction by the shareholders, will purchase 180 shares of Series C preferred stock for $180,000 in cash.

We have approximately 568 shareholders of record. Many of our shareholders hold a small number of shares.

As of April 7, 2005, approximately 508 shareholders of record of our common stock owned fewer than 2,000 shares. At that time, these shareholders represented approximately 89.4% of the total number of shareholders of record of our common stock, but these accounts represented approximately only 0.3% of the total number of outstanding shares of our common stock. Also at that time, shareholders not of record but beneficially owning fewer than 2,000 shares represented 1,393, or approximately 74.5%, of our 1,871 street name shareholders, but these accounts represented approximately only 1.9% of the total number of outstanding shares of common stock.

Table of Contents

Purpose of the Split Transaction

The purpose behind the Split Transaction is to reduce our number of shareholders of record to below 300. This, in turn, will enable us under the applicable legal standards to elect to deregister our securities under the 1934 Act, thereby going private. We would deregister as soon as possible, in order to (i) eliminate the costs associated with preparing and filing documents under the 1934 Act with the U.S. Securities and Exchange Commission (SEC), (ii) eliminate or reduce the costs and other burdens associated with being a 1934 Act registrant, including the costs of complying with Section 404 of the Sarbanes-Oxley Act of 2002 as to internal control over financial reporting, (iii) avoid the requirement of regular mandatory disclosure of our financial information and management analyses, to the public but also to our competitors and commercial counterparties, even when such disclosure would be adverse to a Company objective, (iv) reduce the costs of administering shareholder accounts and responding to shareholder requests, (v) provide liquidity to shareholders holding less than 2,000 Pre-Split Shares of common stock, and (vi) provide greater flexibility in the management and governance of the Company.

Reasons for the Split Transaction

We expect to benefit from substantial cost savings as a result of the Split Transaction and going private, primarily from avoiding various 1934 Act compliance costs but also simply from reducing the number of shareholder accounts.

The new legal requirements imposed on public companies under Section 404 of the Sarbanes-Oxley Act, including requirements relating to our system of internal controls, add to the administrative burden and costs of being a public company. Our management does not believe that we can prudently pay the expense of complying with these legal requirements. The expenses associated with implementing the additional processes and procedures necessary for compliance with Section 404, which was originally to take effect for our fiscal year 2005 but has now been delayed by the SEC until our fiscal year 2006, and the required attestation of those controls have been estimated to be equal to the entire $95,000 cost of the fiscal 2004 year-end audit. Moreover, compliance with Section 404 would inevitably result in a diversion of management time and attention from other duties.

In addition to the account administration cost reductions which would result directly from the Split Transaction, if we go private we believe we would save approximately $60,000 per year in other costs associated with public filings, including legal and accounting fees associated with filing directly attributable to the public filings.

We would also expect reductions in other administrative costs associated with being a public company, including directors and officers insurance, EDGAR preparation and filing costs and investor relations expenses, of at least $42,000.

The cost of administering each record or beneficial shareholder s account is the same regardless of the number of shares held in that account. Therefore, our costs to maintain such small accounts are disproportionately high when compared to the total number of shares involved. In 2005, assuming that the Split Transaction does not occur, we expect to incur costs of approximately $20.00 per record shareholder for transfer agent and other administrative fees, as well as printing and postage costs associated with the delivery of proxy materials and the annual report required to be distributed to shareholders under the 1934 Act. In addition, in 2005, assuming that the Split Transaction does not occur, we expect to incur costs of approximately $25.00 for each shareholder holding shares in street name through a nominee (i.e., a bank or broker). These fees are in connection with the administrative fees, as well as printing and postage costs associated with the delivery of proxy materials and the annual report. We expect these costs to increase over time in the absence of the Split Transaction.

We expect that we will reduce the total cost of administering record shareholder accounts by at least $10,000 per year if we complete the Split Transaction. Furthermore, we expect that we will reduce the total cost

Table of Contents

of administering street name shareholder accounts by at least $35,000 per year if we complete the Split Transaction, for a total administrative cost savings of $45,000 per year. In light of these disproportionate costs, the board of directors believes that it is in the best interests of the Company and our shareholders as a whole to eliminate the administrative burden and costs associated with such small accounts and such public filings.

We are aware that these estimates of the costs of being a 1934 Act public company are lower than those presented by many other public companies and experts. If we have underestimated these costs, our savings from the Split Transaction and from going private would be even greater.

In addition, although 1934 Act disclosure requirements currently ensure that we provide information about us that the investing public finds useful, the same information is often useful to our competitors and to parties negotiating contracts with us. Going private would enable us to shut off a flow of information that our business adversaries can use against us.

Moreover, the Split Transaction will provide shareholders with fewer than 2,000 Pre-Split Shares with an efficient way to cash out their investment in the Company because we will pay all transaction costs such as brokerage fees in connection with the Split Transaction. Otherwise, shareholders with small holdings would likely incur brokerage fees that are disproportionately high relative to the market value, based on the $0.07 closing price as of April 18, 2005, of their shares if they wanted to sell their stock. The Split Transaction will eliminate these problems for most shareholders with small holdings.

Factors Considered By the Board of Directors

In the course of reaching its decision to recommend to the shareholders the approval of the Split Transaction, our board of directors considered the following factors favoring the Split Transaction:

- anticipated reductions in the expenses of compliance with the reporting, proxy statement disclosure and internal controls compliance requirements of U.S. securities laws and the associated drain on management time and attention;

- anticipated reductions in operating expenses associated with administering a large number of shareholder accounts;

- the value being paid to cash-out any fractional shares resulting from the Reverse Spit is higher than the market value, based on the $0.07 closing price, and higher than the $0.08 per share book value, of the common stock on April 18, 2005, which is prior to announcement of the Split Transaction, and also higher than the $0.10 average closing price for the 30 trading days ending on April 18, 2005;

- the value being paid to cash-out any fractional shares resulting from the Reverse Split is higher than the $0.12846 per share, on a converted basis, we received for the sale of our Series C preferred stock, which is convertible into unregistered shares of our common stock, in September 2004 in conjunction with our debt restructuring.

- the ability of smaller shareholders to receive cash for their shares without being burdened by disproportionately high service fees or brokerage commissions; and the ability of shareholders wishing to remain shareholders to purchase sufficient shares in advance of the Effective Date to cause them to own more than 2,000 Pre-Split Shares.

The board of directors also considered the following potential adverse factors of the Split Transaction:

following the Split Transaction, the shareholders of less than 2,000 Pre-Split Shares before the Reverse Split will cease to hold any equity interest in the Company and will lose their ability to participate in the future growth of the Company, if any, or benefit from increases, if any, in the value of the Company. This factor is somewhat mitigated by the fact that these shareholders may purchase shares of our common stock before the Effective Date to get over the 2,000 share threshold and avoid being cashed out;

Table of Contents

following the Split Transaction, other shareholders whose fractional shares are cashed out in the Reverse Split will, to that extent, lose their ability to benefit from any future increases in shareholder value;

the market for Company stock will become extremely illiquid or even non-existent after the Split Transaction; and

the payment for fractional shares, which cannot exceed $259.87 for any single account, is a taxable transaction for shareholders. This factor is somewhat mitigated by the fact that for many cashed-out shareholders the transaction will result in recognition of a capital loss.

The board of directors considered the following alternative transactions to accomplish the reduction in the number of shareholders to fewer than 300 holders of record and then go private, but ultimately determined the Split Transaction was the preferred method:

(a) A cash tender offer The board of directors believed a cash tender offer would not result in shares being tendered by a sufficient number of record shareholders so as to accomplish the going private objective. It was thought unlikely that many holders of small numbers of shares would make the effort to tender their shares of common stock and the cost of mounting and completing the tender offer could be significant in relation to the value of the shares of common stock sought to be purchased. Additionally, there is the risk that holders of greater than 2,000 shares would tender their shares, thereby causing us to expend significant amounts of cash but not reducing the number of shareholders to less than 300; and

(b) A purchase of shares in the open market The trading market for the common stock is not particularly active; therefore, it would be highly unlikely that shares of common stock could be acquired by us from a sufficient number of record holders to accomplish the board of directors objectives. This is especially so because there is no reason to believe that many record holders of fewer than 2,000 shares would be looking to sell their shares in response to open-market bids. Moreover, such a program could be construed as an issuer self-tender offer, resulting in regulatory compliance costs.

Our board of directors is not aware of any firm offers made by any non-affiliate of the Company for the merger or consolidation of the Company with or into another company, the sale or transfer of all or a substantial portion of the Company s assets or the acquisition of a controlling interest in the company against which the cash-out price can be compared. In addition, our board of directors did not consider a sale of the Company, to non-affiliates or otherwise, as an alternative to the Split Transaction because it believes that the value of the Company will increase, and that, accordingly, a sale of the Company in the future will result in a higher price paid to shareholders than would a sale of the Company at this time. Our board of directors did not consider whether the $0.13 cash-out price is higher than the going-concern value or liquidation value, because any amounts received upon a liquidation of the Company would be paid first to our secured creditors, then to our unsecured creditors, then to holders of our preferred stock and then to the holders of our common stock; the board of directors believes that if the Company were to be liquidated at this time, the proceeds would be insufficient to satisfy all of our secured creditors and unsecured creditors and the holders of our preferred stock.

We did not retain any outside party to provide a report and opinion relating to the fairness of the consideration to be paid to unaffiliated shareholders holding fewer than 2,000 Pre-Split Shares and other fractional shares resulting from the Reverse Split in any one account and the fairness of the Split Transaction to the Company and its remaining shareholders. Based on a recent analysis of the distribution of our shareholders, the Split Transaction would result in the cash-out of about 1,057,000 Pre-Split Shares of common stock at $0.13 per share, for a total cash-out amount of approximately $137,000. However, because holders can continue to buy and sell shares through the effective date of the Split Transaction, this figure might change. No single account can receive more than $259.87 in payment for its Pre-Split Shares of common stock because the maximum number of shares that can be cashed out of any single account is 1,999. No independent committee of the board of directors has reviewed or approved the fairness of the Split Transaction. No unaffiliated representative acting solely on behalf of the unaffiliated shareholders for the purpose of negotiating the terms of the Split Transaction or preparing a report concerning the fairness of the Split Transaction was retained by us or by our unaffiliated

7

directors (indeed, we do not even have any unaffiliated directors). In spite of the absence of an unaffiliated representative acting solely on behalf of the unaffiliated shareholders, we believe that the Split Transaction is fair to all unaffiliated shareholders for the reasons set forth in the remaining portion of this section.

The cash-out price of $0.13, determined by our board of directors, reflects an 86% premium over the closing price of $0.07 as reported for the common stock on April 18, 2005, the day before the announcement of the Split Transaction and a 30% premium over the $0.10 average closing price for the 30 trading days ending on the day before the announcement of the Split Transaction. The board of directors believes that the Split Transaction is procedurally and substantively fair to all unaffiliated shareholders both those whose interest in the Company will be wholly cashed-out and those who will continue to hold shares of the Company after the Split Transaction. Present shareholders (including those whose shares are expected to be cashed out) generally will have an opportunity both to evaluate all of the information contained herein and to compare the potential value of an investment in the Company with that of other available investments. The board of directors believes that the Split Transaction is procedurally fair to our unaffiliated shareholders because the Reverse Split is being effected in accordance with all requirements under California law and hence will require the affirmative vote of the holders of a majority of each class of the Company s outstanding capital stock. In addition, between the date hereof and the Effective Date all shareholders of the Company will have an opportunity to buy or sell in the public market a number of Pre-Split Shares so that holders who would otherwise be cashed out in whole or in part can continue to be shareholders, and continuing holders can also divide or otherwise adjust their existing holdings as to become cashed-out shareholders as to some or all of their Pre-Split Shares. None of our directors or affiliates is expected to act so as to become a wholly cashed-out shareholder. The substantive fairness of the Split Transaction to continuing shareholders as well as cashed-out shareholders is based on the cash-out price of $0.13 per share, which represents a premium over the current market price of the Company s common stock and takes into account the relative advantages, disadvantages, risks and prospects to each group, which are deserved above and elsewhere in this proxy statement, including the section entitled Risk Factors. We believe that, in making their decision to determine the $0.13 cash-out price, our directors were conscious of the importance of the issues (including those that adversely affect continuing shareholders as well as those that affect cashed-out shareholders) and acted in accordance with their fiduciary duties to us and our shareholders.

No provision has been made to grant unaffiliated shareholders access to our corporate files or to obtain counsel or appraisal services at our expense.

The board of directors retains the right to reject (and not implement) the Split Transaction (even after approval thereof) if it determines subsequently that the Split Transaction is not then in the best interests of the Company and its shareholders. If the Split Transaction is not approved, or, if approved, is not implemented, the proposed deregistration of our common stock will not be implemented.

Structure of the Split Transaction

The Split Transaction includes the Reverse Split (with a cash payment in lieu of fractional shares) and the Forward Split of the common stock. If the Split Transaction is approved by shareholders, the Reverse Split is expected to occur on a Saturday, following advance notice by press release. Upon consummation of the Reverse Split, each shareholder of record or beneficial shareholder on that Saturday will receive one share of common stock for each whole block of 2,000 Pre-Split Shares held in his or her account at that time. If a shareholder of record holds 2,000 or more Pre-Split Shares in his or her account, any fractional share in such account after the Reverse Split will be cashed out (and to that extent he or she is referred to here as a Partially Cashed-Out Shareholder). Any shareholder of record who holds fewer than 2,000 Pre-Split Shares in his or her account at the time of the Reverse Split (a Cashed-Out Shareholder) will receive only a cash payment instead of fractional shares and will no longer be a shareholder of the Company after the Split Transaction. Immediately following the Reverse Split and the payment to the Partially Cashed-Out Shareholders and the Cashed-Out Shareholders, all shareholders who are not Cashed-Out Shareholders will receive in the Forward Split effective on the Sunday after the Reverse Split, 2,000 shares of common stock for every one whole share of common stock they held following the Reverse Split.

Table of Contents

We intend for the Split Transaction to treat shareholders holding common stock in street name through a nominee (such as a bank or broker) in the same manner as shareholders whose shares are held of record in their own names, and nominees will be instructed to effect the Split Transaction for their beneficial holders. Accordingly, we also refer to those street name holders who receive a cash payment instead of fractional shares as Partially Cashed-Out Shareholders or Cashed-Out Shareholders , as the case may be. However, nominees may have different procedures and shareholders holding shares in street name should contact their nominees.

In general, the Split Transaction can be illustrated by the following examples:

HYPOTHETICAL SCENARIO	RESULT
Mr. Smith is a shareholder who holds 1,000 shares of common stock in his account before the Split Transaction.	Instead of receiving a fractional share of common stock immediately after the Reverse Split, Mr. Smith s shares will be converted into the right to receive cash. Mr. Smith would receive $130.00 ($0.13 x 1,000 shares). Note: If Mr. Smith wants to continue his investment in the Company, before the Effective Date, he can buy at least 1,000 more shares. Mr. Smith would have to act far enough in advance of the Split Transaction so that the purchase is completed and the additional shares are credited in his account by the Effective Date.
Ms. Jones has two separate accounts. As of the Effective Date, she holds 1,000 shares of common stock in one account and 1,500 shares of common stock in the other.	Ms. Jones will receive cash payments equal to the cash-out price of her common stock in each account instead of receiving fractional shares. Ms. Jones would receive two checks totaling $325.00 (1,000 shares x $0.13 = $130.00; 1,500 shares x $0.13 = $195.00) Note: If Ms. Jones wants to continue her investment in the Company, she can consolidate or transfer her two accounts before the Effective Date into an account with at least 2,000 Pre-Split Shares. Alternatively, she can buy at least 1,000 more shares for the first account and 500 more shares for the second account, and hold them in her respective accounts. She would have to act far enough in advance of the Split Transaction so that the consolidation or the purchase is completed by the Effective Date.
Mr. Walker holds 10,000 shares of common stock as of the Effective Date.	After the Split Transaction, Mr. Walker will continue to hold 10,000 shares of common stock.
Mr. Wu holds 20,500 shares of common stock as of the Effective Date.	In the Reverse Split, Mr. Wu s stock is combined into 10 whole shares plus an entitlement to $65.00 cash (500 x $0.13 = $65.00). In the Forward Split, the 10 whole shares will be divided into 20,000 shares of common stock.

Table of Contents

HYPOTHETICAL SCENARIO	RESULT
Ms. Harris holds 1,000 shares of common stock in street name in a brokerage account as of the Effective Date.	We intend for the Split Transaction to treat shareholders holding shares of common stock in street name through a nominee (such as a bank or broker) in the same manner as shareholders whose shares are registered in their names. Nominees will be instructed to effect the Split Transaction for their beneficial holders. If this occurs, Ms. Harris will receive, through her broker, a check for $130.00 (1,000 shares x $0.13). However, nominees may have a different procedure and shareholders holding shares of common stock in street name should contact their nominees.

Effect of the Split Transaction on the Company

Our Articles of Incorporation, as amended, currently authorize the issuance of 70,000,000 shares of common stock and 25,000,000 shares of preferred stock, for an aggregate of 95,000,000 shares. As of the record date, 33,822,033 shares of common stock were outstanding, and 1,531 shares of Series C preferred stock were outstanding. Based upon our best estimates, if the Split Transaction had been consummated as of the record date, the number of outstanding shares of common stock would have been reduced by the Split Transaction from 33,822,033 to approximately 32,765,472. This would have reduced the number of holders of record of common stock from approximately 568 to approximately 60 or by approximately 508 shareholders of record and would also have reduced our number of street-name shareholders from approximately 1,871 to approximately 478 or by approximately 1,393 street-name shareholders. There would be no change in the number of shares of, or holders of, Series C preferred stock as a result of the Split Transaction, except that Redwood Holdings, LLC would buy an additional 180 shares of Series C preferred stock for $180,000 in order to satisfy Comerica Bank s requirement that the cash-out payments in lieu of fractional shares be financed by the simultaneous sale of other equity securities (see Other Issues Related to the Split Transaction Source of Funds and Financial Effect of the Split Transaction).

Our common stock and our preferred stock rights are currently registered under Section 12(g) of the 1934 Act and, as a result, we are subject to the periodic reporting and other requirements of the 1934 Act. As a result of the Split Transaction, we will have less than 300 holders of record of our publicly-traded common stock and the requirement that the Company maintain its registration under the 1934 Act will become terminable; we could, and would, elect to become a private company. As a result of the Company s deregistration, our shares of common stock will no longer have an effective trading market, and as a practical matter will no longer be publicly traded or quoted on the over-the-counter market. In addition, following the Split Transaction we and our insiders will no longer be required to file periodic and other reports with the SEC, and we will formally terminate our reporting obligations under the 1934 Act. In connection with the proposed Split Transaction, we have filed a Rule 13e-3 Transaction Statement on Schedule 13E-3 (the Schedule 13E-3) with the SEC.

The Split Transaction constitutes a part of a going private transaction under the U.S. securities laws.

Based on the aggregate number of shares owned by holders of less than 2,000 Pre-Split Shares as of the record date, and the estimated number of other fractional shares that would result from the Reverse Split, we estimate that payments of cash in lieu of the issuance of fractional shares will total approximately $137,000 in the aggregate. No shareholder with a single account can receive more than $259.87.

The common stock will continue to have no par value and the number of authorized common shares will remain the same following consummation of the Split Transaction.

Table of Contents

Accounting Treatment of the Split Transaction

We plan to account for the cash-out of fractional share interests as stock repurchases, which will have the effect of reducing the carrying amount of our common stock. There will be no other material accounting effects associated with the Split Transaction.

Material Federal Income Tax Consequences

The following is a discussion of the material anticipated federal income tax consequences of the Split Transaction to shareholders of the Company. It should be noted that this discussion is based upon the federal income tax laws currently in effect and as currently interpreted. This discussion does not take into account possible changes in such laws or interpretations, including any amendments to applicable statutes, regulations and proposed regulations, or changes in judicial or administrative rulings, some of which may have retroactive effect. This discussion is provided for general information only, and does not purport to address all aspects of the range of possible federal income tax consequences of the reverse stock split and is not intended as tax advice to any person. In particular, and without limiting the foregoing, this discussion does not account for or consider the federal income tax consequences to shareholders of the Company in light of their individual investment circumstances or to holders subject to special treatment under the Federal income tax laws (for example, life insurance companies, regulated investment companies, and foreign taxpayers). This discussion does not discuss any consequence of the Split Transaction under any state, local or foreign tax laws.

No ruling from the Internal Revenue Service will be obtained regarding the federal income tax consequences to the shareholders of the Company in connection with the Split Transaction. The Company has not received an opinion of counsel regarding the federal income tax consequences to the Company and its shareholders in connection with the Split Transaction. However, each shareholder is encouraged to consult his or her tax adviser regarding the specific tax consequences of the Split Transaction to such shareholder, including the application and effect of federal, state, local and foreign taxes, and any other tax laws.

The board of directors believes that the Split Transaction will be a tax-free recapitalization to the Company and its continuing shareholders and a taxable transaction to Cashed-Out Shareholders and, to the extent their fractional shares are cashed out, to Partially Cashed-Out Shareholders, all as further detailed below. If the Reverse Split qualifies as a recapitalization described in Section 368(a)(1)(E) of the Internal Revenue Code of 1986, as amended (the Code), (i) no gain or loss will be recognized by a shareholder of common stock who is neither a Cashed-Out Shareholder nor a Partially Cashed-Out Shareholder, (ii) any Cashed-Out Shareholder of Partially Cashed-Out Shareholder who receives cash proceeds, which cannot exceed $259.87 for any single shareholder account, from the sale of fractional shares of common stock will recognize a gain or loss equal to the difference, if any, between such proceeds and the basis of its common stock allocated to its fractional share interests, and such gain or loss, if any, will generally constitute capital gain or loss if its fractional share interests are held as capital assets at the time of their sale, (iii) the tax basis of the new common stock received by holders of common stock will be the same as the tax basis of the common stock exchanged therefore, minus (in the case of Partially Cashed-Out Shareholders) the basis allocated to the cashed-out fractional share interest, and (iv) the holding period of the new common stock in the hands of holders of new common stock will include the holding period of their common stock exchanged therefor, provided that such common stock was held as a capital asset immediately before the exchange.

Certain Cashed-Out Shareholders and Partially Cashed-Out Shareholders may be subject to information reporting with respect to the cash received in exchange for their fractional shares of common stock. If you are subject to information reporting and do not provide appropriate information when requested, you may also be subject to backup withholding at a rate of 28%. Any amount withheld from you under such rules is not an additional tax and may be refunded or credited against your federal income tax liability, provided that the required information is properly furnished in a timely manner to the IRS.

No Opinion of Financial Advisor

Our board of directors did not retain any advisor to deliver a fairness opinion in connection with the Split Transaction.

Table of Contents

Risk Factors

You should consider the following risks prior to casting your vote on the two proposals described in this proxy statement.

Risks Associated with the Split Transaction

NONE OF THE BOARD MEMBERS WHO ARE RECOMMENDING THE SPLIT TRANSACTION IS INDEPENDENT, AND THE FAIRNESS OF THE SPLIT TRANSACTION TO UNAFFILIATED SHAREHOLDERS HAS NOT BEEN ANALYZED OR OPINED UPON BY ANY INDEPENDENT THIRD PARTY OR FINANCIAL ADVISOR.

None of our board members are independent; two of our directors are affiliated with our controlling shareholder, and our remaining director is the President and Chief Executive Officer of the Company. Accordingly, the fairness of the Split Transaction to our unaffiliated shareholders, including those whose minority interest in the Company will be cashed out, has not been considered, and shareholder approval of the Split Transaction is not being recommended, by any independent board members or any independent committee of the board. In addition, our board of directors did not retain any independent third party or financial advisor to deliver a fairness opinion in connection with the Split Transaction or to analyze the fairness of the $0.13 per share consideration to our unaffiliated shareholders.

Risks Associated with Remaining A Shareholder

WE WOULD NO LONGER BE A PUBLIC COMPANY. THE LACK OF LIQUIDITY FOR SHARES OF OUR COMMON STOCK FOLLOWING THE EFFECTIVE DATE MAY ADVERSELY AFFECT THE VALUE OF YOUR SHARES.

Following the Split Transaction, we would have less than 300 shareholders of record. As a result, we would become entitled under applicable law to, and in fact we promptly would, deregister our shares of common stock under the 1934 Act. Once we deregister our shares of common stock, we will not file any more current, quarterly or annual reports with the SEC. As a result, there will be no effective trading market for our shares and shareholders desiring to sell their shares would probably have a difficult time finding a buyer for these shares. This lack of liquidity would probably adversely affect your ability to sell your shares and the price which a buyer is willing to pay for the shares.

YOU WOULD LOSE THE BENEFITS OF THE 1934 ACT.

As mentioned, we would no longer be disclosing the kind of information now disclosed in our current, quarterly and annual reports, nor would we be disclosing the kind of information now disclosed in our proxy statements for annual and special shareholder meetings and written consent solicitations. In addition, our officers, directors and significant shareholders would no longer need to file statements of their securities transactions and ownership under Sections 16 or 13(d) of the 1934 Act. It will be much more difficult for you to monitor the status of your investment. In addition, we will not be required to comply with Sarbanes-Oxley Act Section 404 s requirements regarding internal control over financial reporting.

WE DO NOT INTEND TO PAY DIVIDENDS OR MAKE OTHER DISTRIBUTIONS TO OUR COMMON SHAREHOLDERS IN THE FORESEEABLE FUTURE.

We have never paid dividends on our common stock and we do not intend to do so in the foreseeable future. Accordingly, continuing shareholders will not receive any dividends with respect to their shares of common stock.

Table of Contents

WE DO NOT HAVE ANY PLANS TO SELL THE COMPANY OR OTHERWISE ENTER INTO A TRANSACTION THAT WOULD PROVIDE LIQUIDITY FOR YOUR SHARES.

We do not have any present intention or plans to sell the Company or enter into any other transaction that would provide shareholders with a liquidity event for their shares, which means your shares could remain illiquid for an indefinite period.

SHAREHOLDERS WILL CONTINUE TO BE SUBJECT TO THE OPERATIONAL AND OTHER RISKS FACING US, WHICH RISKS, IF REALIZED, COULD RESULT IN A SUBSTANTIAL REDUCTION IN THE VALUE OF THEIR SHARES OF COMMON STOCK.

Following the Split Transaction, we will continue to face the same risks we have faced in the past, including without limitation the risks described in the risk factor beginning We have a short-term obligation that we cannot afford to pay under the caption Risk Factors in our Form 10-K, as amended, attached to this proxy statement as Exhibit A, and in our Form 10-Q, attached to this proxy statement as Exhibit B, as well as the other risks described in the Form 10-K and the Form 10-Q. There is no guarantee that we will be able to adequately address these risks and the value of your shares may never reach $0.13 or more per share.

Risks Associated with Not Being A Shareholder

SHAREHOLDERS WHO ARE CASHED OUT WILL FORFEIT THE OPPORTUNITY TO PARTICIPATE IN ANY FUTURE GROWTH IN THE VALUE OF THEIR SHARES.

Shareholders who are completely cashed out in the Split Transaction will no longer be shareholders in the Company (unless they subsequently acquire shares from other shareholders following the Effective Date) and will no longer participate in any growth in the value of our common stock that may occur in the future. Continuing shareholders will, to the extent their interest is partially cashed out in lieu of fractional shares, similarly lose the right to participate in any future growth in the value of the cashed-out shares. It is possible that the value of our shares could exceed $0.13 in the future.

THE CURRENT FAIR VALUE OF YOUR SHARES MAY BE MORE THAN $0.13.

The $0.13 cash out price was determined by calculating the average closing price of our common stock over the 30-day period prior to the announcement of the Split Transaction and adding a premium of 30%, which may not in fact indicate the true current value of your shares. We did not use a financial advisor or obtain any fairness opinion regarding the $0.13 price. Due to the nature of the Split Transaction, California statutes do not give you any dissenters rights or appraisal rights, even if you believe the true value of your Pre-Split Shares was more than $0.13 per share.

Table of Contents

PROPOSAL NO. 1

AMENDMENT OF ARTICLES OF INCORPORATION TO EFFECT A REVERSE STOCK SPLIT

The board of directors has authorized, and recommends for your approval, a Split Transaction comprising two separate transactions pursuant to which:

- a reverse stock split (the Reverse Split) pursuant to which each block of 2,000 shares of common stock registered in the name of a shareholder or held in a shareholder s street-name stock brokerage account at the effective time of the Reverse Split will be converted into one share of common stock;
  - shareholders holding fewer than 2,000 shares of common stock, of record or in a street-name stock brokerage account, will cease to be shareholders and instead will receive a cash payment of $0.13 per share for each Pre-Split Share;
  - shareholders holding more than 2,000 shares of common stock, of record or in a street-name stock brokerage account, will, to the extent their number of shares is not exactly divisible by 2,000 and therefore the Reverse Split would result in a fractional share as well as one or more whole shares, receive instead of the fractional share a cash payment of $0.13 for each Pre-Split Share which became part of the fractional share;
- a forward stock split (the Forward Split) pursuant to which each whole share of common stock outstanding following consummation of the Reverse Split and fractional share payment will be converted into 2,000 shares of common stock.

For example: if you hold 10,000 Pre-Split Shares at the effective time of the Split Transaction, your holdings will remain as 10,000 shares of common stock. If you hold 1,500 Pre-Split Shares at the effective time of the Split Transaction, you would cease to be a shareholder and instead we would pay you $195 cash. If you hold 20,500 Pre-Split Shares at the effective time of the Split Transaction, you would become a holder of 20,000 shares of common stock and we would pay you $65 in cash in lieu of the Reverse Split fractional share.

The Split Transaction would be formally effected by two successive amendments of our Articles of Incorporation. If approved by the shareholders, the Split Transaction will become effective on a weekend as may be determined by the board of directors (the Effective Date). It is anticipated that upon such approval, we would issue a press release giving at least three business days advance notice of the Effective Date, and the Effective Date would occur that weekend. The Reverse Split would occur on the Saturday and the Forward Split would occur on the Sunday. The forms of proposed amendment to the Company s Articles of Incorporation, as amended, necessary to effect the Split Transaction are attached to this proxy statement as Exhibit D.

Any holder of less than 2,000 Pre-Split Shares who desires to retain an equity interest in the Company after the Effective Date may do so by purchasing, in the public market, before the Effective Date, a sufficient number of shares of common stock such that the shareholder holds 2,000 or more Pre-Split Shares. Similarly, holders of more than 2,000 Pre-Split Shares may purchase, in the public market, before the Effective Date, a sufficient number of shares of common stock to top off one s holding so that it becomes exactly divisible by 2,000 so the Reverse Split would not result in an indicated fractional share; that way, none of one s interest in the Company would be cashed out. There can be no assurance that shares will be available for purchase on the public market at an attractive price.

The first proposal is to approve an amendment to the Company s Articles of Incorporation to effect the Reverse Split portion of the Split Transaction.

Vote Required

Approval of this proposal requires the affirmative vote of the holders of the majority of the outstanding shares of common stock, the affirmative vote of the holders of the majority of the outstanding shares of Series C preferred stock, and also the affirmative vote of the holders of the majority of the voting power of all stock

14

entitled to vote. Abstentions (including failures to return consents) and broker nonvotes have the same effect as a negative vote. Outstanding shares of common stock are entitled to one vote each and outstanding shares of Series C preferred stock are entitled to 7,784.52 votes each.

Recommendation of the Board of Directors

The board of directors has unanimously determined that the Split Transaction, including the Reverse Split, is both substantively and procedurally fair to, and in the best interest of, the Company and our shareholders and unanimously recommends a vote FOR the proposal to approve the Reverse Split as described in this proxy statement.

PROPOSAL NO. 2

AMENDMENT OF ARTICLES OF INCORPORATION TO EFFECT A FORWARD STOCK SPLIT

FOLLOWING THE REVERSE SPLIT

As more fully described in Proposal No. 1, the board of directors has authorized and recommends for your approval a Split Transaction comprising the Reverse Split, followed by the Forward Split.

Proposal No. 2 is to approve an amendment to the Company s Articles of Incorporation to effect the Forward Split portion of the Split Transaction following the Reverse Split. The amendment of the Articles to effect the Forward Split is contingent upon shareholder approval of the Reverse Split and will be effected only after completion of the Reverse Split. See Proposal No. 1 for a description of the principal effects of the Split Transaction.

Vote Required

Approval of this proposal requires the affirmative vote of the holders of the majority of the outstanding shares of common stock, the affirmative vote of the holders of the majority of the outstanding shares of Series C preferred stock, and also the affirmative vote of the holders of the majority of the voting power of all stock entitled to vote. Abstentions (including failures to return consents) and broker nonvotes have the same effect as a negative vote. Outstanding shares of common stock are entitled to one vote each and outstanding shares of Series C preferred stock are entitled to 7,784.52 votes each.

Recommendation of the Board of Directors

The board of directors has unanimously determined that the Split Transaction, including the Forward Split, is both substantively and procedurally fair to, and in the best interest of, the Company and our shareholders and unanimously recommends a vote FOR the proposal to approve the Forward Split as described in this proxy statement.

OTHER ISSUES RELATED TO THE SPLIT TRANSACTION

Source of Funds and Financial Effect of the Split Transaction

The costs of the Split Transaction, which include the cash-out payments to be made to shareholders plus about $50,000 for professional fees and other expenses related to the transaction, are not expected to have any material adverse effect on the Company s capitalization, liquidity, results of operations or cash flow. Because the actual number of Pre-Split Shares which will be cashed-out by the Company is unknown at this time, the total cash we would pay to holders is unknown, but is estimated to be about $137,000.

In order to finance the cash payment in lieu of fractional shares, we have entered into an agreement to sell 180 newly issued and unregistered shares of Series C preferred stock to Redwood Holdings, LLC for $180,000 cash. Redwood Holdings, LLC is an affiliate of our controlling shareholder Redwood West Coast, LLC and our directors Thomas A. Donelan and Christopher P. Hendy. Any such sale of Series C preferred stock is contingent upon the shareholder approval of the Split Transaction, and upon the subsequent approval by the board of directors to implement the Split Transaction. This equity investment to maintain our cash levels is required by our lender Comerica Bank as a condition to its waiver of our covenant not to repurchase common stock.

The cash-out payment in lieu of fractional shares could be characterized as a stock redemption violating California Corporations Code Section 500. That section prohibits the redemption of stock unless certain financial tests are met. Under Section 316 of the California Corporations Code, if a redemption is made in violation of Section 500, our directors could be jointly and severally liable to our creditors for the amount of the illegal distribution plus interest and various costs.

Effect of the Split Transaction on the Affiliates

Our affiliates, including executive officers and directors, will participate in the Split Transaction to the same extent as non-affiliates. The affiliates all currently own sufficient shares of common stock (over 2,000 each) or Series C preferred stock so that they will all continue to be shareholders after the effectiveness of the Split Transaction. As with all other remaining shareholders, the percentage ownership by the affiliates of the total outstanding common shares after the Split Transaction may increase slightly or decrease slightly, depending on the size of the indicated fractional share. Notwithstanding this, Redwood Holdings, LLC will in connection with the Split Transaction purchase 180 shares of Series C preferred stock for $180,000 cash. This will increase the percentage ownership of Redwood Holdings, LLC and its affiliates (including Jerry L. Ruyan and our directors Thomas A. Donelan and Christopher P. Hendy) of our common stock, on a beneficial ownership basis, by about 3 percentage points each.

The Split Transaction will have no effect on the rights or preferences of the outstanding Series C preferred stock, nor on any of our stock options or warrants outstanding.

Conduct of the Company s Business After the Split Transaction

We expect our business and operations to continue as they are currently being conducted and, except as disclosed in this document, the Split Transaction is not anticipated to have any material effect upon the conduct of our business. If the Split Transaction is consummated, all persons owning fewer than 2,000 Pre-Split Shares of common stock will no longer have any equity interest in, and will not be shareholders of, the Company and, therefore, will not participate in our future potential or earnings and growth.

We have no current plans or proposals to effect any extraordinary corporate transaction such as a merger, reorganization or liquidation; to sell or transfer any material amount of our assets; to change our board of directors or management; to change materially our indebtedness or capitalization; or otherwise to effect any material change in our corporate structure of business.

Our internal corporate governance practices and our procedures for internal control will remain unchanged, although we generally will not be making any future changes in them as might be mandated for companies subject to the 1934 Act. We will continue to be subject to all provisions of California corporate law.

Receiving Cash Payment In Lieu of Shares

We will not issue any fractional shares in connection with the Split Transaction. Instead, we will pay $0.13 for each such Pre-Split Share to which a fractional share is traceable. We refer to this amount as the Cash-Out

Table of Contents

Price. If the shareholders approve the Split Transaction, and if the board of directors approves the implementation of the Split Transaction, we anticipate that we would issue a press release giving at least three business days advance notice of the Effective Date and the Effective Date would occur that weekend.

All amounts payable to shareholders will be subject to applicable state laws relating to abandoned property (see Escheat Laws below). No brokerage commissions will be payable by shareholders in connection with the Split Transaction. We will not pay interest on cash sums due any shareholder pursuant to the Split Transaction.

Assuming the Split Transaction occurs, as soon as practicable after the Effective Date we will mail a letter of transmittal to each Partially Cashed-Out Shareholder and each Cashed-Out Shareholder. The letter of transmittal will contain instructions for the surrender of the certificate or certificates to our exchange agent in exchange for the Cash-Out Price, and, in the case of the Partially Cashed-Out Shareholders, a new certificate for the post-Forward Split shares which were not cashed out. No cash payment will be made to any shareholder of record until the shareholder of record has surrendered the outstanding certificate(s), together with the letter of transmittal, to our exchange agent. For Partially Cashed-Out Shareholders and Cashed-Out Shareholders whose shares are held in street name, you will not receive a transmittal letter; rather, your cash payment will be sent directly to your nominee. No dissenters or appraisal rights are available under the California Corporations Code, the Company s By-laws or Articles of Incorporation, as amended, to any shareholders (see Other Issues Related to the Split Transaction Dissenters Rights below).

Exchange of Stock Certificates

It is currently anticipated that Mellon Investor Services, LLC will serve as exchange agent to receive stock certificates of Synbiotics Corporation from, and to send cash payments to, our shareholders entitled to receive them. Promptly following the effective date of the Split Transaction, the exchange agent will send a letter of transmittal to each Cashed-Out Shareholder and each Partially Cashed-Out Shareholder, which will describe the procedures for surrendering stock certificate(s) in exchange for the cash consideration and, in the case of the Partially Cashed-Out Shareholders, a new share certificate for the post-Forward Split shares which were not cashed out. Upon receipt of the certificate(s) and properly completed letters of transmittal, the exchange agent will within approximately 20 business days make the appropriate cash payment and, where applicable, deliver the new stock certificate. No interest will accrue on the cash consideration.

PLEASE DO NOT SEND IN ANY STOCK CERTIFICATES AT THIS TIME.

Effective Time

If this proposal is approved by the shareholders and the board of directors decides to proceed with the Split Transaction, the effective time of the Split Transaction will occur on a weekend, after we have given advance notice by press release and after the Secretary of State of the State of California accepts for filing the amendments to the Articles of Incorporation, as amended.

Regulatory Approvals

We are not aware of any material governmental or regulatory approval required for completion of the transaction, other than compliance with the relevant federal securities laws and the corporate laws of California.

Escheat Laws

The unclaimed property and escheat laws of each state provide that under circumstances defined in that state s statutes, holders of unclaimed or abandoned property must surrender that property to the state. Persons whose shares are cashed out and whose addresses are unknown to us, or who do not return their stock certificates

17

Table of Contents

and request payment for their cashed-out shares, generally will have a period of years from the Effective Date in which to claim the cash payment payable to them. For example, with respect to shareholders whose last known addresses are in California, as shown by our records, the period is three years. Following the expiration of that three-year period, the Unclaimed Property Law of California would likely cause the cash payments to escheat to the State of California. For shareholders who reside in other states or whose last known addresses, as shown by our records, are in states other than California, such states may have abandoned property laws which call for such state to obtain either (i) custodial possession of property that has been unclaimed until the owner reclaims it; or (ii) escheat of such property to the state. Under the laws of such other jurisdictions, the holding period or the time period which must elapse before the property is deemed to be abandoned may be shorter or longer than three years. If we do not have an address for the holder of record of the shares, then unclaimed cash-out payments would be turned over to our state of incorporation, the state of California, in accordance with its escheat laws.

Dissenters Rights

No dissenters or appraisal rights are available under the California Corporations Code to shareholders who may wish to dissent from the Split Transaction. There may exist other rights or actions under state law for shareholders who are aggrieved by reverse stock and/or forward stock splits generally, or by cash sales of convertible preferred stock to affiliates. Although the nature and extent of such rights or actions are uncertain and may vary depending upon facts or circumstances, shareholder challenges to corporate action in general are related to the fiduciary responsibilities of corporate officers and directors and to the fairness of corporate transactions. For example, shareholders could, if they deemed such to be applicable, take appropriate legal action against us and our board of directors, and claim that the transaction was unfair to the unaffiliated shareholders, and/or that there was no justifiable or reasonable business purpose for the Split Transaction. Shareholders holding less than 2,000 Pre-Split Shares who want to remain shareholders may purchase a sufficient number of additional shares on the open market in order to hold more than 2,000 Pre-Split Shares prior to the Effective Date of the Split Transaction. Those shareholders who do not desire to remain shareholders may sell a sufficient number of shares such that they hold fewer than 2,000 Pre-Split Shares before the Effective Date of the Split Transaction in order to be cashed out in the Split Transaction. In a similar way, larger shareholders can buy or sell shares before the Effective Date in order to generate a fractional share, which would be cashed out, or to avoid the generation of a fractional share and thus avoid being cashed out to any extent.

MANAGEMENT

Information regarding our board of directors and executive officers is located at Item 10 Directors and Executive Officers of the Registrant of our Annual Report on Form 10-K, which is included as Exhibit A to this proxy statement. No director or executive officer of the Company has, during the past five years, been convicted in a criminal proceeding (excluding traffic violations or similar misdemeanors) or was a party to any judicial or administrative proceeding (except for matters that were dismissed without sanction or settlement) that resulted in a judgment, decree or final order enjoining the person from future violations of, or prohibiting activities subject to, federal or state securities laws, or a finding of violations of such laws. Each director and executive officer is a citizen of the United States, except for Serge Leterme who is a citizen of France.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth the beneficial ownership of each class of our voting stock as of April 7, 2005 of each of our directors, 5% shareholders, each person (the Named Executive Officers) who

was our chief executive officer in 2004;

was serving as an executive officer on December 31, 2004 and was one of the four most highly compensated executive officers whose total 2004 salary and bonus exceeded $100,000; or but for the fact that he was not serving as an executive officer on December 31, 2004, would have been included under the preceding bullet point;

and of our directors and executive officers as a group. Except as noted, and except for the effect of applicable community-property laws, each person has sole investment and voting power over the shares shown. Percentages are calculated using the SEC s beneficial ownership rules and are based on 45,738,152 shares of our common stock assumed outstanding (33,822,033 shares actually outstanding and 11,916,119 assumed outstanding upon conversion of the Series C preferred stock) and 1,531 shares of our Series C preferred stock outstanding as of April 7, 2005. See the first footnote to this table for a statement of the ownership percentage of our common stock without this special assumption.

This table does not include the Split Transaction s effect of cashing out certain shares, nor does it include the anticipated purchase by Redwood Holdings, LLC of 180 shares of Series C preferred stock (which would confer beneficial ownership of 1,401,214 shares of underlying common stock). Such shares are not included either for Redwood Holdings, LLC or its affiliates Messrs. Donelan, Hendy and Ruyan (see footnotes 2, 3 and 6).

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership	Percent of Class
Common Stock:		
Keith A. Butler[1] c/o Synbiotics Corporation 11011 Via Frontera San Diego, CA 92127		
Thomas A. Donelan[1][2][4][6][7] c/o Redwood Holdings, LLC 9468 Montgomery Road Cincinnati, OH 45242	24,042,293	52.3%
Clifford Frank[1] c/o Synbiotics Corporation 11011 Via Frontera San Diego, CA 92127	366,105	*
Paul R. Hays[1][3][5] c/o Synbiotics Corporation 11011 Via Frontera	1,753,701	3.8%

San Diego, CA 92127		
Christopher P. Hendy[(1)(2)(4)(6)(7)] c/o Redwood Holdings, LLC 9468 Montgomery Road Cincinnati, OH 45242	24,253,723	52.7%
Serge Leterme, Ph.D.[(1)] c/o Synbiotics Europe SAS 2 rue Alexander Fleming 69637 Lyon, Cedex 07, France	636,938	1.4%
B. Kent Luther[(1)(3)] c/o Synbiotics Corporation 11011 Via Frontera San Diego, CA 92127	31,250	*

19

Table of Contents

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Ownership	Percent of Class
Redwood West Coast, LLC[(1)(6)] c/o Redwood Holdings, LLC 9468 Montgomery Road Cincinnati, OH 45242	21,796,668	47.6%
Remington Capital, LLC[(4)] c/o Redwood Holdings, LLC 9468 Montgomery Road Cincinnati, OH 45242	250,000	*
Jerry L. Ruyan[(1)(2)(4)(6)(7)] c/o Redwood Holdings, LLC 9468 Montgomery Road Cincinnati, OH 45242	25,553,918	55.8%
All executive officers and directors as a group (7 persons)[(1)(2)(3)(4)(5)(6)(7)]	27,742,407	58.8%
Series C Preferred Stock:		
Thomas A. Donelan[(6)(7)] c/o Redwood Holdings, LLC 9468 Montgomery Road Cincinnati, OH 45242	1,331	86.9%
Paul R. Hays[(5)] c/o Synbiotics Corporation 11011 Via Frontera San Diego, CA 92127	100	6.5%
Christopher P. Hendy[(6)(7)] c/o Redwood Holdings, LLC 9468 Montgomery Road Cincinnati, OH 45242	1,331	86.9%

Redwood Holdings, LLC(7) 9468 Montgomery Road Cincinnati, OH 45242	100	6.5%
Redwood West Coast, LLC(6) 9468 Montgomery Road Cincinnati, OH 45242	1,231	80.4%
Jerry L. Ruyan(6)(7) c/o Redwood Holdings, LLC 9468 Montgomery Road Cincinnati, OH 45242	1,331	86.9%
All executive officers and directors as a group (7 persons)(5)(6)(7)	1,431	93.5%

* Less than one percent.

(1) Excluding the effect of the assumed conversion of the Series C preferred stock, the percentage ownership of the common stock would be as follows: Mr. Butler 0.0%; Mr. Donelan 40.2%; Mr. Frank 1.1; Mr. Hays 5.0%; Mr. Hendy 40.8%; Dr. Leterme 1.9%; Mr. Luther 0.1%; Redwood West Coast, LLC 36.1%; Mr. Ruyan 44.9%; all executive officers and directors as a group (7 persons) 49.2%.

(2) Includes 766,483 shares of common stock held by Redwood Holdings, LLC which were acquired pursuant to elections of Redwood West Coast, LLC to receive shares of common stock in lieu of cash dividends on our Series C Preferred Stock held by Redwood West Coast, LLC, as permitted by the Certificate of

Determination of our Series C preferred stock. As required by its Operating Agreement, Redwood West Coast, LLC directed that the shares of Common Stock be issued directly to its members. Redwood Holdings, LLC received 766,483 shares of our common stock in these distributions. Redwood Holdings, LLC is the owner of record of the 766,483 shares of our common stock. In addition, Redwood Holdings, LLC is the record owner of 100 shares of Series C preferred stock of Synbiotics Corporation. The shares are convertible at any time into such number of shares of common stock determined by dividing each share of Series C preferred stock, valued at $1,000, by the conversion price initially set at $0.12846. Mr. Donelan is a 24.9% beneficial owner, Mr. Hendy is a 24.9% beneficial owner and Mr. Ruyan is a 49.8% beneficial owner of Redwood Holdings, LLC, which has sole voting and dispositive power with respect to the shares. Messrs. Donelan, Hendy and Ruyan disclaim beneficial ownership of these share, except to the extent of their direct pecuniary interest in Redwood Holdings, LLC.

(3) Includes options to purchase our common stock which are exercisable on or before June 6, 2005 as follows: Mr. Hays 950,000 shares; Mr. Luther 31,250 shares.

(4) Includes a warrant to purchase 250,000 shares of our common stock for $0.17 per share held by Remington Capital, LLC. The warrant is exercisable at any time, in whole or in part, through September 1, 2010. Remington Capital, LLC is indirectly owned 100% by Redwood Holdings, LLC. Mr. Donelan is a 24.9% beneficial owner, Mr. Hendy is a 24.9% beneficial owner and Mr. Ruyan is a 49.8% beneficial owner of Redwood Holdings, LLC. Messrs. Donelan, Hendy and Ruyan disclaim beneficial ownership of these shares, except to the extent of their direct pecuniary interest in Redwood Holdings, LLC.

(5) Mr. Hays is the owner of 100 shares of Series C preferred stock of Synbiotics Corporation. The shares are convertible at any time into such number of shares of common stock determined by dividing each share of Series C preferred stock, valued at $1,000, by the conversion price initially set at $0.12846.

(6) Redwood West Coast, LLC is the record owner of 1,231 shares of Series C preferred stock of Synbiotics Corporation. The shares are convertible at any time into such number of shares of common stock determined by dividing each share of Series C preferred stock, valued at $1,000, by the conversion price initially set at $0.12846. Mr. Donelan is a 17.7572% owner of Redwood West Coast, LLC owning 16.7581% individually and 0.9991% through Redwood Holdings, LLC (Mr. Donelan is a 24.9% owner of Redwood Holdings, LLC). Mr. Hendy is a 20.0038% owner of Redwood West Coast, LLC owning 19.0347% individually and 0.9991% through Redwood Holdings, LLC (Mr. Hendy is a 24.9% owner of Redwood Holdings, LLC). Mr. Ruyan is a 56.0053% owner of Redwood West Coast, LLC owning 54.0071% individually and 1.9982% through Redwood Holdings, LLC (Mr. Ruyan is a 49.8% owner of Redwood Holdings, LLC). In addition, Messrs. Donelan, Hendy and Ruyan serve on the Management Committee of Redwood West Coast, LLC, which has sole voting and dispositive power with respect to the shares. Messrs. Donelan, Hendy and Ruyan disclaim beneficial ownership of the shares reflected above, except to the extent of their direct and indirect pecuniary interests in Redwood West Coast, LLC.

(7) Includes 100 shares of Series C preferred stock of Synbiotics Corporation owned by Redwood Holdings, LLC. The shares are convertible at any time into such number of shares of common stock determined by dividing each share of Series C preferred stock, valued at $1,000, by the conversion price initially set at $0.12846. Mr. Donelan is a 24.9% owner of Redwood Holdings, LLC, Mr. Hendy is a 24.9% owner of Redwood Holdings, LLC, and Mr. Ruyan is a 49.8% owner of Redwood Holdings, LLC. Messrs. Donelan, Hendy and Ruyan disclaim beneficial ownership of the shares reflected above, except to the extent of their direct pecuniary interests in Redwood Holdings, LLC.

Table of Contents

PRIOR STOCK PURCHASES BY AFFILIATES

The following table sets forth information regarding purchases of our voting stock by each of our directors and affiliated shareholders:

Quarter Ended	Shares	Type of Stock	Price Range	Average Price
Thomas A. Donelan:				
March 31, 2003	176,668	Common	$ 0.12846	$ 0.12846
June 30, 2003	43,423	Common	$ 0.12846	$ 0.12846
March 31, 2004	37,563	Common	$ 0.44550	$ 0.44550
September 30, 2004	74,559	Common	$ 0.23600	$ 0.23600
December 31, 2004	49,989	Common	$ 0.17600	$ 0.17600
March 31, 2005	68,488	Common	$ 0.12846	$ 0.12846
Paul R. Hays:				
June 30, 2003	1,600,000	Common option	$ 0.08000	$ 0.08000
December 31, 2003	400,000	Common option	$ 0.34000	$ 0.34000
September 30, 2004	100	Series C preferred	$ 1,000.00000	$ 1,000.00000
December 31, 2004	10,653	Common	$ 0.17600	$ 0.17600
December 31, 2004	400,000	Common option	$ 0.14000	$ 0.14000
March 31, 2005	14,596	Common	$ 0.12846	$ 0.12846
Christopher P. Hendy:				
March 31, 2003	214,522	Common	$ 0.12846	$ 0.12846
June 30, 2003	52,727	Common	$ 0.12846	$ 0.12846
March 31, 2004	45,612	Common	$ 0.44550	$ 0.44550
September 30, 2004	84,688	Common	$ 0.23600	$ 0.23600
December 31, 2004	56,779	Common	$ 0.17600	$ 0.17600
March 31, 2005	77,792	Common	$ 0.12846	$ 0.12846
Redwood Holdings, LLC:				
March 31, 2003	476,555	Common	$ 0.12846	$ 0.12846
June 30, 2003	117,133	Common	$ 0.12846	$ 0.12846
March 31, 2004	353,535	Common	$ 0.44550	$ 0.44550
September 30, 2004	17,852	Common	$ 0.23600	$ 0.23600
September 30, 2004	100	Series C preferred	$ 1,000.00000	$ 1,000.00000
December 31, 2004	22,622	Common	$ 0.17600	$ 0.17600
March 31, 2005	30,995	Common	$ 0.12846	$ 0.12846
Jerry L. Ruyan:				
March 31, 2003	694,045	Common	$ 0.12846	$ 0.12846
June 30, 2003	170,591	Common	$ 0.12846	$ 0.12846
March 31, 2004	147,570	Common	$ 0.44550	$ 0.44550
September 30, 2004	240,287	Common	$ 0.23600	$ 0.23600
December 31, 2004	161,101	Common	$ 0.17600	$ 0.17600
March 31, 2005	220,721	Common	$ 0.12846	$ 0.12846

Table of Contents

MARKET FOR COMMON STOCK

Information regarding the market for our common stock is located at Item 5 Market for Registrant s Common Equity, Stockholder Matters and Issuer Purchases of Equity Securities of our Annual Report on Form 10-K, which is included as Exhibit A to this proxy statement.

On April 18, 2005, the last full trading day before we announced the proposed Split Transaction, the closing price for our common stock in the over-the-counter market was $0.07.

On April 7, 2005, the last trading day before the record date, the closing price for our common stock in the over-the-counter market was $0.07.

The market price for our common stock is subject to fluctuation and shareholders are urged to obtain current market quotations.

FINANCIAL AND OTHER INFORMATION

This information is located at Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations ; Item 7A Quantitative and Qualitative Disclosures About Market Risk ; Item 8 Financial Statements and Supplementary Data ; and Item 9 Changes in and Disagreements With Accountants on Accounting and Financial Disclosure of our Annual Report on Form 10-K for the year ending December 31, 2004, which is included as Exhibit A to this proxy statement;. Item 1 Financial Statements , Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations and Item 3 Quantitative and Qualitative Disclosures About Market Risk of our Quarterly Report on Form 10-Q for the quarter ending March 31, 2005, which is included as Exhibit B to this proxy statement; and the pro forma financial information which is included as Exhibit C to this proxy statement.

By order of the Board of Directors

Keith A. Butler

Secretary

Table of Contents

Exhibit A

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

Amendment No. 1

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the year ended December 31, 2004

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number 0-11303

SYNBIOTICS CORPORATION

(Exact name of registrant as specified in its charter)

California	**95-3737816**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
11011 Via Frontera	
San Diego, California	**92127**

(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (858) 451-3771

Securities registered pursuant to Section 12(b) of the Exchange Act: None

Securities registered pursuant to Section 12(g) of the Exchange Act: Common Stock

Preferred Stock Purchase Rights

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and no disclosure will be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ¨ No x

The aggregate market value of the common stock held by non-affiliates of the registrant as of June 30, 2004 was approximately $3,041,000 based on the closing sale price as reported by the NASD over-the-counter bulletin board. Shares of common stock held by each officer, director and holder of 10% or more of the outstanding common stock, if any, have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of March 21, 2005, there were 21,606,126 shares of our common stock outstanding.

Table of Contents

EXPLANATORY NOTE

On April 20, 2005, we filed a Schedule 13-E3 and a preliminary proxy statement with the Securities and Exchange Commission (SEC) pertaining to a proposed going-private transaction. Our Annual Report on Form 10-K for the year ending December 31, 2004 was included as Exhibit A to the preliminary proxy statement. We are amending certain portions of our Form 10-K, originally filed with the SEC on March 22, 2005, in response to comments received from the SEC.

SYNBIOTICS CORPORATION

INDEX

Table of Contents

PART I

Item 1. Business

General

Synbiotics Corporation is a leading provider of rapid diagnostic and laboratory diagnostic products for the animal health care industry. We are one of a small number of companies that focuses exclusively on animal health and we are a major provider of diagnostic products to the animal health market. Our product portfolio consists of 93 diagnostic test kits and detection devices. Many of our products hold strong positions in their specific markets. In recent years we have been moving to refocus our business on our core diagnostics products.

In 2002, we sold our instrument manufacturing operations, which were located in Rome, New York, and we disposed of our PennHIP® business, which was located in Malvern, Pennsylvania.

In 2001, we ended our participation in the veterinary vaccines business.

In 2000, we acquired our poultry diagnostic products business, and we disposed of W3COMMERCE, an Internet marketing services subsidiary.

Market and Product Overview

We sell our products globally to veterinary practices, laboratories and poultry producers. We believe that our current and intended future products will offer veterinarians and other professionals an opportunity to improve the quality and expand the scope of animal health care services.

Our most commercially successful products are our canine heartworm diagnostics (representing 24% of our net sales in 2004 and 2003, and 36%, of our net sales in 2002). We estimate that we have approximately a 15% share of the estimated $30 million U.S. canine heartworm diagnostics market. Sales of these products have historically been strongest during the first half of the year when distributors purchase merchandise to sell to veterinarians for the heartworm season.

Marketing

We sell our products throughout the world. In the United States, we market our line both directly and through independent distributors which, taken together, have approximately 90 outlets, 600 field sales representatives, and 200 telemarketing representatives covering the 25,000 veterinary clinics throughout the country. We also sell directly to laboratories and other centralized facilities. Outside the United States, we sell our small-animal products through distributors, and our food animal products directly to laboratories. We maintain a marketing and sales force, which trains distributor representatives, responds to technical inquiries and promotes products directly to veterinarians, laboratories and poultry producers.

Manufacturing

We manufacture most of our products at our facilities located in San Diego, California and Lyon, France. However, we rely on outside manufacturers for our WITNESS® canine heartworm, feline leukemia and canine parvovirus diagnostic products, and our SCA 2000 instrument products. We manufacture the key biological materials contained in our WITNESS® canine heartworm, feline leukemia and canine parvovirus diagnostic products.

Until early 2003, we relied on Agen Biomedical Limited as the contract manufacturer of our key Witness® products. After Agen terminated the supply agreement, we identified a replacement, U.S.-based contract manufacturer and began the re-introduction of these Witness® products to the market in January 2004.

Table of Contents

Patents and Trade Secrets

We believe that our proprietary technology is an important competitive factor in our business, and that protection of our intellectual property rights is a high priority. The basic hybridoma (the cell that produces the monoclonal antibody) technology is in the public domain and is therefore not patentable. However, numerous improvements, variations and applications of hybridoma technology may prove to be patentable. Considering the difficulty of enforcing any patent rights to such improvements, and the rapid advancements in the field, we generally seek, and will continue to seek, to protect our interests by treating our particular variations in the production of monoclonal antibodies as trade secrets. We also pursue, and intend to continue to aggressively pursue, protection for new products, new methodological concepts, and compositions of matter through the use of patents where obtainable. At present, we have been granted 8 U.S. patents. In fact, in 2004 we successfully settled litigation with Agen pertaining to our heartworm detection patent; in 2003 we successfully settled litigation with Heska Corporation pertaining to our heartworm detection patent. This patent expires in December 2005.

Government Regulation

Most diagnostic test kits for animal health applications marketed in the U.S. require approval by the United States Department of Agriculture (USDA). Certain foreign countries in which we market our diagnostic products also require governmental approval for animal diagnostic products. Our instrumentation products are not subject to USDA regulation. Our canine semen freezing products and canine ovulation timing diagnostic products fall within the definition of devices as that term is defined in the Federal Food, Drug, and Cosmetic Act and, therefore, may be subject to regulation by the FDA.

Our manufacturing facilities in San Diego and Lyon, France are licensed by the USDA and adhere to Good Manufacturing Practices (GMP) standards. Our French manufacturing facility, which is ISO 9002 certified, is not licensed by any foreign regulatory agency as there is no licensing requirement. The manufacturing facilities of our important suppliers are subject to licensing and regulatory approval in both the United States and Europe.

In addition to the foregoing, our operations may be subject to future legislation and/or rules issued by domestic or foreign governmental agencies with regulatory authority relating to our business.

Competition

We are a major provider of diagnostic products to the animal health market. Most of our competitors are either small divisions of larger human health and chemical companies or smaller companies that sell veterinary products while trying to diversify into the higher profile, and more regulated, human health field. The principal competitor in the industry is IDEXX Laboratories, Inc., a publicly traded company with annual revenues of $549,000,000 (for 2004) that develops, manufactures, and distributes detection and diagnostic products for animal health, food, and environmental testing applications.

The market for animal health care products is extremely competitive. Companies in the animal health care market compete to develop new products, to market and manufacture products efficiently, to implement effective research strategies, and to obtain regulatory approval. Our current competitors include IDEXX Laboratories, a significantly larger company, Heska Corporation, to whom we granted a non-exclusive license of our canine heartworm patent in 2003, and Agen Biomedical Limited, to whom we granted a non-exclusive license of our canine heartworm patent in 2004, the former contract manufacturer of certain of our WITNESS® diagnostic products. These companies have greater financial, manufacturing, marketing, and research resources than we do. In addition, IDEXX Laboratories prohibits its distributors from selling competitors products, including ours. Further, additional competition could come from new entrants to the animal health care market. We cannot assure you that we will be able to compete successfully in the future or that competition will not harm our business.

Our core canine heartworm diagnostic products can be subject to significant additional competition, affecting both our market share and our average selling price. We sued Heska for infringing our patent; the suit was settled in 2003 and Heska agreed to pay us a royalty. We also sued Agen, which entered the U.S. market in 2003, for infringing our patent; the suit was settled in 2004 and Agen agreed to pay us a royalty. However, our

Table of Contents

patent expires in December 2005. Despite expiration of the patent, the biological component of our in-clinic canine heartworm diagnostic test is proprietary to us; however, pursuant to our settlement with Agen, we supply Agen with our biological materials for their competing tests in this area and in the canine parvovirus area.

Research and Development

We spent approximately $1,486,000 and $1,177,000 on research and development activities during the years ended December 31, 2004 and 2003, respectively. These figures include both internal research and development and expenditures under contracts for research and development activities with outside parties relating to certain veterinary diagnostic products which utilize licensed technology.

Employees

As of December 31, 2004, we had a total of 96 employees worldwide, 93 of whom were full-time. In March 2005, we effected a two-person reduction in force at SBIO-E.

Raw Materials

The manufacturing of diagnostics and diagnostic instruments requires raw materials which generally are, and have been, readily available from several sources, or which (in the case of certain proprietary biological materials) we culture ourselves.

Financial Information About Industry Segments and Financial Information About Foreign and Domestic Operations and Export Sales

See Note 14 to our financials statements in Item 8 of Part II of this Form 10-K.

Item 2. Properties

We lease two buildings in San Diego, California. The buildings contain approximately 42,000 square feet of space, and house our corporate and sales headquarters, executive offices, U.S. research and development laboratories and manufacturing facilities. We also lease an approximately 25,000 square foot building in Lyon, France which houses Synbiotics Europe s (SBIO-E) corporate and sales headquarters, executive offices, research and development laboratories and manufacturing facilities. In addition, we lease a small research office in College Park, Maryland.

We believe that these facilities are adequate for our current level of operations.

Item 3. Legal Proceedings

None.

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

The Annual Meeting of Shareholders was held on October 7, 2004. The following matters were submitted to a vote, with the results below:

(a) Election of directors:

Nominee	For	Withheld
Thomas A. Donelan	36,746,936	698,908
Paul R. Hays	36,727,791	718,053
Christopher P. Hendy	36,727,271	718,573

(b) Approval of the 2004 Stock Option/Stock Issuance Plan:

For	Against	Abstain	Broker Non-Votes
28,144,839	1,197,937	73,695	8,029,373

Table of Contents

PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock is quoted in the over-the-counter market under the symbol SBIO. Price ranges reported are the high and low sale price information as reported by the over-the-counter market, or, in some periods, the NASD s OTC Bulletin Board. All such market quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission. As of March 21, 2005, there were approximately 567 shareholders of record of our common stock.

Year	Quarter	High	Low
2003	1st Quarter	$ 0.09	$ 0.07
	2nd Quarter	$ 0.20	$ 0.06
	3rd Quarter	$ 0.19	$ 0.11
	4th Quarter	$ 0.93	$ 0.13
2004	1st Quarter	$ 0.61	$ 0.31
	2nd Quarter	$ 0.44	$ 0.21
	3rd Quarter	$ 0.27	$ 0.10
	4th Quarter	$ 0.22	$ 0.12

We have never paid cash dividends on our common stock and do not expect to do so in the foreseeable future. In addition, the terms of our bank loan and of our Series C preferred stock restrict our ability to pay any cash dividends on our common stock.

Item 6. Selected Financial Data

	Year Ended December 31,				
	2004	2003	2002	2001	2000
	(In Thousands, Except Per Share Data)				
Consolidated Statement of Operations Data:					
Total revenues	$ 19,219	$ 19,211	$ 21,671	$ 26,532	$ 29,738
(Loss) income from continuing operations	(647)	1,287	(6,862)	626	(13,193)
Net (loss) income	(647)	1,287	(14,401)	431	(18,518)
Basic (loss) income per share:					
(Loss) income from continuing operations	(0.04)	0.06	(0.48)	0.06	(1.43)
Net income (loss)	(0.04)	0.06	(1.00)	0.04	(2.00)
Diluted (loss) income per share:					
(Loss) income from continuing operations	(0.04)	0.03	(0.48)	0.06	(1.43)
Net (loss) income	(0.04)	0.03	(1.00)	0.04	(2.00)

	December 31,

	2004	2003	2002	2001	2000
			(In Thousands)		
Consolidated Balance Sheet Data:					
Total assets	$ 15,522	$ 15,341	$ 15,436	$ 26,502	$ 32,202
Long-term obligations	5,148	2,134	6,478	10,943	7,508

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

The information contained in this Management s Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Annual Report on Form 10-K contains both historical financial information and forward-looking statements. Forward-looking statements are characterized by words such as

Table of Contents

intend , plan , believe , will , would , etc. Historical financial information may not be indicative of future financial performance. In fact, future financial performance may be materially different than the historical financial information presented herein. Moreover, the forward-looking statements about future business or future results of operations are subject to significant uncertainties and risks, including those detailed under the caption Certain Risk Factors , which could cause actual future results to differ materially from what is suggested by the forward-looking information.

Overview

We are still working to recover from the effects of our cash crisis in 2002. Our auditors report on our 2004 financial statements contains a going-concern explanatory paragraph a statement that there is substantial doubt about our ability to continue as a going concern. Our total revenues and net sales have been declining annually since 2000, although they were essentially flat in 2004 from 2003. We believe that our operations have stabilized and that, with continued attention to steady and careful execution of our turnaround business plan, we can increase shareholder value.

Our main challenge in 2005 will be to resolve our unsecured contractual obligations of $1,000,000 due in July 2005 and $1,500,000 due in July 2006, both to the same unrelated third party. We cannot afford to make these payments as scheduled. If we miss the July 2005 payment, the entire obligation will be accelerated and will begin bearing interest at 10.5%.

In September 2004, we successfully resolved a similar situation, where we were unable to pay at maturity the remaining $4,804,000 principal amount of our loan from Comerica Bank. The resolution involved extension and amendment of the loan terms and the sale by Comerica of most of the loan to a company affiliated with Redwood West Coast, LLC, our majority shareholder.

The profitability of our canine heartworm diagnostic products has diminished due to competition from new entrants to the in-clinic canine heartworm diagnostics market, Heska and Agen. We believe their products infringed our U.S. patent in this area, and we separately sued them for patent infringement. Although we incurred significant litigation costs, the final settlements of these cases in 2003 and 2004 did not include barring their products from the market. Agen s distributor appears to be following a price-cutting strategy, so this new competition is adversely affecting both our market share and our average selling price. In any event, our U.S. patent in this area expires in December 2005, and after then we would be unable to prevent any further additional competitors from entering this market.

We believe our results in 2005 and thereafter will benefit if we can avoid the heavy patent litigation expense we experienced in 2002, 2003 and, particularly, 2004. We currently are not involved in any litigation.

Our management and board of directors are beginning to explore a possible transaction that would result in our ceasing to be subject to SEC filing and reporting requirements. This possible transaction is a reverse stock split in which shareholders who do not hold a minimum number of shares of our common stock would have their shares converted into cash. Such a transaction would also result in a slight increase in the equity ownership of our shareholders whose shares are not converted into cash.

We have been monitoring the costs of operating as a publicly reporting company to determine whether, in our judgment, the direct and indirect costs outweigh the benefits to us and our shareholders. We incur significant costs associated with being a publicly traded company. Among other things, these costs include legal fees and audit fees (including fees for quarterly reviews performed by our auditors). In 2004, we began incurring the direct and indirect costs associated with Sarbanes-Oxley Act Section 404 compliance, and these will add significantly to our costs. The expenses associated with implementing the additional processes and procedures necessary for Section 404 compliance, which was originally to take effect for our fiscal year 2005 but has now

Table of Contents

been delayed by the SEC until our fiscal year 2006, and the required attestation of those controls have been estimated to be equal to the entire cost of the fiscal 2004 year-end audit. Moreover, Section 404 compliance will inevitably result in a diversion of management time and attention from other duties.

We have not reached any conclusion about whether the costs of being a publicly traded SEC reporting company outweigh the benefits, but as noted above we are evaluating a possible transaction the effect of which would be that we would no longer remain an SEC reporting company. Any such transaction would be designed to result in our having less than 300 stockholders of record, making us eligible to cease making SEC filings, such as annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and proxy statement disclosures, as well as our not having to comply with Section 404. While there would be a one-time cost to this transaction, which would be subject to shareholder approval, we believe that the decrease in ongoing direct costs would be approximately $150,000 per year.

If we decide to do a transaction as described above, public trading in our common stock, which is currently traded over-the-counter, would effectively become impossible after we opted out of our SEC filing obligations, due to the lack of publicly available information about us such as financial statements.

Results of Operations

Year Ended December 31, 2004 Compared to Year Ended December 31, 2003

Our net sales for 2004 decreased by $59,000 or less than 1% from 2003. The decrease reflects a decrease in our diagnostic product sales of $613,000 offset by an increase in our instrument product sales of $554,000, and also reflects a 10% increase in foreign currency exchange rates which affects the consolidation of SBIO-E and itself added $638,000 to our 2004 revenues. Sales of our diagnostic products decreased primarily due to additional competition in the canine heartworm diagnostic market from Agen Biomedical Ltd. (Agen), as well as disappointing performance at SBIO-E. Agen s in-clinic canine heartworm diagnostic product is similar to our Witness® canine heartworm diagnostic test kit. Our instrument product sales increased primarily due to increased placements of our SCA 2000 blood coagulation timing instrument and the resulting sales of the related consumables, as well as increases in the average selling prices of the consumables.

Agen is currently distributing its products in the U.S. through Vedco, a co-operative buying group. Several of the member-owners of this buying group also distribute our canine heartworm and other products, but have decided to promote Agen s canine heartworm product instead of ours. Additionally, Agen s distributors marketed the canine heartworm product with a price which is significantly less than previously established prices in this market. As a result, we have been forced to compete on price and our average selling price for our Witness® canine heartworm product during 2004 was 16% less than that during 2003. We do not believe that this price erosion will be easily reversed, especially after our U.S. canine heartworm detection patent expires in late 2005.

In April 2003, Agen terminated its supply agreement with us. Agen had been our contract manufacturer for certain of our Witness® in-clinic diagnostic products including canine heartworm, feline leukemia, feline heartworm and canine parvovirus, using key biological components which we manufacture at our facilities and had provided to Agen. We then identified a U.S.-based alternate contract manufacturer of the same Witness® products previously manufactured for us by Agen. We licensed the alternate-source Witness® canine heartworm product with the USDA, and we began selling this product in January 2004. We licensed the alternate-source Witness® feline leukemia product with the USDA, and began selling this product in August 2004. Our alternate-source canine parvovirus product was licensed by the USDA, and we began selling this product, in February 2005. In addition to the material impact during 2004, we also believe that our results of operations and financial condition could be materially adversely affected in 2005 and beyond if we are unable to fully succeed in reintroducing the alternate-source products into the market.

In December 2004, one of our distributor customers placed an order totaling $546,000, which was shipped and invoiced in December 2004. The order represented approximately 50% of the customer s prior twelve months purchases. We believe that due to the size of the order, the customer will not be placing any significant

Table of Contents

orders with us during the first quarter of 2005. Because the heartworm selling season straddles December and the first part of the next year, our year-to-year periodic results often vary as a result of such timing differences.

We recognize revenue from product sales when title and risk of loss transfers to our customer, which is generally upon shipment. Amounts we charge to our customers for shipping and handling are included in our net sales. We provide promotional discounts and rebates to certain of our distributors. Based upon the structure of these rebate programs and our past history, we are able to accurately estimate the amount of rebates at the time of sale. These rebates are recorded as a reduction of our net sales. We recognize license fee revenue ratably over the license term when we have further performance obligations to our licensee. In the event that we have no further performance obligations to our licensee, we recognize license fee revenue upon receipt.

Our cost of sales as a percentage of our net sales was 48% during 2004 as compared to 49% during 2003. The decrease is due to improved margins on our Witness® canine heartworm diagnostic and feline leukemia products due to a change in contract manufacturers (offset by decreased selling prices), and on our SCA 2000 consumables due to increased selling prices. A significant portion of our manufacturing costs are fixed.

Among our major products, our DiroCHEK® canine heartworm diagnostic products and our poultry products are manufactured at our facilities, whereas our WITNESS® in-clinic canine heartworm, feline leukemia, and canine parvovirus diagnostic products and our SCA 2000 instrument products are manufactured by third parties. We manufacture the key biological materials contained in our WITNESS® canine heartworm, feline leukemia and canine parvovirus diagnostic products. In addition to affecting our gross margins, outsourcing of manufacturing renders us relatively more dependent on the third-party manufacturers. Agen, the previous contract manufacturer of certain of our Witness® products, ceased to supply us with those products In April 2003. We then identified a U.S.-based alternate contract manufacturer of the same Witness® products previously contract manufactured for us by Agen, and the cost of these products to us is lower than the cost of those contract manufactured for us by Agen. However, we lost substantial sales during the hiatus between the two contract manufacturers. In 2004 we incurred costs to re-license the in-clinic feline leukemia and canine parvovirus diagnostic products with the USDA, and we incurred costs in 2003 to re-license the in-clinic canine heartworm diagnostic product with the USDA.

Our research and development expenses increased by $309,000 or 26% during 2004 as compared to 2003. The increase is a result of a $103,000 increase in research and development expenses contracted by us from a third party, and increase of $68,000 in laboratory supplies, and $56,000 directly reflecting an increase in foreign currency exchange rates over 2003 of 10%. The increase in the foreign currency exchange rates affects the consolidation of SBIO-E. Our research and development expenses as a percentage of our net sales were 8% and 6% during 2004 and 2003, respectively.

Our selling and marketing expenses did not change significantly during 2004 as compared to 2003. Our selling and marketing expenses as a percentage of our net sales were 22% during 2004 and 2003.

Our general and administrative expenses increased $2,139,000 or 61% during 2004 as compared to 2003. The increase is primarily due to $1,314,000 of legal expenses associated with our lawsuit with Agen. We hope to minimize legal expenses in 2005, and we are not currently involved in any litigation. In addition, an extra $158,000 of our 2004 general and administrative expenses were simply due to an increase in foreign currency exchange rates over 2003 of 10%. The increase in the foreign currency exchange rates affects the consolidation of SBIO-E. Our general and administrative expenses as a percentage of our net sales were 30% and 18% during 2004 and 2003, respectively.

In December 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123R, Share-Based Payments (FAS 123R). FAS 123R is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation , and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees and its related implementation guidance.

Table of Contents

FAS 123R requires that the cost of all awards of equity instruments made to employees in exchange for employment services be recorded at fair value on the grant date, and the cost be charged to expense as the award vests. The determination of fair value is based upon option-pricing models (for example, Black-Scholes) adjusted for characteristics unique to the equity instrument.

We will be required to charge to expense the fair value of employee stock options which vest on or after July 1, 2005, and we expect to record compensation expense related to unvested employee stock options outstanding as of December 31, 2004, as follows: 2005 $33,000; 2006 $67,000; 2007 $46,000; 2008 $9,000.

In September 2003, we filed a lawsuit against Agen alleging that Agen infringed a patent owned by us relating to canine heartworm diagnostic technology. In June 2004, we entered into a settlement agreement with Agen which resolved all outstanding claims in the lawsuit. As part of the agreement, each party licensed certain intellectual property rights from the other party, including Agen licensing from us the patent relating to the canine heartworm diagnostic technology, and we received $425,000 in June 2004, and we will receive $425,000 in June 2005. As a result, we recorded a one-time credit to operating expenses totaling $850,000 during 2004. In addition, we agreed that we will continue to supply certain proprietary biologicals to Agen at specified prices, and we will receive a percentage of Agen s sales of Agen products containing the supplied biologicals. The Agen products compete directly with similar products of ours in the marketplace.

In November 1998, we filed a lawsuit against Heska Corporation alleging that Heska infringed a patent owned by us relating to heartworm diagnostic technology. In March 2003, we entered into settlement and license agreements with Heska which resolved all outstanding claims in the lawsuit. As part of those agreements, each party has licensed certain intellectual property rights from the other party, including Heska licensing from us the patent relating to the heartworm diagnostic technology. In addition, we received $250,000 in April 2003, and we are receiving $265,000 in 24 monthly installments of $11,000 beginning in January 2004. As a result, we recorded a one-time credit to operating expenses totaling $515,000 during 2003. In addition, Heska agreed to make royalty payments to us on its sales of licensed canine heartworm diagnostic products beginning April 2003, until our patent expires in December 2005.

As a result of these settlement agreements, our royalty income during 2004 increased by $67,000 or 17% as compared to 2003. Any future royalty income will, of course, depend on the other companies net sales, which tend to be at the expense of our own product sales; also, depressed pricing in the market will tend to reduce the other companies net sales and thus reduce our future royalty income.

Our net interest expense decreased by $46,000 or 9% during 2004 as compared to 2003. The decrease is due to decreases in the outstanding principal balance of our bank debt, and due to the restructuring of our bank debt in September 2004.

We recognized a benefit from income taxes of $60,000 during 2004 as compared to a benefit from income taxes of $2,000 during 2003. The change is due primarily to an $84,000 deferred foreign tax benefit related to SBIO-E in 2004, offset by current foreign income tax expense related to SBIO-E during 2004 and minimum state income taxes in 2004.

A review of our business, in light of the market, reveals that our food animal diagnostics are not meeting their relative geographic sales potentials. Food animal diagnostics measure the health of herds or flocks and provide information for the economic management of herds or flocks. We currently manufacture all our poultry products at our San Diego, California facility and the majority of our livestock products at our Lyon, France facility. Both lines perform better in their local markets. Our intent is to better internationalize those portfolios. We are also developing, both internally and through in-licensing arrangements, new food animal diagnostic products that would expand and enhance our existing product line. These growth opportunities will necessitate additional expenses in research and development as well as improved marketing to effectively target this market

if the development projects come to fruition successfully. In March 2005, we effected a two-person reduction in force at SBIO-E, in part as a result of this review. The reduction in force related to senior management positions. Due to severance costs associated with this reduction in force, the impact on our 2005 results of operations will be negligible. The savings from the reduction in force will be more readily evident in our 2006 results of operations.

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002

Our net sales for 2003 decreased by $2,557,000 or 12% from 2002. The decrease reflects a decrease in our diagnostic product sales of $2,858,000 offset by an increase in our instrument product sales of $301,000. Sales of our diagnostic products decreased due to the termination by Agen of our supply agreement under which Agen supplied us with certain of our Witness® diagnostic products, as discussed below, leaving us with no inventory of these products for over half the year. Our instrument product sales increased primarily due to increased placements of our SCA 2000 blood coagulation timing instrument, and the resulting sales of the related consumables.

In April 2003, we were notified by Agen that Agen was terminating its supply agreement with us due to late payment of invoices for test kits. Agen had been the contract manufacturer for certain of our Witness® in-clinic diagnostic products including canine heartworm, feline leukemia, feline heartworm and canine parvovirus, using key biological components which we manufacture at our facilities and had provided to Agen. These Witness® products represented $4,345,000 and $8,069,000 of our net sales during 2003 and 2002, respectively.

We identified a U.S.-based alternate contract manufacturer of the same Witness® products previously manufactured for us by Agen and began the process of licensing the alternate-source Witness® products with the USDA.

Agen introduced into the U.S. market in October 2003 a canine heartworm diagnostic product which is essentially identical to our Witness® canine heartworm diagnostic test kit, including biological components which incorporate our patented technology. In September 2003, we filed a patent infringement lawsuit against Agen claiming that Agen has willfully infringed our U.S. Patent No. 4,789,631 pertaining to heartworm detection technology. In addition to seeking damages, we asked for an injunction against Agen, preventing Agen from importing, selling or offering for sale their canine heartworm diagnostic test kit in the United States. The lawsuit was ultimately settled in June 2004.

Our cost of sales as a percentage of our net sales was 49% during 2003 and 2002. The preservation of margin despite reduced sales was heartening, because a significant portion of our internal manufacturing costs are fixed. Among our major products, our DiroCHEK® canine heartworm diagnostic products and our poultry products are manufactured at our facilities, whereas our WITNESS® in-clinic canine heartworm, feline leukemia, and canine parvovirus diagnostic products and our SCA 2000 instrument products are manufactured by third parties. We manufacture the key biological materials contained in our WITNESS® canine heartworm, feline leukemia and canine parvovirus diagnostic products. In addition to affecting our gross margins, outsourcing of manufacturing renders us relatively more dependent on the third-party manufacturers. Agen, the previous contract manufacturer of certain of our Witness® products, ceased to supply us with those products In April 2003. We identified a U.S.-based alternate contract manufacturer of the same Witness® products previously contract manufactured for us by Agen, and the cost of these products to us is lower than the cost of those contract manufactured for us by Agen. In 2003 we also incurred costs to re-license these products with the USDA.

Our research and development expenses decreased by $203,000 or 15% during 2003 as compared to 2002. The decreases are a result of a cost reduction program that was implemented at the end of the third quarter of 2002, offset by costs incurred 2003 related to the re-launching of our Witness® canine heartworm product. Our research and development expenses as a percentage of our net sales were 6% during 2003 and 2002.

11

Table of Contents

Our selling and marketing expenses decreased $228,000 or 5% during 2003 as compared to 2002. The decreases are a result of a cost reduction program, including reductions in headcount, that were implemented at the end of the third quarter of 2002. Our selling and marketing expenses as a percentage of our net sales were 22% and 20% during 2003 and 2002, respectively.

Our general and administrative expenses decreased by $5,283,000 or 60% during 2003 as compared to 2002. The decrease during 2003 was primarily attributable to the non-recurrence of $3,682,000 of retention bonuses that became payable in the first quarter of 2002. The decrease was also attributable to a cost reduction program, including reductions in headcount, that was implemented at the end of the third quarter of 2002, and favorable effects of foreign currency exchange rates on our intercompany balances. 2002 expenses were also higher due to severance costs for three senior officers, including our former chief executive officer. Our general and administrative expenses as a percentage of our net sales were 19% and 41% during 2003 and 2002, respectively. Excluding the first quarter 2002 bonus expense our general and administrative expenses would have been $5,090,000 or 24% of our net sales during 2002.

In 2003 we incurred $421,000 of litigation expenses related to the Agen and Heska lawsuits. Our litigation expenses in 2002 were $161,000, all for the Heska lawsuit.

In November 1998, we filed a lawsuit against Heska Corporation alleging that Heska infringed our U.S. Patent No. 4,789,631 relating to heartworm diagnostic technology. In March 2003, we entered into settlement and license agreements with Heska which resolved all outstanding claims in the lawsuit. As part of those agreements, each party has licensed certain intellectual property rights from the other party, including Heska licensing from us the patent relating to the heartworm diagnostic technology. In addition, we received $250,000 in April 2003, we will receive $265,000 in 24 monthly installments of $11,000 beginning in January 2004. As a result, we recorded a one-time credit to operating expenses totaling $515,000 during 2003. We receive royalty payments on sales of licensed canine heartworm diagnostic products beginning April 2003. We recognized royalty income related to this license totaling $277,000 during 2003.

Our net interest expense decreased by $177,000 or 26% during 2003 as compared to 2002. The decrease was due to decreases in the prime rate, and to decreases in the outstanding principal balances of our bank debt.

We recognized a benefit from income taxes of $2,000 during 2003 as compared to a provision for income taxes of $7,000 during 2002. We are limited in the utilization of certain of our Federal and state net operating loss carryforwards. As a result of this limitation, $15,351,000 of our Federal net operating loss carryforwards, and $969,000 of our state net operating loss carryforwards, may expire before they can be utilized. In addition, California placed a moratorium on the utilization of net operating loss carryforwards for 2003.

In the first quarter of 2002, we adopted Statement of Financial Accounting Standards No. 142 (FAS 142), Goodwill and Other Intangible Assets . In connection with the adoption of FAS 142, we performed a transitional goodwill impairment assessment. As a result of this impairment assessment, we recorded an impairment of $7,649,000, net of income tax benefit of $106,000, which is classified as a cumulative effect of a change in accounting principle in the first quarter of 2002. FAS 142 requires that we perform subsequent impairment assessments on an annual basis, or on an interim basis if events occur that may cause an impairment of our goodwill and other intangible assets. In 2002, as a result of the annual assessment based upon the market price of the our common stock on December 31, 2002, we recorded an additional impairment loss of $2,877,000. Based upon the market price of the Company s common stock on December 31, 2003, there was no impairment loss resulting from the annual impairment assessment in 2003.

Table of Contents

Financial Condition and Liquidity

The following table summarizes the future cash payments related to our contractual obligations (other than trade payables) as of December 31, 2004 (amounts are in thousands):

	Total	2005	2006	2007	2008	2009	Thereafter
Long-term debt	$ 4,381	$ 546	$ 542	$ 390	$ 343	$ 371	$ 2,189
Operating leases	4,833	956	766	524	414	414	1,759
Other long-term obligations	2,500	1,000	1,500				

On September 23, 2004, we entered into an amendment (the Credit Agreement Amendment) of our credit agreement with Comerica Bank (Comerica), effective as of September 1, 2004. Our note to Comerica had matured on January 25, 2004, but we were unable to pay the matured amount and instead we commenced negotiations which ultimately led to the Credit Agreement Amendment. The outstanding principal balance of our bank debt immediately prior to the Credit Agreement Amendment was $4,472,000. Under the Credit Agreement Amendment, we issued an amended promissory note to Comerica in the amount of $599,000 (the Comerica Note), and Comerica sold the remaining principal of $3,873,000 to Remington Capital, LLC (Remington), which is an affiliate of Redwood West Coast, LLC, our majority shareholder. We simultaneously issued an amended promissory note to Remington in the amount of $3,873,000 (the Remington Note).

The Comerica Note bears interest at the rate of prime plus 2%, and is payable in monthly installments, from October 1, 2004 to August 1, 2007, of $9,000 plus accrued interest (except the payments due on September 1, 2005 and 2006 are in the amount of $151,000 plus accrued interest). The Remington Note, which is subordinate to the Comerica Note, bears interest at the fixed rate of 7.75%, and is payable in blended monthly installments of principal and interest, from September 25, 2004 to August 25, 2014, of $46,000. Both the Comerica Note and the Remington Note are secured by substantially all of our assets.

Pursuant to the Credit Agreement Amendment, we issued to both Comerica and Remington warrants to purchase 250,000 shares of our unregistered common stock at an exercise price of $0.17 per share. The warrants are exercisable at any time through September 1, 2010.

In addition, on September 2, 2004, we entered into a Series C Purchase Agreement (the Series C Agreement) with Redwood Holdings, LLC, Paul Hays and Fintan and Janice Molloy. Under the Series C Agreement, simultaneously with the closing under the Credit Agreement Amendment, we sold to the above named parties a total of 250 newly-issued shares of unregistered Series C preferred stock for consideration totaling $250,000 in cash. Redwood Holdings, LLC and Mr. Hays each received 100 shares at the September 23, 2004 closing, and Mr. and Mrs. Molloy received 50 shares at the September 23, 2004 closing. Each share of Series C preferred stock is convertible at any time into 7,785 unregistered shares of our common stock (subject to anti-dilution adjustments).

On October 3, 2004, we sold to an unrelated third party 50 newly-issued shares of our unregistered Series C preferred stock for consideration totaling $50,000 in cash. Each share of Series C preferred stock is convertible at any time into 7,785 unregistered shares of our common stock (subject to anti-dilution adjustments).

Remington is indirectly owned 100% by Jerry L. Ruyan, Thomas A. Donelan and Christopher P. Hendy (collectively Redwood). Redwood also owns 94% of the remaining 2,800 shares of our Series C preferred stock originally outstanding and is our controlling shareholder. Mr. Donelan and Mr. Hendy, two of the three members of our board of directors, each own 24.9% of Redwood Holdings, LLC. Mr. Hays is our President and Chief Executive Officer, and is also a member of our board of directors.

As of December 31, 2004, we had working capital of $4,943,000. We have a $1,000,000 contractual obligation due in July 2005, and another $1,500,000 contractual obligation, to the same party, due in July 2006.

Table of Contents

We do not believe that our cash position will be sufficient to fund our operations and service our bank debt for the next twelve months if we also pay the $1,000,000 contractual obligation when it becomes due. The contractual obligation is unsecured. In the event that we do not make the payment when it comes due, the $1,500,000 due in July 2006 becomes immediately due, and the entire $2,500,000 will begin bearing interest at 10.5%. We plan on approaching the party to whom we owe these contractual obligations in an effort to enter into a payment arrangement; however, there can be no assurance that any such renegotiation will be successful. As a result, we may well require additional financing in the future, and there can be no assurance that such financing would be available to us on favorable terms, or at all. Because our stock price is low, any equity financing would significantly dilute current shareholders.

Our operations are moderately seasonal due to the sales of our canine heartworm diagnostic products. Our sales and profits have historically tended to be concentrated in the first half of the year, as our distributors prepare for the heartworm season by purchasing diagnostic products for resale to veterinarians. The operations of SBIO-E have reduced our seasonality as sales of their large animal diagnostic products tend to occur evenly throughout the year. In addition, sales of our SCA 2000 instruments and supplies and our poultry diagnostic products reduce our seasonality.

Certain Risk Factors

Our future operating results are subject to a number of factors, including:

We have a short-term obligation that we cannot afford to pay in accordance with it terms; we may need additional capital in the future

Our auditors report on our 2004 financial statements contains a going-concern explanatory paragraph.

As of December 31, 2004, we had working capital of $4,943,000. We have a $1,000,000 contractual obligation due in July 2005, and another $1,500,000 contractual obligation, to the same unrelated party, due in July 2006. We do not believe that our current working capital will be sufficient to fund our operations and service our bank debt for the next twelve months if we also pay the $1,000,000 contractual obligation when it becomes due. The contractual obligation is unsecured. In the event that we do not make the payment when it comes due, the $1,500,000 due in July 2006 becomes immediately due, and the entire $2,500,000 will begin bearing interest at 10.5%. We plan to renegotiate this unsecured debt; however, there can be no assurance that any such renegotiation will be successful. As a result, we may well require additional financing in the future, and there can be no assurance that such financing would be available to us on favorable terms, or at all. Because our stock price is low, any equity financing would significantly dilute current shareholders. We may also need to raise additional funds if our estimates of revenues, working capital and/or capital expenditure requirements change or prove inaccurate or in order for us to respond to unforeseen technological or marketing hurdles or to take advantage of unanticipated opportunities.

Further, our future capital requirements will depend on many factors beyond our control or ability to accurately estimate, including continued scientific progress in our product development programs, the cost of manufacturing scale-up, the costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims, competing technological and market developments, and the cost of establishing effective sales and marketing arrangements. Such funds may not be available at the time or times needed, or available on terms acceptable to us. If adequate funds are not available, or are not available on acceptable terms, we may not be able to take advantage of market opportunities, to develop new products, or to otherwise respond to competitive pressures. This inability could materially harm our business.

If we are unable to fully succeed in responding to competition in the canine heartworm market and in other business, it could also hinder our ability to obtain any other necessary additional capital and/or create sooner the need to obtain financing.

Table of Contents

We may be unable to fully succeed in reintroducing our key Witness® products

Agen was the contract manufacturer of certain of our Witness® in-clinic diagnostic products, and Agen ceased supplying these products in April 2003. We have licensed the alternate-source Witness® canine heartworm, feline leukemia virus and canine parvovirus products with the USDA (now supplied by another contract manufacturer), and we began selling the canine heartworm product in January 2004, the feline leukemia virus product in August 2004 and the canine parvovirus product in February 2005. In addition to the risks that the alternate-source products will experience quality issues, cannot be supplied reliably, etc., we cannot ensure that after our products have been off the market for several months we will necessarily be able to regain our previous market share and our previous price points.

The market in which we operate is intensely competitive, especially with regard to our key canine heartworm diagnostic products, and many of our competitors are larger and more established

The market for animal health care products is extremely competitive. Companies in the animal health care market compete to develop new products, to market and manufacture products efficiently, to implement effective research strategies, and to obtain regulatory approval. Our current competitors include IDEXX Laboratories, a significantly larger company, Heska Corporation and Agen. These companies have greater financial, manufacturing, marketing, and research resources than we do. In addition, IDEXX Laboratories prohibits its distributors from selling competitors products, including ours. Further, additional competition could come from new entrants to the animal health care market. We cannot assure you that we will be able to compete successfully in the future or that competition will not harm our business.

Our canine heartworm diagnostic products constituted 24% of our sales for the year ended December 31, 2004. In addition to our historic competition with IDEXX Laboratories, the sales leader in this product category, our sales have been substantially affected by Heska entering the market in 1999, and their benefiting from us being out of the market after Agen terminated our supply agreement. Since October 2003, Agen has also entered the market. Additional competition, including erosion of the average selling price, from Agen in this key market with this product has seriously damaged us. We could face renewed competition from other new competitors when our U.S. heartworm patent expires in December 2005.

Under our settlement with Agen in June 2004, we licensed Agen our U.S. heartworm patent. In addition we agreed to sell to Agen the same biological components as are used in our own Witness® in-clinic canine heartworm and canine parvovirus diagnostic products. Agen is therefore able to manufacture and sell canine heartworm diagnostic and canine parvovirus products that are substantially the same as ours. If Agen were to have its in-clinic canine heartworm diagnostic products made by the same contract manufacturer as we use, it would further diminish our ability to distinguish our products in the marketplace and achieve satisfactory pricing.

As previously mentioned, as a result of Agen ceasing to contract manufacture our Witness® products our sales were materially adversely affected in 2003 and 2004, and we believe that our sales could be materially adversely affected in 2005 and beyond if we are unable to fully succeed in reintroducing the alternate-source products into the market. There can be no assurances that we will be able to achieve our previous sales levels of these in-clinic products.

We have a history of losses and an accumulated deficit

Although we were profitable in 2003, we had a loss in 2004, and we have had a history of annual losses. We have incurred a consolidated accumulated deficit of $46,113,000 at December 31, 2004. We may not achieve annual profitability again, and if we are profitable in the future there can be no assurance that profitability can be sustained.

Table of Contents

We rely on third party distributors for a substantial portion of our sales

We have historically depended upon distributors for a large portion of our sales, and we may not have the ability to establish and maintain an adequate independent sales and marketing capability in any or all of our targeted markets. Distributor agreements render our sales exposed to the efforts of third parties who are not employees of Synbiotics and over whom we have no control. Their failure to generate significant sales of our products could materially harm our business. Reduction by these distributors of the quantity of our products which they distribute would materially harm our business. Also, the distributors are not bound to us by long-term agreements, and a decision by any major distributor to stop doing business with us could materially hurt our revenues. Agen is currently distributing its products through Vedco, a co-operative buying group. Several of the members/owners of this buying group also distribute our products, but have decided to promote Agen s canine heartworm product instead of ours. IDEXX Laboratories prohibition against its distributors carrying competitors products, including ours, has made, and could continue to make, some distributors unavailable to us. In the past, we have lost major distributors to IDEXX Laboratories.

We depend on key executives and personnel

Our future success will depend, to a significant extent, on the ability of our management to operate effectively, both individually and as a group. Competition for qualified personnel in the animal health care products industry is intense, and we may not be successful in attracting and retaining such personnel. There are only a limited number of persons with the requisite skills to serve in those positions and it may become increasingly difficult to hire such persons. The loss of the services of any of our key personnel or the inability to attract or retain qualified personnel could harm our business.

We depend on third party manufacturers, and may experience problems in obtaining supplies of our key products

We contract for the manufacture of some of our products, including our Witness® in-clinic canine heartworm, feline leukemia virus and canine parvovirus diagnostic products and our SCA 2000 instrument products. We also expect that some of our anticipated new products will be manufactured by third parties. In addition, some of the products manufactured for us by third parties are licensed to us by their manufacturers. There are a number of risks associated with our dependence on third-party manufacturers including:

- the potential for a decision by the manufacturer to cease supplying us and/or to make and market competing products;
- reduced control over delivery schedules;
- quality assurance;
- manufacturing yields and costs;
- whether the manufacturer maintains financial and operational stability;
- the potential lack of adequate capacity during periods of excess demand;

- limited warranties on products supplied to us;
- increases in prices and the potential misappropriation of our intellectual property; and
- limited negotiating leverage in the event of disputes with the third-party manufacturers.

If our third party manufacturers fail to supply us with an adequate number of finished products, our business would be significantly harmed. We have no long-term contracts or arrangements with any of our vendors that guarantee product availability, the continuation of particular payment terms or the extension of credit limits.

If we encounter delays or difficulties in our relationships with our manufacturers, the resulting problems could have a material adverse effect on us.

Table of Contents

As mentioned above, in 2003 Agen, the previous contract manufacturer of certain of our Witness® in-clinic products, ceased to supply us with those products, and entered the market with competing products.

We rely on new and recent products

We rely to a significant extent on new and recently developed products, and expect that we will need to continue to introduce new products to be successful in the future. There can be no assurance that we will obtain and maintain market acceptance of our products. There can be no assurance that future products, including our alternate-source in-clinic diagnostic products, will meet applicable regulatory standards, be capable of being produced in commercial quantities at acceptable cost or be successfully commercialized.

There can be no assurance that new products can be manufactured at a cost or in quantities necessary to make them commercially viable. If we are unable to produce internally, or to contract for, a sufficient supply of our new products on acceptable terms, or if we should encounter delays or difficulties in our relationships with manufacturers, the introduction of new products would be delayed, which could have a material adverse effect on our business.

Our canine heartworm business is moderately seasonal

Our operations are moderately seasonal due to the timing of sales of our canine heartworm diagnostic products. Our sales and profits have historically tended to be concentrated in the first half of the year as our distributors prepare for the heartworm season by purchasing diagnostic products for resale to veterinarians. One effect of this is a need to devote large amounts of cash to building canine heartworm diagnostic products inventory in preparation for the canine heartworm selling season at a time when our working capital is relatively low.

Any failure to adequately establish or protect our proprietary rights may adversely affect us, and our canine heartworm diagnostic patent expires in December 2005

We rely on a combination of patent, copyright, and trademark laws, trade secrets, and confidentiality and other contractual provisions to protect our proprietary rights. These measures afford only limited protection. Our means of protecting our proprietary rights in the U.S. or abroad may not be adequate and competitors may independently develop similar technologies. Our future success will depend in part on our ability to protect our proprietary rights and the technologies used in our principal products. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use trade secrets or other information that we regard as proprietary. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. Issued patents may not preserve our proprietary position. Even if they do, competitors or others may develop technologies similar to or superior to our own. If we do not enforce and protect our intellectual property, our business will be harmed. From time to time, third parties, including our competitors, have asserted patent, copyright, and other intellectual property rights to technologies that are important to us. We expect that we will increasingly be subject to infringement claims as the number of products and competitors in the animal health care market increases.

The results of any litigated matter are inherently uncertain. Litigation is costly regardless of its outcome and can require significant management attention. In the event of an adverse result in any litigation with third parties that could arise in the future, we could be required to:

pay substantial damages, including treble damages if we are held to have willfully infringed;

cease the manufacture, use and sale of infringing products;

expend significant resources to develop non-infringing technology; or

obtain licenses to the infringing technology.

Table of Contents

Licenses may not be available from any third party that asserts intellectual property claims against us on commercially reasonable terms, or at all.

Also, because our patents and patent applications cover novel diagnostic approaches:

- the patent coverage which we receive could be significantly narrower than the patent coverage we seek in our patent applications; and
- our patent positions involve complex legal and factual issues which can be hard for patent examiners or lawyers asserting patent coverage to successfully resolve.

Because of this, our patent position could be vulnerable and our business could be materially harmed. In any event, our important United States canine heartworm diagnosis patent will expire in December 2005.

The U.S. patent application system also exposes us to risks. In the United States, the first party to make a discovery is granted the right to patent it and patent applications are generally maintained in secrecy for 18 months. For these reasons, we can never know if we are the first to discover particular technologies. Therefore, we can never be certain that our technologies will be patented and we could become involved in lengthy, expensive, and distracting disputes concerning whether we were the first to make the disputed discovery. Any of these events would materially harm our business.

Our business is regulated by the United States and various foreign governments

Our business is subject to substantial regulation by the United States government, most notably the United States Department of Agriculture, and the French government. In addition, our operations may be subject to future legislation and/or rules issued by domestic or foreign governmental agencies with regulatory authority relating to our business. There can be no assurance that we will continue to be in compliance with any of these regulations.

For marketing outside the United States, we and our suppliers are subject to foreign regulatory requirements, which vary widely from country to country. There can be no assurance that we and our suppliers will meet and sustain compliance with any such requirements.

Redwood controls us

The Series C preferred stock owned by Redwood represents a majority of the voting power of all our stock. Redwood can, and does, control the election of our entire Board of Directors, and also controls all fundamental strategic decisions. In addition, an affiliate of Redwood acquired from Comerica Bank a $3,873,000 note issued by us and secured by our assets. At December 31, 2004, the outstanding balance on this note was $3,809,000. Our ability to negotiate effectively with the note holder, if such negotiation were ever to be necessary or desirable, might be compromised by Redwood s multifaceted control of us.

We use hazardous materials

Our business requires that we store and use hazardous materials and chemicals. Although we believe that our procedures for storing, handling, and disposing of these materials comply with the standards prescribed by local, state, and federal regulations, the risk of accidental contamination or injury from these materials cannot be completely eliminated. If any of these materials were mishandled, or if an accident with them occurred, the consequences could be extremely damaging and we could be held liable for them. Our liability for such an event would materially harm our business and could exceed all of our available resources for satisfying it.

Table of Contents

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Our market risk consists primarily of the potential for changes in interest rates and foreign currency exchange rates.

Interest Rate Risk

The fair value of our long-term debt at December 31, 2004 was approximately $4,381,000, of which $572,000 has a variable interest rate based on the prime rate. A change in interest rates of five percentage points would not have a material impact on our financial condition, results of operations and cash flows as it relates to our variable rate debt.

Foreign Currency Exchange Rate Risk

Our foreign currency exchange rate risk relates to the operations of SBIO-E as it transacts business in Euros, its local currency. However, this risk is limited to our intercompany receivable from SBIO-E and the conversion of its financial statements into the U.S. dollar for consolidation. There is no foreign currency exchange rate risk related to SBIO-E s transactions outside of the European Union as those transactions are generally denominated in Euros. Similarly, all of the foreign transactions of our U.S. operations are denominated in U.S. dollars. We do not generally hedge our cash flows on intercompany transactions, nor do we hold any other significant derivative securities or hedging instruments based on currency exchange rates. As a result, the effects of a 5% change in exchange rates would have a material impact on our financial condition, results of operations and cash flows, but only to the extent that it relates to the conversion of SBIO-E s financial statements, including its intercompany payable to us, into the U.S. dollar for consolidation. For example, the increase in the value of the euro over the dollar as of and for the year ended December 31, 2004, resulted in a $638,000 increase in our revenues, a $728,000 increase in our expenses, a $371,000 increase in our assets and a $112,000 increase in our liabilities (other than shareholders equity). For the year ended December 31, 2004, 38% of our net sales were net sales of SBIO-E.

Table of Contents

Item 8. Financial Statements and Supplementary Data

Index to Financial Statements

All other schedules are omitted because they are not applicable or the required information is included in the consolidated financial statements and notes thereto.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors

and Shareholders of

Synbiotics Corporation

We have audited the consolidated financial statements listed in the accompanying index of Synbiotics Corporation and its subsidiary as of December 31, 2004 and 2003, and for each of the years in the three year period ended December 31, 2004. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Synbiotics Corporation and its subsidiary as of December 31, 2004 and 2003, and the consolidated results of their operations and their cash flows for each of the years in the three year period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company has an accumulated deficit of $46,113,000, and the Company has a $1,000,000 contractual obligation due in July 2005, and another $1,500,000 contractual obligation, to the same party, due in July 2006. The Company does not believe that its cash position will be sufficient to fund its operations and service its debt for the next twelve months if it also pays the $1,000,000 contractual obligation when it becomes due in July 2005. These factors, among others, raise substantial doubt about its ability to continue as a going concern. Management s plans in regards to these matters are also described in Note 2. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

LEVITZ, ZACKS & CICERIC

Certified Public Accountants

San Diego, California

March 8, 2005

Table of Contents

SYNBIOTICS CORPORATION

CONSOLIDATED BALANCE SHEET

	December 31,	
	2004	**2003**
ASSETS		
Current assets:		
Cash and equivalents	$ 792,000	$ 1,045,000
Accounts receivable (net of allowance for doubtful accounts of $151,000 and $125,000 in 2004 and 2003)	2,574,000	2,686,000
Inventories	6,208,000	5,266,000
Other current assets	1,424,000	878,000
	10,998,000	9,875,000
Property and equipment, net	979,000	1,232,000
Goodwill, net	1,397,000	1,397,000
Intangibles, net	1,851,000	2,358,000
Other assets	297,000	479,000
	$ 15,522,000	$ 15,341,000
LIABILITIES AND SHAREHOLDERS EQUITY:		
Current liabilities:		
Accounts payable and accrued expenses	$ 4,557,000	$ 4,005,000
Current portion of long-term debt	546,000	4,804,000
Other current liabilities	952,000	
	6,055,000	8,809,000
Long-term debt	3,835,000	
Other liabilities	1,313,000	2,134,000
	5,148,000	2,134,000
Commitments and contingencies (Note 13)		
Shareholders equity:		
Series C convertible preferred stock, $1,000 liquidation preference per share (aggregating $3,100,000 and $2,800,000 at December 31, 2004 and 2003), 4,000 shares authorized, 3,100 and 2,800 shares issued and outstanding at December 31, 2004 and 2003	2,904,000	2,604,000
Common stock, no par value, 70,000,000 shares authorized, 21,154,000 and 20,025,000 shares issued and outstanding at December 31, 2004 and 2003	46,636,000	46,316,000
Common stock warrants	1,110,000	1,035,000
Accumulated other comprehensive loss	(218,000)	(411,000)
Accumulated deficit	(46,113,000)	(45,146,000)
Total shareholders equity	4,319,000	4,398,000

	$ 15,522,000	$ 15,341,000

See accompanying notes to consolidated financial statements.

22

Table of Contents

SYNBIOTICS CORPORATION

CONSOLIDATED STATEMENT OF OPERATIONS AND COMPREHENSIVE (LOSS) INCOME

	Year Ended December 31,		
	2004	**2003**	**2002**
Revenues:			
Net sales	$ 18,746,000	$ 18,805,000	$ 21,362,000
License fees			300,000
Royalties	473,000	406,000	9,000
	19,219,000	19,211,000	21,671,000
Operating expenses:			
Cost of sales	9,051,000	9,133,000	10,450,000
Research and development	1,486,000	1,177,000	1,380,000
Selling and marketing	4,165,000	4,150,000	4,378,000
General and administrative	5,628,000	3,489,000	8,772,000
Patent litigation settlement	(850,000)	(515,000)	
Impairment losses			2,877,000
	19,480,000	17,434,000	27,857,000
(Loss) income from operations	(261,000)	1,777,000	(6,186,000)
Other expense:			
Interest, net	(446,000)	(492,000)	(669,000)
(Loss) income before income taxes	(707,000)	1,285,000	(6,855,000)
(Benefit from) provision for income taxes	(60,000)	(2,000)	7,000
(Loss) income from continuing operations	(647,000)	1,287,000	(6,862,000)
Discontinued operations, net of tax			217,000
(Loss) income before cumulative effect of a change in accounting principle	(647,000)	1,287,000	(6,645,000)
Cumulative effect of a change in accounting principle, net of tax			(7,756,000)
Net (loss) income	(647,000)	1,287,000	(14,401,000)
Translation adjustment	193,000	547,000	453,000
Comprehensive (loss) income	$ (454,000)	$ 1,834,000	$ (13,948,000)
Net (loss) income available to common shareholders	$ (868,000)	$ 1,077,000	$ (14,596,000)
Basic (loss) income per share:			
(Loss) income from continuing operations	$ (0.04)	$ 0.06	$ (0.48)
Discontinued operations, net of tax			.01
Cumulative effect of a change in accounting principle, net of tax			(0.53)

Net (loss) income	$ (0.04)	$ 0.06	$ (1.00)
Diluted (loss) income per share:			
Income (loss) from continuing operations	$ (0.04)	$ 0.03	$ (0.48)
Discontinued operations, net of tax			.01
Cumulative effect of a change in accounting principle, net of tax			(0.53)
Net (loss) income	$ (0.04)	$ 0.03	$ (1.00)

See accompanying notes to consolidated financial statements.

Table of Contents

SYNBIOTICS CORPORATION

CONSOLIDATED STATEMENT OF CASH FLOWS

	Year Ended December 31,		
	2004	**2003**	**2002**
Cash flows from operating activities:			
Net (loss) income	$ (647,000)	$ 1,287,000	$ (14,401,000)
Adjustments to reconcile net (loss) income to net cash (used for) provided by operating activities:			
Depreciation and amortization	1,096,000	1,170,000	899,000
Receivable for patent litigation settlement	(425,000)	(265,000)	
Retention bonus payable in common stock			2,641,000
Legal settlement payable in common stock			15,000
Impairment losses			2,877,000
Note receivable for discontinued operations			(500,000)
Cumulative effect of a change in accounting principle			7,756,000
Changes in assets and liabilities, net of effect of acquisitions:			
Accounts receivable	165,000	79,000	802,000
Inventories	(844,000)	436,000	(125,000)
Other assets	(81,000)	24,000	267,000
Accounts payable and accrued expenses	381,000	(1,455,000)	(1,475,000)
Deferred revenue			(300,000)
Other liabilities	132,000	163,000	150,000
Net cash (used for) provided by operating activities	(223,000)	1,439,000	(1,394,000)
Cash flows from investing activities:			
Acquisition of property and equipment	(179,000)	(276,000)	(193,000)
Receipts from notes receivable	233,000	92,000	
Net cash provided by (used for) investing activities	54,000	(184,000)	(193,000)
Cash flows from financing activities:			
Payments of long-term debt	(424,000)	(1,186,000)	(1,241,000)
Proceeds from issuance of preferred stock, net	300,000		2,604,000
Net cash (used for) provided by financing activities	(124,000)	(1,186,000)	1,363,000
Net (decrease) increase in cash and equivalents	(293,000)	69,000	(224,000)
Effect of exchange rates on cash	40,000	107,000	54,000
Cash and equivalents beginning of period	1,045,000	869,000	1,039,000
Cash and equivalents end of period	$ 792,000	$ 1,045,000	$ 869,000

See accompanying notes to consolidated financial statements.

Table of Contents

SYNBIOTICS CORPORATION

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

	Common Stock		Preferred Stock Series B		Preferred Stock Series C		Common Stock Warrants	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total
	Shares	Amount	Shares	Amount	Shares	Amount				
Balance, December 31, 2001	8,990,000	$ 40,286,000					$ 1,035,000	$ (1,411,000)	$ (31,766,000)	$ 8,144,000
Reclassification of mandatorily redeemable common stock (Note 9)	621,000	3,107,000								3,107,000
Issuance of common stock pursuant to retention bonus agreements (Note 10)	8,255,000	2,642,000								2,642,000
Issuance of common stock in conjunction with the settlement of litigation	88,000	15,000								15,000
Issuance of preferred stock (Note 10)			2,800	$ 2,604,000						2,604,000
Exchange of preferred stock (Note 10)			(2,800)	(2,604,000)	2,800	$ 2,604,000				
Cumulative translation adjustment								453,000		453,000
Net loss									(14,401,000)	(14,401,000)
Balance, December 31, 2002	17,954,000	46,050,000			2,800	2,604,000	1,035,000	(958,000)	(46,167,000)	2,564,000
Issuance of common stock in lieu of cash dividends on preferred stock (Note 10)	2,071,000	266,000							(266,000)	
								547,000		547,000

Cumulative translation adjustment										
Net income									1,287,000	1,287,000
Balance, December 31, 2003	20,025,000	46,316,000			2,800	2,604,000	1,035,000	(411,000)	(45,146,000)	4,398,000
Issuance of common stock in lieu of cash dividends on preferred stock (Note 10)	1,129,000	320,000							(320,000)	
Issuance of preferred stock (Note 10)					300	300,000				300,000
Issuance of common stock warrants in conjunction with amendment of debt agreement (Note 10)							75,000			75,000
Cumulative translation adjustment								193,000		193,000
Net loss									(647,000)	(647,000)
Balance, December 31, 2004	21,154,000	$ 46,636,000			3,100	$ 2,904,000	$ 1,110,000	$ (218,000)	$ (46,113,000)	$ 4,319,000

See accompanying notes to consolidated financial statements.

SYNBIOTICS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 SIGNIFICANT ACCOUNTING POLICIES:

The Company

Synbiotics Corporation (the Company), incorporated in 1982, develops, manufactures and markets diagnostic products for animals. The Company s principal markets are veterinary practices, laboratories and poultry producers in the United States, Canada, Europe, Africa, Asia, Oceania and Latin America. The Company s products are sold primarily to wholesale distributors, and also directly to veterinarians, laboratories and poultry producers.

Principles of Consolidation

The consolidated financial statements of the Company include the accounts of its wholly-owned subsidiary Synbiotics Europe SAS (SBIO-E). All significant intercompany transactions and accounts have been eliminated in consolidation.

Trade Accounts Receivable

Trade accounts receivable are stated at the amount management expects to collect from outstanding balances. Management provides for probable uncollectible amounts through a charge to earnings and a credit to a valuation allowance based on its assessment of the current status of individual accounts. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to trade accounts receivable. Changes in the valuation allowance have not been material to the financial statements.

Amounts owed to the Company from one customer represented 27% of the Company s trade accounts receivable as of December 31, 2004, substantially all of which was collected subsequent to December 31, 2004.

Inventories

Inventories are stated at the lower of cost or market; cost is determined using the first-in, first-out method. We periodically review the carrying cost of our inventories by product to determine the adequacy of our reserves for obsolescence. In accounting for inventories we must make estimates regarding the estimated net realizable value of our inventory. This estimate is based, in part, on our forecasts of future sales and shelf life of each product.

Property and Equipment

Property and equipment, including leasehold improvements, are recorded at cost. Maintenance costs are charged to operations as incurred. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of five to eight years or the lease terms, if shorter.

Goodwill and Other Intangible Assets

As of January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142 (FAS 142), Goodwill and Other Intangible Assets . FAS 142 changed the accounting for goodwill from an amortization method to an impairment-only approach. Under FAS 142, goodwill is tested annually and whenever events or circumstances occur indicating that goodwill might be impaired. In connection with the adoption of FAS 142, the Company performed a transitional goodwill impairment assessment. As a result of this impairment assessment, in the first quarter of 2002 the Company recorded an impairment loss of $7,756,000 which is classified as a cumulative effect of a change in accounting principle for the year ended December 31, 2002. Subsequent

SYNBIOTICS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

impairment assessments will be performed, at a minimum, in the fourth quarter of each year; and subsequent impairments, if any, will be classified as an operating expense. The Company s measurement of fair value upon adoption was based upon a fairness opinion prepared by an independent investment advisor in conjunction with the Redwood transaction (Note 3). The Company s measurement of fair value for subsequent impairment assessments will be the market price of the Company s common stock on the date the assessment is performed.

Patents and licenses are recorded at cost and are amortized ratably over the life of the respective patents or licenses.

Long-Lived Assets

As of January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets (FAS 144). FAS 144 supersedes FAS 121 Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of . FAS 144 applies to all long-lived assets (including discontinued operations) and consequently amends Accounting Principles Board Opinion No. 30 (APB 30), Reporting Results of Operations Reporting the Effects of Disposal of a Segment of a Business . FAS 144 develops one accounting model for long-lived assets that are to be disposed of by sale. FAS 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally, FAS 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. The adoption of FAS 144 did not have a material impact on the Company s financial position or results of operations.

Fair Value of Financial Instruments

The carrying amounts for cash and cash equivalents at December 31, 2004 and 2003 approximate their fair values. The carrying amount of the debt approximates fair value at December 31, 2004 and 2003 as the variable interest rate on the debt approximates current market rates of interest. The carrying amount of the other liabilities approximates fair value at December 31, 2004 and 2003 as the imputed interest rate of 8.42% approximates current market rates of interest.

Translation of Financial Statements

The financial statements for SBIO-E whose functional currency is the Euro are translated in the following manner: assets and liabilities at the year end rates; shareholders equity at historical rates; and results of operations at the monthly average exchange rates. The effects of exchange rate changes are reflected as a separate component of shareholders equity.

Revenue Recognition

Revenue from products is recognized when title and risk of loss transfers to the customer. Amounts charged to customers for shipping and handling are included in net sales, and shipping and handling costs are included in cost of sales. The Company provides promotional discounts and rebates to certain of its distributors. Based upon the structure of these rebate programs and the Company s past history, the Company is able to accurately estimate the amount of rebates at the time of sale. These rebates are recorded as a reduction of net sales. License fee revenue is recognized ratably over the license term when the Company has a further performance obligation to the licensee. In the event that the Company has no further performance obligation to the licensee, license fee revenue is recognized upon receipt.

Table of Contents

SYNBIOTICS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Advertising Costs

The Company recognizes the costs of advertising at the time such charges are incurred. Advertising expense totaled $231,000, $342,000 and $338,000 during the years ended December 31, 2004, 2003 and 2002, respectively.

Stock-Based Compensation

The Company measures its stock-based employee compensation using the intrinsic value method. The following disclosures present as reported amounts, utilizing the intrinsic value method, and pro forma amounts, after applying the fair value method, related to stock-based awards made to employees that were outstanding as of December 31, 2004, 2003 and 2002:

	Year Ended December 31,		
	2004	**2003**	**2002**
Net (loss) income:			
As reported	$ (647,000)	$ 1,287,000	$ (14,401,000)
Pro forma	$ (720,000)	$ 1,147,000	$ (14,615,000)
Basic net (loss) income per share:			
As reported	$ (0.04)	$ 0.06	$ (1.00)
Pro forma	$ (0.05)	$ 0.05	$ (1.01)
Diluted net (loss) income per share:			
As reported	$ (0.04)	$ 0.03	$ (1.00)
Pro forma	$ (0.05)	$ 0.03	$ (1.01)
Stock-based employee compensation:			
As reported	$	$	$
Pro forma	$ 73,000	$ 140,000	$ 214,000

For disclosure purposes, the fair value of each option granted is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions for grants in 2004, 2003 and 2002, respectively: dividend yield of 0% for all years; expected volatility of 131.5%, 148.1% and 121.3%; risk-free interest rates of 2.8%, 2.1% and 3.1%; and expected lives of 3.8 years, 3.7 years and 3.7 years.

In December 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123R, Share-Based Payments (FAS 123R). FAS 123R is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation , and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees and its related implementation guidance.

FAS 123R requires that the cost of all awards of equity instruments made to employees in exchange for employment services be recorded at fair value on the grant date, and the cost charged to expense as the award vests. The determination of fair value is based upon option-pricing models (for example, Black-Scholes) adjusted for characteristics unique to the equity instrument.

The Company will be required to charge to expense the fair value of employee stock options which vest on or after July 1, 2005, and expects to record compensation expense related to unvested employee stock options outstanding as of December 31, 2004, as follows: 2005 $33,000; 2006 $67,000; 2007 $46,000; 2008 $9,000.

Income Taxes

The Company s current income tax expense is the amount of income taxes expected to be payable for the current year. A deferred income tax asset or liability is computed for the expected future impact of differences

Table of Contents

SYNBIOTICS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

between the financial reporting and tax bases of assets and liabilities as well as the expected future tax benefit to be derived from tax loss and tax credit carryforwards. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount more likely than not to be realized in future tax returns. The effect of tax rate changes are reflected in income during the period such changes are enacted.

Net (Loss) Income Per Share

Basic net (loss) income per share is computed as net (loss) income less cumulative preferred stock dividends divided by the weighted average number of common shares outstanding during the period. Diluted net (loss) income per share is computed as net (loss) income divided by the weighted average number of common shares and potential common shares, using the treasury stock method, outstanding during the period (Note 12).

Cash and Equivalents

Cash and equivalents include cash investments which are highly liquid and have an original maturity of three months or less.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Comprehensive (Loss) Income

Comprehensive (loss) income is defined as the change in equity (net assets) of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. The Company reports in the financial statements, in addition to net (loss) income, comprehensive (loss) income and its components including foreign currency items.

Segment Reporting

Operating segments are determined consistent with the way that management organizes and evaluates financial information internally for making operating decisions and assessing performance. The Company operates in one segment.

Concentrations of Risk

The Company relies on a third party for the manufacture of certain of its canine heartworm diagnostic products. The Company has the right to manufacture these products in the event that the third party is unable to supply these products. However, the regulatory process involved in transferring the manufacturing may cause a delay in the manufacturing and a possible loss of sales, which may affect operating results adversely.

NOTE 2 GOING CONCERN:

The accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. As

Table of Contents

SYNBIOTICS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

shown in the consolidated financial statements, although profitable in 2003, during 2004 and 2002 the Company incurred net losses of $647,000 and $14,401,000, respectively, and had an accumulated deficit of $46,113,000 as of December 31, 2004.

The Company has a $1,000,000 contractual obligation due in July 2005, and another $1,500,000 contractual obligation, to the same party, due in July 2006. These obligations are recorded at their accreted value in the accompanying consolidated balance sheet under other current liabilities and other liabilities. The Company does not believe that its cash position will be sufficient to fund its operations and service its bank debt for the next twelve months if it also pays the $1,000,000 contractual obligation when it becomes due in July 2005. The contractual obligation is unsecured. In the event that the Company does not make the payment when it comes due, the $1,500,000 due in July 2006 becomes immediately due, and the entire $2,500,000 will begin bearing interest at 10.5%. The Company plans to renegotiate this unsecured debt; however, there can be no assurance that any such renegotiation will be successful.

These factors raise substantial doubt about the Company s ability to continue as a going concern for a reasonable period of time. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

Note 3 RELATED PARTY AND CONTROLLING SHAREHOLDER:

Thomas A. Donelan, Christopher P. Hendy and Jerry L. Ruyan own 99% of Redwood Holdings, LLC. Redwood Holdings, LLC, owns 4% of the Company s Series C preferred stock (Note 10), and also owns 3% of the Company s common stock (Note 10).

Redwood West Coast, LLC, owns 90% of the Company s Series C preferred stock (Note10). Messrs. Donelan, Hendy and Ruyan and Redwood Holdings, LLC, collectively, own 94% of Redwood West Coast, LLC.

Remington Capital, LLC, is the holder of a promissory note from the Company with a balance at December 31, 2004, of $3,809,000 (Note 8), and is the holder of a warrant to purchase 250,000 shares of the Company s common stock (Note 10). Remington Capital, LLC, is indirectly owned 100% by Redwood Holdings, LLC.

Representatives of Redwood Holdings, LLC, Redwood West Coast, LLC, and Remington Capital, LLC, (collectively Redwood) constitute 67% of the Company s Board of Directors. Redwood controls approximately 58% of the Company s voting stock, and is therefore the Company s controlling shareholder.

The Company pays to Redwood a monthly management fee of $15,000.

Note 4 DISCONTINUED OPERATIONS:

In August 2002, the Company sold its instrument manufacturing operations, located in Rome, New York, to Danam Acquisition Corp., located in Dallas, Texas, in exchange for a $500,000 note receivable. The note is payable, beginning in September 2002, in 60 monthly principal payments of $8,000 plus interest at 5%, is secured by the assets of the disposed operations (all of which had been previously written off by the Company), and is guaranteed by Drew Scientific Group PLC (the parent of Danam Acquisition Corp.) The Company has recorded the $500,000 gain in discontinued operations.

In November 2002, the Company terminated the license agreement for its PennHIP® operations, located in Malvern, Pennsylvania, and transferred all of the assets related to the PennHIP® operations to the University of Pennsylvania. No consideration was received for the transferred assets.

Table of Contents

SYNBIOTICS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 5 PATENT LITIGATION SETTLEMENTS:

In November 1998, the Company filed a lawsuit against Heska Corporation in the United States District Court for the Southern District of California alleging that Heska infringed a patent owned by the Company relating to heartworm diagnostic technology. In March 2003, the Company and Heska entered into settlement and license agreements which resolved all outstanding claims in the lawsuit. As part of those agreements, each party licensed certain intellectual property rights from the other party, including Heska licensing from the Company the patent relating to the heartworm diagnostic technology. In addition, the Company received $250,000 in April 2003, will receive $265,000 in 24 monthly installments of $11,000 beginning in January 2004. As a result, the Company has recorded a one-time credit to operating expenses totaling $515,000 during the year ended December 31, 2003. Also, the Company is receiving royalty payments on Heska s sales of licensed canine heartworm diagnostic products beginning April 2003.

In September 2003, the Company filed a lawsuit against Agen Biomedical Ltd. (Agen) in the United States District Court for the Southern District of California alleging that Agen infringed a patent owned by the Company relating to heartworm diagnostic technology. In June 2004, the Company and Agen entered into a settlement agreement which resolved all outstanding claims in the lawsuit. As part of the agreement, each party licensed certain intellectual property rights from the other party, including Agen licensing from the Company the patent relating to the heartworm diagnostic technology. In addition, the Company received $425,000 in June 2004, and will receive $425,000 in June 2005. As a result the settlement, the Company recorded a one-time credit to operating expenses totaling $850,000 during the year ended December 31, 2004. In addition, the Company will supply certain biologicals to Agen at specified prices, and the Company will receive a percentage of Agen s sales of Agen products containing the supplied biologicals.

NOTE 6 COMPOSITION OF CERTAIN FINANCIAL STATEMENT CAPTIONS:

	December 31,	
	2004	**2003**
Inventories:		
Raw materials	$ 3,125,000	$ 2,532,000
Work in process	357,000	477,000
Finished goods	2,726,000	2,257,000
	$ 6,208,000	$ 5,266,000
Other current assets:		
Notes receivable	$ 658,000	$ 233,000
Prepaid taxes	342,000	282,000
Income taxes receivable	192,000	138,000
Other	232,000	225,000

	$ 1,424,000	$ 878,000
Property and equipment:		
Laboratory equipment	$ 2,438,000	$ 2,203,000
Leasehold improvements	586,000	561,000
Office and computer equipment	1,505,000	1,444,000
Construction in progress		21,000
	4,529,000	4,229,000
Less accumulated depreciation and amortization	(3,550,000)	(2,997,000)
	$ 979,000	$ 1,232,000

Table of Contents

SYNBIOTICS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Depreciation expense was $459,000, $545,000 and $515,000 during the years ended December 31, 2004, 2003 and 2002, respectively.

	December 31,	
	2004	2003
Accounts payable and accrued expenses:		
Accounts payable	$ 2,767,000	$ 1,284,000
Accrued vacation	484,000	365,000
Accrued compensation	327,000	440,000
Accrued royalties	339,000	247,000
Accrued professional fees	156,000	371,000
Other	484,000	1,298,000
	$ 4,557,000	$ 4,005,000

NOTE 7 GOODWILL AND OTHER INTANGIBLES:

On January 1, 2002, the Company adopted FAS 142 (Note 1). As a result, in the first quarter of 2002 the Company recorded an impairment loss of $7,756,000 which is classified as a cumulative effect of a change in accounting principle, and ceased to amortize goodwill. In the fourth quarter of 2002, the Company performed its annual impairment assessment, and, as a result of decreases in the market price of the Company s common stock during 2002, recorded an additional impairment loss of $2,877,000. The fair value used in the annual assessment was determined based upon the market price of the Company s common stock on December 31, 2002. Based upon the market price of the Company s common stock on December 31, 2004 and 2003, there was no impairment loss resulting from the annual impairment assessment in 2004 or 2003.

The Company has allocated all of its goodwill to its only reporting unit, which is also its only reportable segment (Note 14). Changes in the carrying amount of goodwill were as follows:

Balance at December 31, 2001	$ 12,074,000
Impairment loss	(10,633,000)
Effect of currency exchange rates	(44,000)
Balance at December 31, 2002, 2003 and 2004	$ 1,397,000

Other intangible assets were as follows:

	December 31, 2004		December 31, 2003	
	Gross Carrying Value	**Accumulated Amortization**	**Gross Carrying Value**	**Accumulated Amortization**
Patents	$ 5,423,000	$ 3,685,000	$ 5,108,000	$ 2,922,000
Licenses	618,000	505,000	618,000	446,000
	$ 6,041,000	$ 4,190,000	$ 5,726,000	$ 3,368,000

Table of Contents

SYNBIOTICS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Amortization expense was $631,000 and $625,000 during the years ended December 31, 2004 and 2003, respectively. The weighted-average amortization periods for patents and licenses are 9 years and 10 years, respectively, and the weighted-average amortization period for total intangible assets is 9 years. Annual pretax amortization for other intangibles over the next five years is estimated to be as follows:

2005	$ 613,000
2006	604,000
2007	497,000
2008	66,000
2009	45,000
	$ 1,825,000

NOTE 8 NOTE PAYABLE AND LONG-TERM DEBT:

On September 23, 2004, the Company entered into an amendment (the Credit Agreement Amendment) of its credit agreement with Comerica Bank (Comerica), effective as of September 1, 2004. The outstanding principal balance of the Company s bank debt immediately prior to the Credit Agreement Amendment was $4,472,000. Under the Credit Agreement Amendment, the Company issued an amended promissory note to Comerica in the amount of $599,000 (the Comerica Note), and Comerica sold the remaining principal of $3,873,000 to Remington Capital, LLC (Remington). The Company simultaneously issued an amended promissory note to Remington in the amount of $3,873,000 (the Remington Note).

The Comerica Note bears interest at the rate of prime plus 2% (effectively 7.25% at December 31, 2004), and is payable in monthly installments, from October 1, 2004 to August 1, 2007, of $9,000 plus accrued interest (except the payments due on September 1, 2005 and 2006 are in the amount of $151,000 plus accrued interest). The Remington Note, which is subordinate to the Comerica Note, bears interest at the fixed rate of 7.75%, and is payable in blended monthly installments of principal and interest, from September 25, 2004 to August 25, 2014, of $46,000. Both the Comerica Note and the Remington Note are secured by all of the Company s assets.

In conjunction with the Credit Agreement Amendment, the Company issued to Comerica and Remington warrants to purchase an aggregate of 500,000 shares of the Company s common stock (Note 10).

Principal payments during the next five years are as follows: 2005 $544,000; 2006 $544,000; 2007 $390,000; 2008 $343,000; 2009 $371,000.

Interest paid during 2004, 2003 and 2002 totaled $317,000, $334,000 and $502,000, respectively. The 2004 amount includes $75,000 paid to Remington.

NOTE 9 MANDATORILY REDEEMABLE COMMON STOCK:

621,000 shares issued in conjunction with the 1997 acquisition of SBIO-E were subject to certain registration rights as well as put and call provisions. As of December 31, 2001, the Company classified the shares on the balance sheet as mandatorily redeemable and had accreted the value of the shares to the put option price, using the interest method, with the accretion being charged directly to retained earnings.

On June 1, 2001, the Company assigned its feline leukemia virus vaccine distribution agreement with Intervet, Inc. to Merial Limited, Merial S.A.S. and Merial, Inc. (collectively Merial). In exchange, Merial waived its right to sell to the Company the above mentioned 621,000 shares of the Company s common stock at

Table of Contents

SYNBIOTICS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

$5.00 per share (the Put Right). Merial also agreed to allow the Company to pay accrued royalties, under a separate agreement, totaling $613,000 in ten monthly installments of $61,300 which began in July 2001. If the Company failed to meet its royalty payment obligation, the Put Right would have reverted to Merial. When the final royalty payment was made in April 2002, and the Put Right was extinguished, the Company reclassified the mandatorily redeemable common stock to shareholders equity.

In March 1999, the Company amended its U.S. feline leukemia virus vaccine supply agreement with Merial, and the Company received $1,453,000 which it was recognizing as license fee revenue ratably over the remaining life of the supply agreement. As the Company has assigned its distribution agreement with Intervet, Inc. to Merial, the Company has no further contractual obligations under the supply agreement and recognized, in June 2001, the remaining $868,000 of deferred license fee revenue.

NOTE 10 SHAREHOLDERS EQUITY:

In January 2002, the Company amended cash retention bonus agreements with certain employees (the Converted Retention Bonuses) so that, instead of cash, the employees received, on May 15, 2002, an aggregate of 8,255,000 shares of the Company s common stock under the 1995 Stock Option/Stock Issuance Plan. The Company also agreed to pay the employees income tax withholding obligation related to the Converted Retention Bonuses. In January 2002, the Company recorded compensation expense, including the employees income tax withholding obligation, related to the Converted Retention Bonuses totaling $3,029,000. In addition, the Company also amended its remaining employee cash retention bonus agreements (the Cash Retention Bonuses) so that the amounts that would have become payable upon the consummation of the Redwood transaction would instead be payable in January 2003, and were paid in December 2002. The Company recorded compensation expense totaling $653,000 in January 2002 related to the Cash Retention Bonuses.

Redwood, the majority holder of the Series C preferred stock, as permitted by the Certificate of Determination of the Series C preferred stock, elected to receive shares of the Company s common stock in lieu of the cash dividends as follows:

Accrued Through	Date Declared	Amount	Shares Issued	Date Distributed
January 31, 2003	March 26, 2003	$ 213,000	1,662,000	March 26, 2003
April 30, 2003	June 12, 2003	53,000	409,000	June 12, 2003
January 31, 2004	March 11, 2004	158,000	354,000	March 11, 2004
July 31, 2004	September 7, 2004	105,000	445,000	September 7, 2004
October 31, 2004	December 6, 2004	58,000	330,000	December 7, 2004
January 31, 2005	March 1, 2005	58,000	452,000	March 2, 2005

Preferred Stock

The Company is authorized to issue up to 25,000,000 shares of preferred stock. The preferred stock may be issued in one or more series. The Board of Directors is authorized to fix or alter the dividend rights, dividend rate, conversion rights, voting rights, rights and terms of redemption (including sinking fund provisions), redemption price or prices, and the liquidation preferences of any wholly unissued series of preferred stock, and the number of shares constituting any such series and the designation thereof, or any of them; and to increase or decrease the number of shares of any series subsequent to the issuance of shares of that series, but not below the number of shares of such series then outstanding. In case the number of shares of any series shall be so decreased, the shares constituting such decrease shall resume the status that they had prior to the adoption of the resolution originally fixing the number of shares of such series.

Table of Contents

SYNBIOTICS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Series A Preferred Stock

The Company has a Series A Junior Participating Preferred Stock (the Series A Preferred) consisting of 200,000 shares. Each share of Series A Preferred is entitled to 1,000 votes. Each Series A Preferred share is entitled to dividends, payable in cash quarterly, in an amount equal to 1,000 times the aggregate per share amount of dividends declared on the common stock. In the event that no common stock dividends are declared, each share of Series A Preferred is entitled to $.001 per share. The Series A Preferred is entitled to a liquidation preference of $1,000 per share, plus accrued and unpaid dividends; provided, however, that each Series A Preferred share is entitled to receive an aggregate amount per share equal to 10,000 times the aggregate amount per share distributed to the holders of common stock. In the event of a consolidation, merger, combination, etc., each share of Series A Preferred shall be exchanged into 1,000 times the aggregate per share consideration of the common stock. There were no shares of Series A Preferred issued and outstanding as of December 31, 2004 and 2003.

Series A Preferred Stock Purchase Rights

As part of the Company s implementation of a poison pill shareholder rights plan, the Company issued preferred share purchase rights (the Rights) to purchase, for $10.00 (the Purchase Price), 1/1000th of a share of Synbiotics Series A Preferred (the Unit). The Rights are not exercisable until the earlier to occur of (i) a public announcement that beneficial ownership of 20% or more of the Company s outstanding common stock has been acquired or (ii) 10 business days (or a later date as determined by the Board of Directors) following the commencement of, or announcement of an intention to make, a tender offer or exchange offer to acquire beneficial ownership of 20% or more of the outstanding common stock of the Company.

At any time after the beneficial ownership of 20% or more of the outstanding shares of the Company s common stock has been acquired (but before the acquiring party has acquired 50% of the outstanding common stock) the Company may exchange all or part of the Rights for Units at an exchange ratio equal to (subject to adjustment to reflect stock splits, stock dividends and similar transactions) the Purchase Price divided by the then current per share market price per Unit on the Distribution Date. In January 2002, in conjunction with the Redwood transaction (Note 3), the rights plan was amended so that the Rights would not be exercisable upon the consummation of the Redwood transaction.

At any time prior to the public announcement that the beneficial ownership of 20% or more of the outstanding common stock of the Company has been acquired, the Company may redeem the Rights in whole, but not in part, at a price of $0.001 per Right (the Redemption Price). The redemption of the rights will be effective at such time as the Board of Directors in its sole discretion may establish.

The Rights will expire on October 7, 2008, unless the expiration date is extended or unless the Rights are earlier redeemed or exchanged by the Company.

Series B Preferred Stock

In January 2002, the Company designated and authorized 4,000 shares of Series B Preferred Stock (the Series B Preferred). In January 2002, the Company issued to Redwood 2,800 shares of Series B Preferred in exchange for $2,800,000 cash, less $186,000 of issuance costs. In October 2002, the Company entered into a Stock Swap Agreement with Redwood whereby the Company issued 2,800 shares of Series C Preferred Stock to Redwood in exchange for Redwood s 2,800 shares of Series B Preferred.

Table of Contents

SYNBIOTICS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Series C Preferred Stock

In October 2004, the Company sold to an unrelated third party 50 newly-issued shares of unregistered Series C preferred stock (the Series C Preferred) of the Company for consideration totaling $50,000 in cash.

In September 2004, the Company entered into a Series C Purchase Agreement (the Series C Agreement) with Redwood Holdings, LLC (Note 3), Paul Hays and Fintan and Janice Molloy. Under the Series C Agreement, simultaneously with the closing under the Credit Agreement Amendment (Note 8), the Company sold to the above named parties a total of 250 newly-issued shares of unregistered Series C Preferred for consideration totaling $250,000 in cash. Redwood Holdings, LLC and Mr. Hays each received 100 shares at the September 23, 2004 closing, and Mr. and Mrs. Molloy received 50 shares at the September 23, 2004 closing. Mr. Hays is the Company s President and Chief Executive Officer, and is also a member of the Company s Board of Directors.

In October 2002, the Company designated and authorized 4,000 shares of Series C Preferred, and entered into a Stock Swap Agreement with Redwood whereby the Company issued 2,800 shares of Series C Preferred to Redwood in exchange for Redwood s 2,800 shares of Series B Preferred.

Each Series C Preferred share is entitled to cumulative dividends, payable in cash quarterly (although an election can be made by Redwood, as the majority holder of the Series C Preferred, to receive the dividends in shares of the Company s common stock in the event the dividends are not paid within 30 days), in an annual amount of $75 per share; each Series C Preferred share is also entitled to, in effect, the dividends which had accumulated on a corresponding Series B Preferred share before the time of the swap. The Series C Preferred is entitled to a liquidation preference of $1,000 per share, plus accumulated and unpaid dividends. Each share of Series C Preferred has voting power equivalent to 7,785 shares of common stock. Each share of Series C Preferred is convertible into 7,785 shares of common stock (subject to anti-dilution adjustments).

Stock Warrants

Pursuant to the Credit Agreement Amendment (Note 8), the Company issued to both Comerica and Remington warrants to purchase 250,000 shares of its unregistered common stock at an exercise price of $0.17 per share. The warrants are exercisable at any time through September 1, 2010. The Company has valued the warrants at $75,000 using the Black-Scholes option pricing model.

In conjunction with a November 2000 amendment to its bank debt agreement, the Company issued to the bank a warrant to purchase 250,000 shares of the Company s common stock at an exercise price of $2.00 per share. The warrant is exercisable at any time through November 30, 2007. The Company has valued the warrant at $32,000 using the Black-Scholes option pricing model.

In conjunction with the 1997 acquisition of SBIO-E, the Company issued to a financial institution a warrant to purchase 240,000 shares of the Company s common stock at an exercise price of $.01 per share. The warrant is exercisable at any time through May 31, 2007 and contains certain anti-dilution provisions and registration rights. The Company has valued the warrant at $1,003,000 using the Black-Scholes option pricing model. In January 2002, the warrant was adjusted, pursuant to its anti-dilution provisions, and is now exercisable into 343,000 shares of the Company s common stock at an exercise price of $0.007 per share.

Stock Option Plans

The Company has a 2004 Stock Option/Stock Issuance Plan (the 2004 Plan) and a 1995 Stock Option/Stock Issuance Plan (the 1995 Plan) (collectively, the Option Plans).

36

Table of Contents

SYNBIOTICS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Under the 2004 Plan, adopted in July 2004, an aggregate of 3,000,000 shares of the Company s common stock were reserved for issuance. The 2004 Plan is administered by the Board of Directors and provides that exercise prices shall be determined, for non-qualified options, by the Board of Directors, and, for incentive options, not less than 100 percent of the fair market value of the shares at the date of grant. Options will generally vest at the rate of 1/16th of the granted shares in each continuous quarter of employment and have an exercise period not more than ten years from date of grant.

The Company had previously adopted the 1995 Plan whereby an aggregate of 2,600,000 shares of the Company s common stock were initially reserved for issuance. The 1995 Plan is administered by the Board of Directors and provides that exercise prices shall not be less than 85 percent (non-qualified options) and 100 percent (incentive options) of the fair market value of the shares at the date of grant. Options will generally vest at the rate of 1/16th of the granted shares in each continuous quarter of employment and have an exercise period not more than ten years from date of grant. In January 2002, in conjunction with the Redwood transaction (Note 3), the 1995 Plan was amended so that an aggregate of 10,753,000 shares of the Company s common stock was reserved for issuance. In July 2003, the Plan was further amended so that an aggregate of 13,753,000 shares of the Company s common stock was reserved for issuance.

The following is a summary of the Option Plans activity:

	Shares	Weighted-Average Exercise Price
Outstanding at December 31, 2001	1,292,000	$ 3.44
Granted	1,600,000	$ 0.08
Forfeited	(958,000)	$ 3.44
Outstanding at December 31, 2002	1,934,000	$ 0.66
Granted	400,000	$ 0.34
Expired	(16,000)	$ 4.71
Outstanding at December 31, 2003	2,318,000	$ 0.58
Granted	500,000	$ 0.20
Expired	(77,000)	$ 3.33
Outstanding at December 31, 2004	2,741,000	$ 0.43

Options to purchase an aggregate of 960,000 shares, 518,000 shares and 334,000 shares were exercisable under the Option Plans as of December 31, 2004, 2003 and 2002, respectively, with weighted-average exercise prices of $0.94, $2.09 and $3.43 at December 31, 2004, 2003 and 2002, respectively. The weighted-average fair value of options granted under the Option Plans during the years ended December 31, 2004, 2003 and 2002 was $0.16 per share, $0.29 per share and $0.04 per share, respectively. There was no compensation expense during 2004, 2003 and 2002 related to the Option Plans.

Table of Contents

SYNBIOTICS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following is a summary of stock options outstanding at December 31, 2004:

	Options Outstanding			Options Exercisable	
Exercise Price Range	**Number**	**Weighted-Average Remaining Contractual Life (Years)**	**Weighted-Average Exercise Price**	**Number**	**Weighted-Average Exercise Price**
$0.08 $1.00	2,500,000	8.7	$ 0.15	719,000	$ 0.13
$1.01 $2.54	42,000	5.1	$ 2.45	42,000	$ 2.45
$2.55 $3.81	123,000	2.6	$ 3.27	123,000	$ 3.27
$3.82 $4.50	76,000	2.9	$ 4.04	76,000	$ 4.04
$0.08 $4.50	2,741,000	8.2	$ 0.43	960,000	$ 0.94

Pursuant to an employment agreement, the Company will issue to its President, on December 30, 2005, options to purchase 400,000 shares of the Company s common stock at an exercise price equal to the fair market value of the Company s common stock on December 30, 2005.

In January 2002, in conjunction with the Converted Retention Bonuses, the Company cancelled options outstanding aggregating 880,000 shares of the Company s common stock. In addition, options to purchase an aggregate of 72,000 shares of the Company s common stock were modified to provide for immediate vesting, and to extend the expiration date to January 25, 2004. No compensation expense was recorded related to these modifications as the exercise prices of all of the options involved was greater than the fair market value of the shares on the modification date.

NOTE 11 INCOME TAXES:

The Company recorded a net (benefit from) provision for income taxes from continuing operations for the years ended December 31, 2004, 2003 and 2002 as follows:

	Year Ended December 31,		
	2004	**2003**	**2002**

Current income tax expense (benefit) from continuing operations:			
Federal			$ (14,000)
State	$ 6,000	$ 1,000	4,000
Foreign	18,000	13,000	20,000
	24,000	14,000	10,000
Deferred income tax (benefit) from continuing operations:			
Federal			
State			
Foreign	(84,000)	(16,000)	(3,000)
	(84,000)	(16,000)	(3,000)
Net income tax (benefit) expense from continuing operations	$ (60,000)	$ (2,000)	$ 7,000

Table of Contents

SYNBIOTICS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Deferred tax assets comprise the following:

	December 31,	
	2004	**2003**
Net operating loss carryforwards	$ 3,031,000	$ 7,782,000
Tax credit carryforwards	282,000	580,000
Patent litigation settlement	361,000	435,000
Depreciation	498,000	382,000
Goodwill	2,326,000	2,660,000
Capital loss carryforwards	412,000	412,000
Accrued compensation	113,000	117,000
Other reserves and accruals	249,000	242,000
	7,272,000	12,610,000
Less valuation allowance	(7,272,000)	(12,610,000)
	$	$

The valuation allowance for deferred tax assets at December 31, 2004 and 2003 is due to management s determination that, as a result of the Company s liquidity concerns and accumulated deficit, it is more likely than not that the deferred tax assets will not be realized in the future.

A reconciliation of the (benefit from) provision for income taxes to the amount computed by applying the statutory Federal income tax rate to income before income taxes follows:

	Year Ended December 31,		
	2004	**2003**	**2002**
Amounts computed at statutory Federal rate	$ (241,000)	$ 437,000	$ (2,331,000)
State income taxes	4,000	86,000	(271,000)
Foreign income taxes	(107,000)	60,000	740,000
Income (deductions) for financial reporting purposes for which there is no current tax (benefit) provision	(112,000)	(26,000)	(9,000)

Utilization of Federal general business tax credits			(41,000)
Expiration of Federal general business tax credits	286,000	188,000	81,000
Expiration of Federal net operating loss carryforwards	5,445,000	220,000	37,000
Expiration of state net general business tax credits	3,000		
Increase (decrease) in valuation allowance	(5,338,000)	(967,000)	1,801,000

			$	$	$ $ $
Guarantees (3)	13,306	5,197	5,935	1,449	725
Purchase Obligations(4)	14,817		14,817		
Standby letters of credit(5)	3,028	3,028			
Total commercial commitments of continuing operations	$ 31,151	$ 8,225	$ 20,752	$ 1,449	$ 725

(1)Effective June 30, 2003, the Company entered into an unsecured line of credit agreement of $30.0 million, with a $5.0 million sub-limit for standby letters of credit, which is intended for working capital purposes. The line of credit expires August 2005. The outstanding balance on the line of credit was $1.0 million at December 31, 2004. Individual units within campus-based operations have unsecured lines of credit, which total $25.0 million, primarily for working capital purposes. The aggregate outstanding balance on the campus-based segments lines of credit was $15.9 million at December 31, 2004, which is included in the current portion of long-term debt. The weighted average short term borrowing rates were 8.1% and 5.8% at December 31, 2004 and December 31, 2003 respectively.

(2)In connection with the sale of substantially all of the Company s K-12 segments to Educate, the Company entered into a three-year management service agreement with Educate. Under the terms of the agreement, Educate will provide certain support services, including, specified accounting, benefits, IT, human resources, purchasing and payroll services to Laureate. Conversely, Laureate will provide certain support services, primarily in the areas of tax and treasury, to Educate. The agreement is based on a fixed-fee, adjusted as appropriate based on increases to predetermined service volumes. The net fee due to Educate on an annual basis is approximately $3.0 million.

(3)Subsequent to the divestiture of the K-12 segments, all leases related to Sylvan Learning Centers acquired by Educate were renegotiated or assigned in the name of Educate during the third quarter of 2003. Leases with remaining payments of $8.2 million through December 2008 are guaranteed by the Company. Under the terms of Asset Purchase Agreement with Educate, the Company is indemnified against any losses suffered as a result of these lease guarantees. On December 10, 2004, Laureate entered into an agreement to guarantee lease payments owed by Kendall College to Key Equipment Finance. Leases with remaining payments of $5.1 million through December 2011 are guaranteed by the Company under this agreement.

(4)As part of the acquisition of ECE, the Company committed to purchase the remaining 30% ownership from the sellers on December 31, 2008 for approximately $9.5 million. The agreement is denominated in Euros, and is subject to foreign currency exchange rate risk on the dates of payment. As part of the acquisition of IFG, the Company committed to additional capital contributions, which will increase the Company s share of ownership. The agreement provides that, no later than July 31, 2006 and July 31, 2007, the Company shall contribute approximately $1.7 million and $2.5 million resulting in an increase in ownership share of 16% and 23%, respectively. In addition, during the period October through November 2008, the sellers may exercise a put option requiring the Company to purchase the remaining 10% ownership for approximately $1.1 million. The agreement is denominated in Euros, and is subject to foreign currency exchange rate risk on the dates of payment.

(5)The Company has approximately $3.0 million outstanding in standby letters of credit. The Company is self-insured for workers compensation and other insurable risks up to predetermined amounts above which third party insurance applies. The Company is contingently liable to insurance carriers under certain of these policies and has provided a letter of credit in favor of the insurance carriers for approximately $1.3 million. The company has also issued a standby letter of credit in the amount of $1.4 million assuring the collectibility of a $1.5 million line of credit at AIEP, which is being used for working capital purposes. The outstanding balance on the AIEP line of credit was $0.4 million at December 31, 2004.

(6)Under terms of note agreements with Kendall College (more fully described in Note 6 to the consolidated financial statements), the Company has committed to providing total funding to Kendall College in the amount of $18.3 million. As of December 31, 2004, the Company has substantially fulfilled this funding commitment. In the event the Company does not exercise its agreement to acquire Kendall College, Kendall is obligated to enter into a lease agreement with the Company beginning July 21, 2006 to lease office space. The lease commitment specifies a term of 36 months and annual rent of $1.0 million.

In connection with certain acquisitions, variable amounts of contingent consideration are payable to the sellers based upon specified terms. All existing contingent consideration agreements are predicated upon improved operating profitability of the acquired entities, based on multiples consistent with those used to calculate the initial purchase price. The Company will record the contingent consideration when the contingencies are resolved and the additional consideration becomes payable.

Additional amounts of contingent consideration are due the sellers of UDLA based on operating results for the three years ending December 31, 2006. No later than March 31, 2006, the Company is obligated to the sellers for an amount equal to 60% of six times (i) average earnings before interest and income taxes (EBIT) for 2004 and 2005, less (ii) 2000 EBIT; this result is reduced by (iii) 42% of certain specified debt. Assuming EBIT remains at 2004 levels for 2005, the Company would be obligated to the sellers for approximately $60.9 million. No later than March 31, 2007, the Company is obligated to the sellers for an amount equal to 20% of four times (i) average EBIT for 2005 and 2006; this result is reduced by (ii) 20% of certain specified debt and (iii), $6.5 million. Assuming EBIT remains at 2004 levels for 2005 and 2006, the Company would be obligated to the sellers for approximately $12.6 million. The Company has pledged its shares of Decon, the holding company that controls and operates UDLA, to satisfy its payment obligations to the sellers. The Company cannot dispose of, place any lien on or encumber the shares without the prior approval of the sellers.

Effective April 1, 2008, the minority owners of UDLA have the right to require the Company to purchase their remaining 20% interest in Decon for a variable purchase price based on average EBIT for certain specified periods. Effective April 1, 2009, the Company has a call right to acquire the remaining 20% interest under a similar methodology for certain specified periods.

Effective April 1, 2009, the minority owners of UNAB and AIEP have the right to require the Company to purchase their 20% interest for a variable purchase price based on average EBIT for certain specified periods. Effective April 1, 2009, the Company has a call right to acquire this 20% interest under a similar methodology for certain specified periods.

Additional amounts of contingent consideration, not to exceed $10.0 million, are due the sellers of KIT eLearning BV equal to four times the average of the audited earnings before interest, income taxes, depreciation and amortization for the calendar years ending December 31, 2006 and 2007. KIT eLearning BV was acquired on March 31, 2004, and is now operated as Laureate Online Education BV.

Related Party Transactions

Transactions between UI and Certain Former Owners

The Company entered into a lease agreement in October 2003 with certain former owners of UI, located in Costa Rica and Panama. In 2004, the Company entered into a new lease with the same parties for the ULACIT campus. The lease agreements enable the Company to operate UI and ULACIT at their established campuses. Both leases have initial terms of fifteen years, with additional five-year extensions available at the Company s option. The leases also contain provisions for the Company, at its option, to purchase the real estate for its fair market value at any time. Under the UI lease, monthly rental payments are based on eight percent of net campus revenues for the first two years and ten percent of net campus revenues in the third year. Subsequent rental payments will be adjusted for inflation. The Company recognized approximately $0.8 million and $0.1 million of rent expense under this lease for the year ended December 31, 2004 and the period from October 15, 2003 through December 31, 2003, respectively. The ULACIT lease has fixed monthly rental payments. The Company recognized approximately $0.1 million of rent expense under this lease for the period from October 25, 2004 through December 31, 2004.

Transactions between UVM and Certain Officers and Minority Shareholders

The Company entered into lease agreements for UVM s university campuses with certain of its officers and minority owners. The leases have an initial term of ten years with an additional two-year extension available at the Company s option. During 2002, this lease was amended to include an additional three-year extension available at the Company s option, for a total term of up to 15 years. The amended lease also gives the Company the option to purchase the real estate at the fair market value of the property at the end of the lease term. Rents are adjusted monthly for inflation. For 2004, 2003 and 2002, the Company incurred approximately $5.6 million, $5.1million and $4.5 million, respectively, of rent under these leases. The lease agreements enable the Company to operate UVM at its already established campuses. The value of the contracts was determined by arms-length negotiation between the parties and based upon the then prevailing market rates, and was corroborated by an independent real estate appraisal.

These officers and minority shareholders also provided staffing services to UVM for one of its campuses in 2004 and four of its campuses in 2003. UVM incurred approximately $0.2 million and $3.0 million of expenses for 2004 and 2003, respectively, in connection with this contract.

In 2003, UVM subcontracted educational programs provided to government employees to a company partially owned by some of its officers and minority shareholders. UVM paid 50% of the revenue, net of related expenses, associated with each government contract to this company, which amounted to $0.1 million for 2003. This was an arms-length agreement between three parties, in which one of the parties was a government agency. In December 2003, UVM officers and minority shareholders sold their interest in the entity providing this service.

Transactions between Les Roches and Certain Officers

Les Roches entered into lease agreements for some of its dormitories and other facilities with the former owners of Les Roches. Pursuant to these agreements, the Company incurred rent expense of approximately $0.5 million for the 2001 fiscal year and $0.3 million from July 26, 2000, the date of acquisition of Les Roches, through December 31, 2000. In January 2002, the Company entered into an agreement with the officers to purchase these properties for approximately $2.7 million.

Transactions between the Company and Affiliates

As discussed more fully in Note 3 to the consolidated financial statements, on June 30, 2003, the Company completed the sale of its K-12 segments to Educate. Prior to the sale, Apollo held the rights to appoint two seats on the Company s Board of Directors. As a result of the sale transaction, these rights were reduced to one Board seat. During the fourth quarter of 2004, concurrent with its initial public stock offering, Apollo resigned its board seat.

As discussed more fully in Note 11 to the consolidated financial statements, in connection with the sale of the Company s K-12 segments, the Company entered into a three-year management service agreement with Educate. The net fee due to Educate on an annual basis is approximately $3.0 million.

Effects of Inflation

Inflation has not had a material effect on the Company s revenues and income from continuing operations in the past three years. Inflation is not expected to have a material effect in the foreseeable future. The Company historically has been able to increase tuition pricing at a rate at or above the rate of inflation.

International Exposure

The Company maintains diverse operations in a broad range of international locations. The international aspects of the Company s operations create additional exposure to political uncertainties, currency devaluations and local country regulations affecting the provision of educational services. Revenues and profits in any period may be significantly impacted by international developments outside the control of the Company.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Market risk is the risk of loss to future earnings, to fair values or to future cash flows that may result from the changes in the price of financial instruments. The Company is exposed to financial market risks, including changes in foreign currency exchange rates, interest rates, equity prices and investment values. The Company occasionally uses derivative financial instruments to protect against adverse currency movements related to significant foreign acquisitions. Exposure to market risks related to operating activities is managed through the Company s regular operating and financing activities.

Foreign Currency Risk

The Company derives approximately 80% of its revenues from students outside the United States. This business is transacted through a network of international subsidiaries, generally in the local currency that is considered the functional currency of that foreign subsidiary. Expenses are also incurred in the foreign currencies to match revenues earned, which minimizes the Company s exchange rate exposure to operating margins. A hypothetical 10% adverse change in average annual foreign currency exchange rates would have decreased operating income and cash flows for 2004 by $11.6 million. The Company generally views its investment in most of its foreign subsidiaries as long-term. The effects of a change in foreign currency exchange rates on the Company s net investment in foreign subsidiaries are reflected in accumulated other comprehensive income (loss) on the Company s consolidated balance sheets. A 10% depreciation in functional currencies relative to the U.S. dollar would have resulted in a decrease in the Company s net investment in foreign subsidiaries of approximately $64.7 million at December 31, 2004.

The Company occasionally enters into foreign exchange forward contracts to reduce the earnings impact of non-functional currency denominated receivables. The primary business objective of the activity is to protect the U.S. dollar value of the Company s assets and future cash flows with respect to exchange rate fluctuations. At December 31, 2004, the Company had two forward contracts with expiration dates in 2005 and 2009, respectively. The change in fair value of the swap exactly offsets the change in fair value of the hedged receivables, with no net impact on earnings.

Interest Rate Risk

The Company holds its cash and cash equivalents in high quality, short-term, fixed income securities. Consequently, the fair value of the Company s cash and cash equivalents would not be significantly impacted by either a 100 basis point increase or decrease in interest rates due to the short-term nature of the Company s portfolio. The Company s revolving credit facility bears interest at variable rates, and the fair value of this instrument is not significantly affected by changes in market interest rates. A 100 basis point decrease in interest rates would have reduced net interest income for 2004 by $0.4 million.

The table below provides information about the Company s financial instruments that are sensitive to changes in interest rates. The table presents cash flows of weighted-average interest rates and principal payments for the following years ended December 31. The fair value of the debt below approximates book value.

Total debt and due to shareholders of acquired companies (in millions of US dollars):	**2005**	**2006**	**2007**	**2008** (in millions)	**2009**	**Thereafter**	**Total**
Fixed rate (Chilean peso)	$ 13.7	$ 15.6	$ 20.4	$ 3.3	$ 0.1	$ 0.4	$ 53.5
Average interest rate	6.3%	6.3%	6.3%	6.6%	8.5%	8.5%	
Fixed rate (Swiss franc)	2.2	0.4	1.6	2.5	2.5	21.3	30.5
Average interest rate	2.8%	2.8%	2.8%	3.0%	3.3%	3.6%	
Fixed rate (Euro)	2.4	1.9	1.3	0.5	1.7	2.3	10.1
Average interest rate	6.2%	6.5%	6.8%	7.0%	6.9%	6.9%	
Fixed rate (Other)	20.2	0.6	3.6				24.4
Average interest rate	1.9%	6.0%	6.0%				
Variable rate (Chilean peso)	7.2	0.2	0.2	0.2	0.2	1.1	9.1
Average interest rate	4.8%	3.5%	3.5%	3.5%	3.5%	3.5%	
Variable rate (Swiss franc)	2.5	2.4	0.9			13.6	19.4
Average interest rate	4.0%	4.0%	4.1%			4.1%	
Variable rate (Euro)	3.1	0.7	0.6	0.7	0.5	4.5	10.1
Average interest rate	3.3%	3.2%	3.2%	3.2%	3.2%	3.2%	
Variable rate (Mexican Peso)	9.5	0.9	0.9	0.9			12.2
Average interest rate	5.4%	1.4%	1.4%	0.7%			
Variable rate (Other)	13.1	1.0	2.0	2.0	2.0	0.5	20.6
Average interest rate	4.6%	3.7%	3.5%	3.7%	4.3%	6.5%	

The weighted-average interest rates for the variable debt were calculated using the interest rate in effect as of December 31, 2004 for each debt instrument.

Investment Risk

The Company has an investment portfolio that includes short-term investments in available-for-sale debt and equity securities. The Company s investment portfolio is exposed to risks arising from changes in these investment values.

All the potential impacts noted above are based on sensitivity analysis performed on the Company s financial position at December 31, 2004. Actual results may differ materially.

Item 8. Financial Statements and Supplementary Data

INDEX TO FINANCIAL STATEMENTS

Report of Independent Registered Public Accounting Firm

On Consolidated Financial Statements

Board of Directors and Stockholders

Laureate Education, Inc.

We have audited the accompanying consolidated balance sheets of Laureate Education, Inc. (formerly Sylvan Learning Systems, Inc.) and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the three years in the period ended December 31, 2004. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits. The financial statements of Chancery Software Limited (a corporation in which the Company had a 42% interest) for the year ended September 30, 2002, have been audited by other auditors and whose report has been furnished to us; insofar as our opinion on the consolidated financial statements relates to data included for Chancery Software Limited, it is based solely on their report. In the consolidated financial statements, the Company s equity in the net losses of Chancery Software Limited is stated at $1,020 for the year ended December 31, 2002.

We conducted our audits in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of the other auditor provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of the other auditor, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Laureate Education, Inc. and subsidiaries at December 31, 2004 and 2003, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 2, to the consolidated financial statements, effective January 1, 2002, the Company changed its method of accounting for goodwill.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Laureate Education, Inc. and subsidiaries internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control- Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 10, 2005 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Baltimore, Maryland
March 10, 2005

LAUREATE EDUCATION, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(Dollar and share amounts in thousands, except per share data)

	December 31, 2004	December 31, 2003
Assets		
Current assets:		
Cash and cash equivalents	$ 105,629	$ 92,145
Available-for-sale securities	4,515	16,765
Receivables:		
Accounts receivable	128,523	90,636
Notes receivable	85,450	44,240
Other receivables	3,507	7,366
	217,480	142,242
Allowance for doubtful accounts	(25,214)	(15,550)
	192,266	126,692
Inventory	4,647	3,375
Deferred income taxes	5,079	
Income tax receivable	33,523	16,542
Prepaid expenses and other current assets	15,238	14,338
Current assets of discontinued operations	20,000	
Total current assets	380,897	269,857
Notes receivable from related party, net of discount of $728 and $14,024 at December 31, 2004 and 2003, respectively	1,219	43,155
Other notes receivable, less current portion, net of allowance of $5,846 and $2,158 at December 31, 2004 and 2003, respectively	49,165	16,074
Property and equipment:		
Land	95,153	68,441
Buildings	266,524	179,911
Construction in-progress	3,154	30,578
Furniture, computer equipment and software	161,153	110,852
Leasehold improvements	56,788	39,824
	582,772	429,606
Accumulated depreciation and amortization	(97,180)	(63,756)
	485,592	365,850
Intangible assets:		
Goodwill	364,973	233,561
Tradenames and accreditations	174,694	79,789
Other intangible assets, net of accumulated amortization of $9,358 and $4,519 at December 31, 2004 and 2003, respectively	11,447	8,845
	551,114	322,195
Deferred income taxes	3,335	29,760
Deferred costs, net of accumulated amortization of $10,025 and $6,663 at December 31, 2004 and 2003, respectively	15,976	11,901
Other assets	16,371	19,208
Long-term assets of discontinued operations	27,041	71,914
Total assets	$ 1,530,710	$ 1,149,914

See accompanying notes to financial statements.

LAUREATE EDUCATION, INC. AND SUBSIDIARIES

Consolidated Balance Sheets (*continued*)

(Dollar and share amounts in thousands, except per share data)

	December 31, 2004	December 31, 2003
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 20,824	$ 33,992
Accrued expenses	108,542	76,080
Income tax payable	15,423	20,346
Current portion of long-term debt	47,010	21,654
Due to shareholders of acquired companies	26,861	4,747
Deferred income taxes	1,205	
Deferred revenue	225,747	152,922
Other current liabilities	10,482	3,022
Total current liabilities	456,094	312,763
Long-term debt, less current portion	86,605	75,100
Due to shareholders of acquired companies, less current portion	29,402	29,941
Deferred income taxes	22,446	204
Other long-term liabilities	19,990	16,765
Total liabilities	614,537	434,773
Commitments and contingent liabilities		
Minority interest	37,538	45,991
Stockholders equity:		
Preferred stock, par value $.01 per share authorized 10,000 shares, no shares issued and outstanding as of December 31, 2004 and 2003		
Common stock, par value $.01 per share authorized 90,000 shares, issued and outstanding shares of 48,813 as of December 31, 2004 and 44,984 issued and outstanding as of December 31, 2003	488	450
Additional paid-in capital	474,928	353,522
Retained earnings	355,989	292,978
Accumulated other comprehensive income	47,230	22,200
Total stockholders equity	878,635	669,150
Total liabilities and stockholders equity	$ 1,530,710	$ 1,149,914

See accompanying notes to financial statements.

LAUREATE EDUCATION, INC. AND SUBSIDIARIES

Consolidated Statements of Operations

(Dollar and share amounts in thousands, except per share data)

	Year ended December 31 2004	2003 (as restated Note 3)	2002
Revenues			
Core operating segments	$ 648,019	$ 471,903	$ 335,608
Ventures		903	395
Total revenues	648,019	472,806	336,003
Costs and expenses			
Direct costs:			
Core operating segments	529,674	393,050	291,619
Ventures		2,122	2,592
General and administrative expenses:			
Core operating segments	21,380	17,774	21,318
Ventures		1,756	4,804
Non-cash stock compensation expense (1)	5,718	23,050	1,046
Total costs and expenses	556,772	437,752	321,379
Operating income	91,247	35,054	14,624
Other income (expense)			
Interest income	20,582	7,280	5,213
Other income (expense)	7,597	(277)	1,692
Interest expense	(7,670)	(8,844)	(8,256)
Ventures investment loss		(8,394)	(2,308)
Loss on other investments			(8,253)
Foreign currency exchange gain (loss)	(956)	257	641
	19,553	(9,978)	(11,271)
Income from continuing operations before income taxes, minority interest, equity in net income (loss) of affiliates, cumulative effect of change in accounting principle	110,800	25,076	3,353
Income tax benefit (expense)	(6,798)	2,930	8,789
Minority interest in (income) loss of consolidated subsidiaries, net of tax:			
Ventures		487	2,058
Other	(21,021)	(14,947)	(6,880)
	(21,021)	(14,460)	(4,822)
Equity in net income (loss) of affiliates, net of tax:			
Ventures		(4,055)	(4,029)
Other	(323)	194	309
	(323)	(3,861)	(3,720)
Income from continuing operations before cumulative effect of change in accounting principle	82,658	9,685	3,600
Loss from discontinued operations, net of income tax expense of $200 in 2004, $6,211 in 2003 and $12,830 in 2002	(6,323)	(5,480)	(4,266)
Gain (loss) on disposal of discontinued operations, net of income tax expense (benefit) of $3,232 in 2004, $32,557 in 2003 and $(7,632) in 2002	(13,324)	41,930	(16,643)
	63,011	46,135	(17,309)

Income (loss) before cumulative effect of change in accounting principle						
Cumulative effect of change in accounting principle, net of income tax benefit of $7,700						(78,634)
Net income (loss)	$	63,011	$	46,135	$	(95,943)
Earnings (loss) per common share, basic:						
Income from continuing operations before cumulative effect of change in accounting principle	$	1.78	$	0.23	$	0.09
Net income (loss)	$	1.36	$	1.10	$	(2.40)
Earnings (loss) per common share, diluted:						
Income from continuing operations before cumulative effect of change in accounting principle	$	1.69	$	0.22	$	0.09
Net income (loss)	$	1.29	$	1.05	$	(2.40)
(1) Composition of non-cash stock compensation expense:						
Direct costs	$	2,823	$	7,850	$	1,046
General and administrative expenses		2,895		15,200		
Total	$	5,718	$	23,050	$	1,046

See accompanying notes to financial statements

LAUREATE EDUCATION, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders Equity

(Dollar and share amounts in thousands)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at January 1, 2002	$ 387	$ 229,386	$ 342,786	$ (26,704)	$ 545,855
Options exercised for purchase of 1,106 shares of common stock, including income tax benefit of $4,257	11	18,960			18,971
Issuance of 24 shares of common stock in connection with the Employee Stock Purchase Plan		376			376
Issuance of 318 shares of common stock in connection with the conversion of debentures	3	4,997			5,000
Issuance of 144 shares of common stock in connection with acquisitions	2	2,999			3,001
Other		1,208			1,208
Comprehensive loss:					
Net loss for the year ended December 31, 2002			(95,943)		(95,943)
Foreign currency translation adjustment				7,366	7,366
Unrealized loss on available-for-sale securities				(117)	(117)
Minimum pension liability adjustment				211	211
Total comprehensive loss					(88,483)
Balance at December 31, 2002	403	257,926	246,843	(19,244)	485,928
Options exercised for purchase of 953 shares of common stock, including income tax benefit of $4,638	10	19,230			19,240
Issuance of 40 shares of common stock in connection with the Employee Stock Purchase Plan		422			422
Issuance of 2,823 shares of common stock in connection with the conversion of debentures	28	43,531			43,559
Issuance of 581 shares of common stock in connection with acquisition of minority interest in Sylvan Ventures LLC	6	5,148			5,154
Issuance of 256 shares of restricted common stock to employees	3	(3)			
Non-cash stock compensation		27,116			27,116
Other equity activity		152			152
Comprehensive income:					
Net income for the year ended December 31, 2003			46,135		46,135
Foreign currency translation adjustment				33,979	33,979
				63	63

Unrealized gain on available-for-sale securities					
Reclassification adjustment for foreign currency translation adjustments realized in net income				7,402	7,402
Total comprehensive income					87,579
Balance at December 31, 2003	450	353,522	292,978	22,200	669,150
Options exercised for purchase of 1,505 shares of common stock, net of 180 replenished shares, including income tax benefit of $5,801	15	25,289			25,304
Issuance of 14 shares of common stock in connection with the Employee Stock Purchase Plan		151			151
Issuance of 2,500 shares in connection with acquisition	25	88,810			88,835
Non-cash stock compensation (includes $1,436 in discontinued operations)		7,154			7,154
Other equity activity	(2)	2			
Comprehensive income:					
Net income for the year ended December 31, 2004			63,011		63,011
Foreign currency translation adjustment				24,988	24,988
Unrealized loss on available-for-sale securities				42	42
Total comprehensive income					88,041
Balance at December 31, 2004	$ 488	$ 474,928	$ 355,989	$ 47,230	$ 878,635

See accompanying notes to financial statements

LAUREATE EDUCATION, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(Dollar amounts in thousands)

	Year Ended December 31, 2004	2003	2002
Operating activities			
Net income (loss)	$ 63,011	$ 46,135	$ (95,943)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization of fixed assets	30,317	25,087	28,820
Amortization	11,241	5,834	2,217
(Gain) loss on disposal of discontinued operations	13,324	(41,930)	2,434
Non-cash stock compensation expense continuing operations	5,718	23,050	1,046
Non-cash stock compensation expense discontinued operations	1,436	4,066	
Acceleration of original issue discount on note receivable repayment	(12,722)		
Loss on assets sold	16	7,894	
Gain on conveyance of land as purchase consideration	(5,169)		
Loss on assets sold discontinued operations			20,244
Loss (gain) on investments	(728)	500	22,135
Other non-cash items	915	1,224	(649)
Minority interest in consolidated subsidiaries	21,021	14,460	4,822
Cumulative effect of change in accounting principle			86,334
Equity in net loss of affiliates	323	3,694	3,968
Deferred income taxes	1,992	(6,471)	(9,108)
Changes in operating assets and liabilities:			
Receivables	(66,702)	(16,058)	(13,038)
Inventory, prepaid expenses and other current assets	12,922	4,814	4,398
Accounts payable and accrued expenses	(271)	8,537	14,410
Income taxes payable	(15,411)	(44,709)	(8,363)
Deferred revenue and other current liabilities	63,109	22,768	17,398
Net cash provided by operating activities	124,342	58,895	81,125
Investing activities			
Purchase of available-for-sale securities	(57,648)	(54,573)	(24,958)
Proceeds from sale or maturity of available-for-sale securities	71,254	67,068	62,210
Proceeds from sale (investments) in affiliates and other investments	4,115	(739)	(4,117)
Proceeds from sale of land	13,107		
Purchase of property and equipment, net	(100,779)	(81,078)	(69,755)
Proceeds from repayment of related party note receivable	55,006		
Proceeds from sale of K-12 segment		96,371	
Cash loaned in exchange for notes receivable	(23,178)		
Proceeds from repayment of notes receivable	2,697		
Cash paid for acquisitions, net of cash acquired	(75,762)	(53,711)	(56,207)
Payment of deferred consideration for prior period acquisitions	(4,303)	(8,178)	
Expenditures for deferred contract costs	(9,918)	(5,108)	(1,905)
Increase in other assets	(2,764)	(2,919)	(2,776)
Net cash used in investing activities	(128,173)	(42,867)	(97,508)
Financing activities			
Proceeds from exercise of options	19,503	14,602	14,714
Proceeds from issuance of common stock	151	422	964
Proceeds from issuance of long-term debt	77,777	22,090	20,816
Payments on long-term debt	(66,939)	(39,482)	(20,142)

Cash received from Ventures minority interest members				2,263		15,425
Cash distributed to Ventures minority interest members						(12,000)
Change in long-term liabilities		1,335		(2,682)		2,020
Net cash provided by (used in) financing activities		31,827		(2,787)		21,797
Effects of exchange rate changes on cash		(10,123)		(19,538)		(2,923)
Net change in cash and cash equivalents		17,873		(6,297)		2,491
Cash and cash equivalents at beginning of year		98,388		104,685		102,194
Cash and cash equivalents at end of year	$	116,261	$	98,388	$	104,685
Cash and cash equivalents classified as:						
Continuing operations	$	105,629	$	92,145	$	94,068
Discontinued operations		10,632		6,243		10,617
Cash and cash equivalents at end of year	$	116,261	$	98,388	$	104,685

See accompanying notes to financial statements.

Laureate Education, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(Dollar and share amounts in thousands, except per share data)

Note 1 - Description of Business and Basis of Presentation

Laureate Education, Inc. and subsidiaries (the Company) is focused exclusively on providing a superior higher education experience to over 159,000 students through the leading global network of accredited campus-based and online universities and higher education institutions (higher education institutions). The Company s educational offerings are delivered through three separate reportable segments: Campus Based - Latin America (Latin America), Campus Based - Europe (Europe) and Laureate Online Education. The campus-based segments of Latin America and Europe own or maintain controlling interests in six and nine separately accredited higher education institutions, respectively. The Latin America segment has locations in Mexico, Chile, Peru, Ecuador, Panama, and Costa Rica. The Europe segment has locations in Spain, Switzerland, and France. The Laureate Online Education segment (formerly Online Higher Education) provides career-oriented degree programs to working adult students through Walden E-Learning, Inc. (Walden), National Technological University (NTU), Laureate Online Education BV (formerly KIT eLearning BV), and Canter and Associates (Canter).

The Ventures business was disbanded in 2003.

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States that require the Company s management to make estimates and assumptions that affect reported amounts and related disclosures. Actual results could differ from those estimates.

Certain amounts previously reported for 2003 and 2002 have been reclassified to conform to the 2004 presentation. As discussed more fully in Note 3, certain business components are classified as discontinued operations in the accompanying consolidated financial statements. The 2003 and 2002 consolidated financial statements have been restated to present the Company s program in India as discontinued operations.

On May 17, 2004, the Company changed its name from Sylvan Learning Systems, Inc. to Laureate Education, Inc. The Company began trading under a new NASDAQ ticker symbol, LAUR, on May 18, 2004.

Note 2 Significant Accounting Policies

Principles of Consolidation and Investments in Affiliates

The various interests that the Company acquires in its affiliated companies are accounted for under three methods: consolidation, equity method, or cost method. The Company determines the method of accounting for its affiliated companies on a case-by-case basis based upon its ownership percentage in each affiliated company, as well as its degree of influence over each affiliated company.

Consolidation. Affiliated companies in which the Company owns, directly or indirectly, or otherwise controls more than 50% of the outstanding voting interests are accounted for under the consolidation method of accounting. Four subsidiaries of the Company consolidate not-for-profit, non-stock universities that are controlled through majority voting interests of their respective Boards of Directors. The Company also has a substantial economic interest in the net assets of these not-for-profit universities. Under the consolidation method, an affiliated company s results of operations are reflected within the consolidated statements of operations. Earnings or losses attributable to other stockholders of a consolidated affiliated company are classified as minority interest in (income) loss of consolidated subsidiaries in the Company s consolidated statements of operations. Minority interest adjusts the Company s consolidated net results of operations to reflect only its share of the after-tax earnings or losses of an affiliated company. Income taxes attributable to minority interest are determined using the applicable statutory tax rates in the jurisdictions where such operations are conducted. These rates vary from country to country. Transactions between the Company and its consolidated affiliated companies are eliminated in consolidation.

Equity Method. Affiliated companies in which the Company owns 50% or less of the outstanding voting interests, but over which the Company exercises significant influence, are accounted for under the equity method of accounting. Significant influence with respect to an affiliated company depends on an evaluation of several factors including, among other things, representation on the associated company s board of directors, ownership percentage and voting rights associated with the Company s holdings in the securities of the affiliated company. Investments accounted for under the equity method are included in Other Assets in the consolidated balance sheets. Under the equity method of accounting, affiliated companies results of operations are not consolidated within the Company s operating results. However, the Company s share of the earnings or losses of these affiliated companies is classified as equity in net income (loss) of affiliates in the consolidated statements of operations. The Company initially records its share of the earnings or losses of an affiliated company based upon its proportionate ownership of voting common stock. If the affiliated company is incurring losses, and previous losses have reduced the common stock investment account to zero, or if the Company holds no common stock, the Company continues to recognize equity method losses based on the ownership level of the particular affiliated company security or loan/advance held by the Company to which the equity method losses are being applied. The Company continues to recognize losses up to the investment carrying value, including any additional financial support made or committed to by the Company.

Cost Method. Investments in equity securities that do not have readily determinable fair values and are not accounted for under either the consolidation or the equity method of accounting are accounted for under the cost method of accounting. Under this method, the Company s investment is carried at its cost and its share of earnings or losses of these companies is not included in the Company s consolidated statements of operations. However, a series of operating losses or other factors may indicate that a decrease in value of the equity investments has occurred which is other than temporary. These impairment losses are included in other expense in the consolidated statements of operations.

Cash Equivalents

The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

Investments in Marketable Securities

Available-for-sale securities are carried at fair value, with any unrealized gains and losses, net of tax, reported in other comprehensive income (loss). The amortized cost of debt securities in this category is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization is included in investment income. Realized gains and losses and declines in value judged to be other than temporary on available-for-sale securities are included in investment and other income. The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as available-for-sale are included in investment and other income.

Fair Value of Financial Instruments

The Company s financial instruments consist primarily of cash and cash equivalents, accounts and notes receivable, available-for-sale investments, accounts payable, due to shareholders of acquired companies, and short and long-term debt. The fair value of these financial instruments approximate their carrying amounts reported in the consolidated balance sheets.

Allowance for Doubtful Accounts

The Company uses estimates to determine the amount of the allowance for doubtful accounts necessary to reduce accounts and notes receivable to their expected net realizable value. The Company estimates the amount of the required allowance by reviewing the status of past-due receivables and analyzing historical bad debt trends. Actual collection experience has not varied significantly from estimates, due primarily to credit policies, collection experience, known and inherent risks in the receivable portfolio, and a lack of concentration of accounts receivable. The provision for credit losses on tuition finance receivables is charged to earnings in amounts sufficient to maintain the allowance for uncollectible accounts at a level the Company believes is adequate to cover the losses of principal and accrued interest in the existing portfolio. The Company charges-off receivables deemed to be uncollectible to the allowance for doubtful accounts. Accounts and tuition finance notes receivable balances are not collateralized. Other long-term notes receivable balances are primarily collateralized by assets or stock of the financed entity.

Inventory

Inventory, consisting primarily of computer software and educational, instructional, and marketing materials and supplies, is stated at the lower of cost (first-in, first-out) or market value.

Property and Equipment

Property and equipment is stated at cost. Included in property and equipment are the direct costs of developing or obtaining software for internal use. Depreciation of buildings and furniture and equipment is computed using the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized using the straight-line method over the lesser of the lease term or the estimated useful life of the asset. Depreciation and amortization periods are as follows:

Buildings	33-50 years
Furniture, computer equipment and software	4-15 years
Leasehold improvements	3-15 years

Goodwill and Other Intangible Assets

Goodwill consists of the cost in excess of fair value of the identifiable net assets of entities acquired in purchase business combinations. Other intangibles include student rosters, accreditation, tradenames, non-competition agreements and curriculum acquired in purchase business combinations. The company uses the income approach to establish accreditation, tradename and student roster asset values. Accreditations and tradenames are valued by the relief from royalty method, estimating the amount of royalty income that would be generated if the assets were licensed in an arms length transaction to a third party. The Company uses the discounted cash flow method to establish acquired student roster asset values. The resulting asset value reflects the present value of the projected earnings generated by the student roster. The cost of intangible assets with determinable useful lives is amortized over estimated useful lives ranging from 1 to 7 years. Goodwill and indefinite-lived intangibles are evaluated annually for impairment and on an interim basis if events or changes in circumstances between annual tests indicate that the asset might be impaired.

Goodwill is potentially impaired when the carrying amount of a reporting unit s goodwill exceeds its implied fair value, as determined under a two-step approach. The first step is to determine the estimated fair value of each reporting unit with goodwill. The reporting units of the Company for purposes of the impairment test are those operating components for which discrete financial information is available and for which operating results are regularly reviewed by segment management. Components are combined when determining reporting units if they have similar economic characteristics. Generally, each higher education institution is a reporting unit for purposes of the impairment tests.

The Company estimates the fair value of each reporting unit by estimating the present value of the reporting unit s future cash flows. If the recorded net assets of the reporting unit are less than the reporting unit s estimated fair value, then no impairment is indicated. Alternatively, if the recorded net assets of the reporting unit exceed its estimated fair value, then goodwill is potentially impaired and a second step is performed. In the second step, the implied fair value of the goodwill is determined by deducting the estimated fair value of all tangible and identifiable intangible net assets of the reporting unit from the estimated fair value of the reporting unit. If the recorded amount of goodwill exceeds this implied fair value, an impairment charge is recorded for the excess.

The Company was first required to test goodwill for impairment upon the adoption of Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (Statement 142). Upon adoption on January 1, 2002, the Company recorded a non-cash charge of $78,634, net of income tax benefit of $7,700, which is reported as a cumulative effect change in accounting principle in the 2002 consolidated statement of operations. The impairment charge relates solely to the WSI reporting units included in discontinued operations.

The impairment test for indefinite-lived assets, consisting of accreditation and tradenames, requires a new determination of the fair value of the intangible asset. The Company generally uses an income approach to determining the fair value of these assets. If the fair value of the intangible asset is less than its carrying value, an impairment loss is recognized for an amount equal to the difference. The intangible asset is then carried at its new fair value.

Deferred Costs

Deferred costs include direct costs incurred for services to higher education institutions licensing distance learning master s programs. These costs are capitalized when incurred and expensed when the related revenue is recognized.

Deferred costs also include the direct cost of internally developing proprietary educational products and materials that have extended useful lives and are licensed or sold to higher education institutions or used at Company-operated institutions. These costs are capitalized and amortized over the estimated useful life of the products and materials, which approximates five years.

Impairment of Long-Lived Assets with Determinable Lives

Long-lived assets, including amortizable intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or group of assets may not be fully recoverable. These events or changes in circumstances may include a significant deterioration of operating results, changes in business plans, or changes in anticipated future cash flows. If an impairment indicator is present, the Company evaluates recoverability by a comparison of the carrying amount of the assets to future undiscounted net cash flows expected to be generated by the assets. Assets are grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows generated by other asset groups. If the assets are impaired, the impairment recognized is measured by the amount by which the carrying amount exceeds the fair value of the assets. Fair value is generally determined by estimates of discounted cash flows. The discount rate used in any estimate of discounted cash flows would be the rate required for a similar investment of like risk.

Assets to be disposed of are reported at the lower of carrying value or fair value, less estimated costs of disposal.

Revenue Recognition

Tuition revenue is recognized ratably over the period of instruction, and is reported net of scholarships and other discounts. Dormitory revenues are recognized over the occupancy period. Tuition paid in advance or unpaid and unearned tuition included in accounts receivable is recorded as deferred revenue.

Revenue from the sale of educational products is generally recognized when shipped and collectibility is reasonably assured.

Direct Costs

Direct costs represent divisional costs of operations, including selling and administrative expenses that are directly attributable to specific operating units.

Advertising

The Company expenses advertising costs as incurred. Advertising expense for the years ended December 31, 2004, 2003 and 2002 was $50,170, $50,210, and $46,384, respectively. Of these amounts, $4,650, $14,033, and $18,709 were included as a component of discontinued operations in 2004, 2003 and 2002, respectively.

Stock Based Compensation

The Company records compensation expense for all employee and director stock-based compensation plans using the intrinsic value method and provides pro forma disclosures of net income (loss) and net earnings (loss) per common share as if the fair value method had been applied in measuring stock compensation expense. Under the intrinsic value method, stock compensation expense is defined as the difference between the amount payable upon exercise of an option and the quoted market value of the underlying common stock on the date of grant or measurement date, or in the case of issuances of restricted stock, the quoted market value of unrestricted shares of common stock on the date of grant. Any resulting compensation expense is recognized ratably over the vesting period, or over the period that the restrictions lapse.

The Company records compensation expense for all stock options granted to non-employees who are not directors in an amount equal to their estimated fair value at the earlier of the performance commitment date or the date at which performance is complete, determined using the Black-Scholes option pricing model. The compensation expense is recognized ratably over the vesting period.

The Black-Scholes option pricing 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. The weighted average estimated fair values of stock options granted during fiscal years 2004, 2003, and 2002 were $14.44, $7.45, and $10.01, respectively.

The following assumptions were used in calculating pro forma stock compensation expense for the years ended December 31:

	2004	**2003**	**2002**
Risk-free interest rate	3.3%	2.5%	4.0%
Expected dividend yield	0.0%	0.0%	0.0%
Expected lives	4-6 years	4-6 years	4-6 years
Expected volatility	46.0%	52.7%	51.1%

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options vesting periods. The Company s pro forma information is as follows for the years ended December 31:

	2004	**2003**	**2002**
Net income (loss), as reported	$ 63,011	$ 46,135	$ (95,943)
	4,292	16,270	627

Stock-based employee compensation expense included in net income (loss) as reported, net of tax						
Stock-based employee compensation expense as if the fair value method had been applied, net of tax		(5,215)		(9,191)		(3,818)
Pro forma net income (loss)	$	62,088	$	53,214	$	(99,134)
Earnings (loss) per share:						
Basic - as reported	$	1.36	$	1.10	$	(2.40)
Basic - pro forma	$	1.34	$	1.25	$	(2.49)
Diluted as reported	$	1.29	$	1.05	$	(2.40)
Diluted pro forma	$	1.27	$	1.20	$	(2.49)

Foreign Currency Translation

The financial statements of foreign subsidiaries with a functional currency other than the U.S. dollar have been translated into U.S. dollars using the current rate method. Assets and liabilities have been translated using the exchange rates at year-end. Income and expense amounts have been translated using the average exchange rates during the year. Translation gains or losses resulting from the changes in exchange rates have been reported as a component of accumulated other comprehensive income (loss) included in the consolidated statements of stockholders equity, net of tax.

Other Comprehensive Income

The Company displays changes to the accumulated balance of other comprehensive income (loss) in the consolidated statements of stockholders equity. The components were as follows at December 31:

	2004	2003
Foreign currency translation adjustment	$ 47,339	$ 22,353
Unrealized loss on available-for-sale securities, net of tax	(109)	(153)
Accumulated other comprehensive income	$ 47,230	$ 22,200

Because deferred taxes are not provided for the unremitted earnings of foreign subsidiaries, deferred taxes are not provided for translation adjustments.

Income Taxes

The Company accounts for income taxes using the liability method. Under the liability method, deferred tax assets and liabilities are determined based on the differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities (i.e. temporary differences) and are measured at prevailing enacted tax rates that will be in effect when these differences are settled or realized.

Impact of Recently Issued Accounting Standards

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123 (revised 2004) (FASB 123R), Share-Based Payment. FASB 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. As permitted by Statement 123, the Company currently accounts for share-based payments to employees using Opinion 25, which generally recognizes no compensation expense for employee stock options. The adoption of the fair value method under FASB 123R could have a significant impact on the results of operations, however it will have no impact on the balance sheet. FASB 123R also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a cash flow from financing activities rather than a cash flow from operating activities. This requirement will reduce net cash flow from operations and increase net cash flow from financing activities in the periods after adoption. The effective date is the first interim reporting period beginning after June 15, 2005. The Company is currently evaluating pricing models and the transition provisions of this standard and will begin expensing stock options in the third quarter of 2005.

Note 3 - Discontinued Operations

During 2003, the Company sold or abandoned its K-12 educational services businesses (K-12) and committed to a plan to sell its Wall Street Institute (WSI) business. During 2004, the Company terminated its program in India. The operations and cash flows of the business components comprising K-12, WSI, and India were, or will be, eliminated from ongoing operations as a result of the sale, abandonment or pending sale, and the Company will not have any significant continuing involvement in the operations after the disposal transactions. Therefore, these operations are classified as discontinued operations for all periods.

K-12

On June 30, 2003, the Company and Educate, Inc. (Educate), a company newly-formed by Apollo Management, L.P., (Apollo) completed the sale to Educate of substantially all of the Company s K-12 segment, including eSylvan Inc. and Connections Academy, Inc., which were investments previously held by Ventures (Principal K-12 Disposal Group). As a result, the Company recorded a gain of $71,752, net of income tax expense of $39,194, from the disposition in 2003, representing the difference between the carrying value of the net assets sold and net proceeds received upon sale.

WSI Business

During the second quarter of 2003, management committed to a plan to dispose of its WSI business. The WSI business owns and operates English-language learning centers in four countries and is a franchisor of English language learning centers in 21 countries. On December 31, 2004, the Company and WSI Education S.a.r.l. executed an Agreement for Purchase of Shares that provided for the acquisition of substantially all of the Company s WSI business units and investments. The consideration for the sale of the shares comprising the WSI business unit will consist of the following at closing:

Cash of $15,000;

A subordinated note in the amount of $15,000, bearing interest at 12.5%.

The final purchase price will be based on the lesser of eight times 2004 audited earnings before interest, taxes, depreciation, and amortization (EBITDA) or $51,000. The Company and the buyer have not completed the process required to provide for a final determination of the sales proceeds. At the time of settlement, the Company is committed to finance up to 50% of the purchase price, capped at four times audited EBITDA, with a note bearing interest at 8% per annum and a step up provision of 0.5% per annum. Additionally, the proceeds received by the Company are subject to post closing adjustments for specified changes in working capital from the date of the agreement to the closing date. The Company is entitled to additional consideration if the operating results of WSI exceed specified levels of earnings in 2005 and 2006, up to a maximum total consideration received of $51,000.

In the fourth quarter of 2004, the Company recorded an estimated loss on disposal of $13,389, net of income tax expense of $3,202. The loss reflects the change in the net realizable value of the net assets of the WSI business (including changes in the carrying value of the net assets resulting from foreign currency fluctuations) adjusted for estimated costs to close the WSI deal and accrued expenses related to indemnifications specified in the agreement. The accrued expenses and closing costs represent management s best estimate based on the facts and circumstances of the transaction. These estimates are subject to change based on new information that may arise in connection with fulfilling the terms of the agreement, and such changes could be material. The Company completed the sale of the WSI business on February 28, 2005.

In 2003, the Company recorded a loss of $20,777, net of income tax benefit of $1,698, to write down the assets of the WSI business to estimated net realizable value.

In June 2002, the Company sold the portion of WSI that is located in Spain (WSI Spain). As a result of the sale, the Company recognized an impairment charge of $14,209, net of income tax benefit of $6,035 in fiscal 2002 related to WSI Spain. This loss is included in loss on disposal of discontinued operations in the consolidated statements of operations.

Other

In the first quarter of 2004, due to the unfavorable regulatory climate for private educational enterprises in India, the Company decided to terminate its current programs there, including the cessation of the educational activities of South Asia International Institute. In conjunction with this decision, the Company reduced the carrying value of its assets in India to expected realizable value upon final disposition.

During 2003, the Company recorded a loss on disposal of discontinued operations of $8,273, net of income tax benefit of $4,425, related to the write-off of the net assets of the Sylvan Learning Center operations in the United Kingdom and France. During the fourth quarter of 2003, the Company made the decision to shut down the operations of the Sylvan Learning Center operations in the United Kingdom. By December 31, 2003 all operations were terminated, the property leases were cancelled and the Company was in the process of dissolving the corporation. In the first quarter of 2004, the Company completed the sale of the Sylvan Learning Center operations in France for solely contingent consideration. To date, no proceeds have been received.

In 2000, the Company sold its computer-based testing division, Sylvan Prometric (Prometric) for approximately $775,000 in cash and recorded a gain on the disposition of approximately $228,454, net of income taxes of $136,800. In 2002, the Company adjusted the gain by recording a loss of $1,743, net of income taxes of $1,162. The adjustment to the recorded gain resulted from the settlement of the working capital provision of the sales agreement and the Company s agreement to pay certain professional fees of the buyer associated with the filing of tax returns and statutory audits related to Prometric.

Summarized Financial Information of Discontinued Operations

Summarized operating results from the discontinued operations included in the Company s consolidated statement of operations were as follows for the year ended December 31:

	K-12			WSI			Other		
	2004	2003	2002	2004	2003	2002	2004	2003	2002
Revenues	$	$ 129,032	$ 218,391	$ 68,765	$ 57,069	$ 49,384	$	$ 967	$ 221
Pre-tax income (loss) from discontinued operations	$ (1,778)	$ 14,719	$ 16,539	$ (1,821)	$ (9,321)	$ (5,020)	$ (2,524)	$ (4,667)	$ (2,955)

Net Assets of WSI at December 31, are as follows:

	2004	2003
Current assets	$ 37,446	$ 37,348
Property and equipment, net	16,311	8,577
Goodwill	27,620	14,276
Other assets	8,773	11,713
Current liabilities	(39,702)	
Long-term liabilities	(566)	
Other comprehensive income	(2,841)	
Net assets of discontinued operations	$ 47,041	$ 71,914

The accompanying balance sheet at December 31, 2003 classifies the assets and liabilities of the WSI disposal group based on the probable timing of receipt of sales proceeds. The liabilities of WSI were not included in the WSI disposal group at December 31, 2003 because it was not certain that the future buyer of WSI would assume those liabilities. The liabilities reflected in the net assets of WSI at December 31, 2004 represent liabilities that the buyer will assume under the December 2004 agreement to sell the WSI business.

Note 4 - Acquisitions

During each of the years presented, the Company acquired certain businesses accounted for using the purchase method of accounting. A portion of the purchase price for these businesses was allocated to identifiable tangible and intangible assets and assumed liabilities based on estimated fair values at the dates of acquisition. Any excess purchase price was allocated to goodwill. Certain acquisitions require the payment of contingent amounts of purchase consideration if specified operating results are achieved in periods subsequent to the acquisition date. Upon the resolution of these contingent payments, the Company records as goodwill any additional consideration owed to the sellers. The results of operations of the acquired businesses are included in the accompanying consolidated financial statements commencing on the date of acquisition.

2004 Acquisitions

Walden

Effective on September 1, 2004, the Company acquired the remaining 49% ownership of Walden, increasing its ownership percentage to 100%. The purchase price of $108,167, including transaction costs, was paid by issuance of 2,500 shares of the Company s common stock and a $19,000 note payable due in January 2005. The value of the common shares issued was determined based on the average market price of the Company s common shares over the two day period before and after the terms of the acquisition were agreed to and announced. The Company accounted for this step acquisition using the purchase method of accounting, allocating the purchase price to its incremental share of acquired identifiable intangible assets and liabilities assumed based on estimated fair values at the date of acquisition, with the excess of $58,979 recorded as additional goodwill. The preliminary allocation of the purchase price is subject to revision based on the final determination of fair values. The final purchase price may differ from this preliminary amount due to adjustment to acquisition-related costs. Walden was purchased to provide distance learning capabilities by offering accredited Ph.D. and Master Degree programs to professional working adults. Full ownership gives the Company the ability to consolidate its online offerings under the Walden post-secondary regional accreditation. Additionally, the removal of minority interest shareholder rights allows Walden management to more efficiently and effectively pursue new business opportunities. The Company acquired a 41% stake in Walden for $32,800 in February 2001, and an additional 10% ownership for $8,000 in February 2002, and also recorded these transactions as step acquisitions with a total purchase price of $39,892, after subtracting previously recorded equity in net losses.

Universidad Europea de Madrid (UEM)

Effective on November 30, 2004, the Company acquired the remaining 22.25% ownership of Prouniversidad S.A., which owns and operates UEM, increasing the Company s ownership percentage to 100%. The purchase price of $48,739, including transaction costs, was paid by transfer of real estate valued at $10,397, with the remainder in cash. The Company accounted for this step acquisition using the purchase method of accounting, allocating the purchase price to its incremental share of identifiable intangible assets and liabilities assumed based on estimated fair values at the date of acquisition, with the excess of $19,847 recorded as additional goodwill. The preliminary allocation of the purchase price is subject to revision based on the final determination of fair values. The final purchase price may differ from this preliminary amount due to adjustment to acquisition-related costs. The Company previously acquired a 54% ownership interest in UEM in 1999 and an additional 23.75% interest in 2001. Each purchase of additional interest was accounted for as a step acquisition, with a total purchase price of $96,480.

Other 2004 Acquisitions

In 2004, the Company acquired the following entities for a total cost of $57,810, which was paid primarily in cash:

KIT eLearning BV - Goodwill of $16,552 was recognized in connection with the acquisition and assigned to the Laureate Online Education segment.

IEDE - Goodwill of $3,126 was recognized in connection with the acquisition and assigned to the Europe segment.

Hispanoamericana - Goodwill of $5,675 was recognized in connection with the acquisition and assigned to the Latin America segment.

An 80% interest in UPC - Goodwill of $3,130 was recognized in connection with the acquisition and assigned to the Latin America segment.

ULACIT - Goodwill of $659 was recognized in connection with the acquisition and assigned to the Latin America segment.

UDLA - Ecuador- No goodwill was recognized in connection with the acquisition of an additional 20% interest in UDLA-Ecuador, bringing total ownership to 80%. This transaction was accounted for as a step acquisition.

A 70% interest in ECE - Goodwill of $8,326 was recognized in connection with the acquisition and assigned to the Europe segment.

A 51% interest in IFG - Goodwill of $5,750 was recognized in connection with the acquisition and assigned to the Europe segment.

For 2004, goodwill related to the acquisition of IEDE is deductible for income tax purposes. The goodwill related to the remaining acquisitions is not deductible.

The following table summarizes the estimated fair values of the all assets acquired and liabilities assumed at the date of acquisition:

	Walden	UEM	All other
Current assets	$	$	$ 28,584
Property and equipment		9,316	33,502
Tradenames and accreditations	64,190	6,892	19,483
Other intangible assets	1,421	592	4,235
Goodwill	58,979	19,847	43,218
Other long-term assets		(3,826)	2,683
Total assets acquired	124,590	32,821	131,705
Current liabilities		3,312	49,247
Long-term debt			17,045
Other long-term liabilities	26,244	2,620	8,233
Minority interest	(9,821)	(21,850)	(630)
Total liabilities	16,423	(15,918)	73,895
Net assets acquired	$ 108,167	$ 48,739	$ 57,810

The following unaudited consolidated pro forma results of operations of the Company give effect to the 2004 acquisitions, assuming that they occurred on January 1, 2003.

	Year ended December 31, 2004		2003 (as restated Note 3)	
Revenues	$	704,499	$	563,293
Income from continuing operations before cumulative effect of change in accounting principle	$	90,012	$	16,621
Net income	$	70,365	$	53,071
Earnings per common share, diluted:				
Income from continuing operations before cumulative effect of change in accounting principle	$	1.78	$	0.36
Net income	$	1.39	$	1.15

2003 Acquisitions

Universidad Andres Bello (UNAB)

Effective May 30, 2003, the Company acquired an 80% interest in Universidad Andres Bello (UNAB), a comprehensive university located in Chile, and Academia de Idiomas y Estudios Profesionales (AIEP), a technical/vocational institute located in Chile, from local Chilean investors. The cash purchase price of $37,821 includes cash payments to the seller of $34,085 and transaction costs of $3,736. The purchase price was allocated to acquired assets totaling $118,257 and assumed liabilities of $80,436 (including bank debt of $21,300 and a seller note of $21,300). The acquisition allows the Company to provide additional product offerings and greater access to post secondary education to other market segments in Chile. In addition, this acquisition broadens the Company s student population, allowing for better utilization of existing management infrastructure in Chile.

Current assets	$	36,454
Property and equipment		8,673
Intangible assets not subject to amortization		27,520
Student roster		5,680
Goodwill		39,249
Other long-term assets		681
Total assets acquired		118,257
Current liabilities		44,963
Long-term debt		42,923
Other long-term liabilities		966
Minority interest		(8,416)
Total liabilities		80,436
Net assets acquired	$	37,821

Unaudited Pro Forma Results of Operations-2003 Acquisition

The following unaudited consolidated pro forma results of operations of the Company give effect to the acquisition of UNAB assuming that it occurred on January 1, 2002.

	Year ended December 31,			
	2003		2002	
	(as restated	Note 3)		
Revenues	$	487,448	$	379,746
Income from continuing operations before cumulative effect of change in accounting principle	$	6,806	$	2,768
Net income (loss)	$	43,256	$	(96,775)
Earnings (loss) per common share, diluted:				
Income from continuing operations before cumulative effect of change in accounting principle	$	0.16	$	0.07
Net income (loss)	$	0.99	$	(2.42)

Other 2003 Acquisitions

The Company acquired the following entities for a total cost of $24,162, which was paid primarily in cash:

Costa Rica/Panama - Goodwill of $7,709 was recognized in connection with the acquisition and assigned to the Latin America segment.

UDLA - Ecuador - No goodwill was recognized in connection with the acquisition of this affiliate previously accounted for under the equity method. The acquisition of the additional interest was accounted for as a step acquisition.

Lago de Guadalupe - Goodwill of $4,198 was recognized in connection with the acquisition and assigned to the Latin America segment.

10 WSI franchises and 4 additional centers - Goodwill of $2,665 was recognized. The results of these operations are included in discontinued operations.

For 2003, the goodwill related to the acquisition of 3 WSI franchises and 4 additional centers, located in Italy, is deductible for income tax purposes. The goodwill related to the remaining acquisitions is not deductible.

2002 Acquisitions

Marbella

On March 1, 2002, the Company acquired for cash all of the outstanding common stock of Hedleton, B.V., which owns all of the capital stock of Escuela Superior De Alta Gestion De Hotel, S.A. (Marbella), a private for-profit university located in Marbella, Spain. Marbella was previously a franchise of Swiss Hotel Association Hotel Management School Les Roches (Les Roches), which was acquired by the Company in 2000. The purchase of Marbella allows the Company to offer Les Roches programs into other regions in Spain as well as expansion into Portugal, Andorra and Morocco. These country rights were previously licensed to the former owners of Marbella. The purchase price for the outstanding common stock totaled approximately $6,746 including acquisition costs of $487.

Universidad de Las Americas (UDLA)

Effective May 1, 2002, the Company acquired an additional 20% ownership interest in Desarrollo del Conocimiento S.A. (Decon), a holding company that controls and operates the UDLA, for cash of approximately $6,673. In 2000 the Company acquired a 60% interest in UDLA. The purchase price of the additional interest was accounted for as a step acquisition.

Glion

Effective August 1, 2002, the Company acquired for cash all of the outstanding common stock of the Glion Group, S.A., the parent company of Glion Hotel School, S.A. (Glion), a leading hotel management school in Switzerland. The acquisition of Glion was made mainly to acquire an additional hospitality sector school to provide economies of scale in the Company s hospitality management sector. This acquisition included additional campus facilities and office space within close proximity of Les Roches, the Company s other hospitality school, to allow for manageable growth by one core management team of the entire operation. The initial purchase price totaled approximately $16,882, including acquisition costs of $1,376. Additionally, the Company made a payment of $2,144 in August 2003 and was required to make a final payment in August 2004 which are included in the aggregate purchase price noted above. The purchase agreement includes a provision for a possible reduction in the purchase price based on the working capital of Glion at the acquisition date. The Company reached a settlement with the sellers in November 2002 agreeing on the adjusted payment of $2,247 plus interest at the one year Swiss LIBOR rate plus 1% (2.01% as of September 1, 2004), which was paid to the sellers in September 2004.

National Technological University (NTU)

In November 2002, Ventures completed its acquisition of substantially all the assets and certain liabilities of the NTU and Stratys Learning Solutions, Inc. (the holding company of NTU) for cash of $7,943 and a promissory note payable of $7,500. This note was paid in full in 2003. NTU is a leading distance learning university accredited by the North Central Association, offering master s degrees for students specializing in engineering, technology and management. NTU was purchased to add the aforementioned degrees for students to the Company s list of higher education degrees.

50

Summary of 2002 Acquisitions

The following table summarizes for all significant 2002 acquisitions and the estimated fair values of the assets acquired and liabilities assumed at the dates of acquisition.

	Domestic Learning Center Franchises(1)	UK and France(2)	Walden(3)	Marbella	UDLA	Glion	NTU
Acquisition date	1/1/02	8/31/02	2/2/02	3/1/02	5/1/02	8/1/02	11/1/02
Current assets	$ 73	$ 428	$ 22,075	$ 2,583	$ 7,170	$ 5,715	$ 1,504
Property and equipment	1,372	723	1,431	533	4,509	47,109	997
Intangible assets not subject to amortization			30,870				8,000
Intangible assets subject to amortization (6 year weighted-average useful life):							
Curriculum			522				
Student roster			1,645	123	107		
Non-compete agreements				104	44	44	
Goodwill	13,631	9,035		5,986	8,540	5,326	10,596
Other long-term assets		37	836		145	122	
Total assets acquired	15,076	10,223	57,379	9,329	20,515	58,316	21,097
Current liabilities	966	1,003	9,513	2,175	8,654	13,190	4,798
Long-term debt				12	4,285	25,468	813
Other long-term liabilities				396		2,776	43
Minority interest			7,974		903		
Total liabilities	966	1,003	17,487	2,583	13,842	41,434	5,654
Net assets acquired	$ 14,110	$ 9,220	$ 39,892	$ 6,746	$ 6,673	$ 16,882	$ 15,443

(1) The net assets related to the Domestic Learning Center franchises were sold in June 2003.

(2) The net assets related to the UK and France acquisition were subsequently sold or abandoned. The results of these operations are included as discontinued operations.

(3) The step acquisition of Walden is detailed under 2004 Acquisitions.

Unaudited Pro Forma Results of Operations-2002 Significant Acquisitions

The following unaudited consolidated pro forma results of operations of the Company give effect to the significant 2002 acquisitions assuming that they occurred on January 1, 2002.

		Year ended December 31, 2002
Revenues	$	357,150
Loss from continuing operations before cumulative effect of change in accounting principle	$	(1,139)
Net loss	$	(100,682)
Loss per common share, diluted:		
Loss from continuing operations before cumulative effect of change in accounting principle	$	(0.03)
Net loss	$	(2.51)

Other 2002 Acquisitions

In 2002, the Company acquired the following entities for a total cost of $4,325, which was paid primarily in cash:

Six Sylvan Learning Center franchises - Goodwill of $3,343 was recognized and assigned to the former K-12 Education Services segment. The results of these operations are included as discontinued operations.

WebEd, an online seller of professional development courses - Goodwill of $370 was recognized and assigned to the Laureate Online Education segment.

An additional 35% interest in EdVerify, for a total voting ownership of 68% - EdVerify is a business-to-business digital service provider that specializes in verifying the higher education enrollment and degree attainment of job candidates and credit requestors. Goodwill of $25 was recognized and assigned to the former Ventures segment.

Two Wall Street Institute franchises located in Argentina - No goodwill was recognized in connection with the acquisition. The results of these operations are included as discontinued operations.

For 2002, the goodwill related to the Learning Center franchises, NTU and WebEd are fully deductible for tax purposes. The goodwill related to the remaining acquisitions is not deductible.

Supplemental Cash Flow Information Related to Acquired Businesses

The following is a summary of changes to assets (other than cash), liabilities, and stockholders equity as a result of the acquisitions described above:

	Year ended December 31, 2004	2003	2002
Working capital, other than cash	$ (41,714)	$ (7,030)	$ (19,247)
Property and equipment	42,818	9,377	55,108
Goodwill	122,044	51,612	39,059
Other intangible assets	96,813	40,579	33,579
Other long-term assets	(1,143)	936	(31,613)
Long-term debt	(17,045)	(48,619)	(33,403)
Due to shareholders of acquired companies	(23,232)		
Other liabilities	(37,096)	(970)	(11,618)
Minority interest	32,301	6,823	(6,499)
Net assets acquired, other than cash	173,746	52,708	25,366
Non-cash consideration, net of tax	(97,984)		
Cash purchase price, net of cash received	75,762	52,708	25,366
K-12 acquisitions included in discontinued operations		(1,003)	(30,841)

Cash purchase price per statement of cash flows	$	75,762	$	53,711	$	56,207

Note 5 - Available-For-Sale Securities

The following is a summary of available-for-sale securities at December 31:

		2004		2003
Equity securities	$	106	$	333
Debt securities		4,409		16,432
	$	4,515	$	16,765

At December 31, 2004, equity securities represent a common stock investment in a public company with a cost of $250 and a quoted market price of $106. The adjustment to unrealized holding loss of $144 is a component of accumulated other comprehensive income (loss), included in the consolidate statement of stockholders equity. The cost of the Company s debt securities approximates their fair value. Aggregate maturities of debt securities are as follows: $3,677 within 1 year and $732 within 2-5 years. The investments are classified as current as the Company views its available-for-sale securities as available for use in its current operations.

Note 6 Other Notes Receivable (Long-term)

Notes receivable from related parties and Other notes receivable consists of the following amounts at December 31:

		2004		2003
Notes receivable from related party, net of allowance of $728 and $14,024 at December 31, 2004 and 2003, respectively	$	1,219	$	43,155
Other trade notes receivable (long-term), net of allowance of $5,846 and $2,158 at December 31, 2004 and 2003, respectively	$	15,339	$	2,446
Other notes receivable (long-term):				
Kendall College		18,026		
Other		15,800		13,628
	$	50,384	$	59,229

On April 27, 2004, the Company received payment in full on one of its notes receivable from Educate in the amount of $55,000 plus accrued interest of $5,461. The subordinated note receivable, originally issued on June 30, 2003 in partial consideration for the sale of the Company s K-12 segment to Educate, was originally recorded net of a $13,448 discount (Educate note). The early retirement of the Educate note resulted in an accelerated recognition of the remaining unamortized original issue discount in the amount of $12,722, which has been included in investment and other income in the 2004 consolidated statement of operations.

On July 21, 2004, the Company entered into an arrangement with Kendall College (Kendall), a not-for-profit corporation that operates a private post-secondary school in Illinois offering culinary and related degree programs. Under the terms of the arrangement, the Company received the right to purchase from Kendall substantially all of its assets, including the campus, and the current right to offer the Company s hospitality management curriculum through a licensing agreement with Kendall College. In accordance with the terms of these agreements, the Company committed to assist Kendall with working capital needs and capital improvements to their Riverworks campus.

The purchase option gives the Company the right to purchase substantially all of Kendall s assets, including the campus, from December 31, 2004 through July 21, 2006 for a purchase price of $3,000 plus the aggregate principal amount and accrued interest outstanding under the subordinated notes payable agreements plus assumption of the aggregate principal amount of the mortgages on the Riverworks campus and specific other liabilities.

The subordinated note agreements consist of three separate promissory notes with principal balances of $3,000, $9,000 and $6,300. The $3,000 note accrues interest at 8% and is due upon the exercise of the option by applying the balance due to the purchase price on the date the option is exercised, or if the option is not exercised by application of the note balance against payments due under a lease agreement for part of the Riverworks Campus by the Company. The $9,000 and $6,300 notes are in the form of credit lines, accrue interest at 8% and are due on the exercise of the option by application to the purchase price on the option closing agreement, or if the option is not exercised in 36 equal monthly installments beginning July 21, 2006. As of December 31, 2004, there is $18,026 outstanding, including accrued interest, under the three promissory notes.

In the event that the Company does not exercise the option agreement, the Company will enter into a lease agreement with Kendall beginning July 21, 2006 to lease space in the Riverworks campus, allowing the Company to offer post-secondary educational programs including its hospitality program. The lease commitment specifies a term of 36 months and annual rent of $1,000.

The program educational licensing agreement allows Kendall the right to use certain intellectual property of Les Roches for purposes of offering a hospitality management degree for a two year period beginning July 22, 2004 in exchange for a royalty based on a fixed percentage of the collected hospitality management net program tuition fees.

The Company has implemented pilot tuition financing programs at its Chilean universities, in order to establish a lending and collections history in this market and attract third party lenders. At December 31, 2004 and 2003, respectively, the Company has long-term tuition finance receivables of $14,004 and $2,446 net of allowance of $5,846 and $2,158, respectively, which are included in other trade notes receivable above. Interest income under these programs for the years ended December 31, 2004 and 2003 was $1,426 and $300, respectively.

Note 7 Goodwill and Other Intangible Assets

The changes in the net carrying amount of goodwill for the years ended December 31, 2004 and 2003 by reportable business segment are follows:

	Balance at December 31, 2003	Acquisitions	Sale or Disposition	Translation and Other	Balance at December 31, 2004
Latin America	$ 118,137	$ 9,464	$	$ 2,845	$ 130,446
Europe	36,669	37,049		4,903	78,621
Laureate Online Education	78,755	75,531		1,620	155,906
	$ 233,561	$ 122,044	$	$ 9,368	$ 364,973

	Balance at December 31, 2002	Acquisitions	Sale or Disposition	Translation and Other (1)	Balance at December 31, 2003
Latin America	$ 59,156	$ 51,156	$	$ 7,825	$ 118,137
Europe	30,440			6,229	36,669
Laureate Online Education	86,309			(7,554)	78,755
Corporate and Ventures	285		(285)		
	$ 176,190	$ 51,156	$ (285)	$ 6,500	$ 233,561

(1) Increase in goodwill includes $1,126 related to a settled contingent payment obligation for Les Roches. This amount is included in Europe Translation and Other of $6,229. Upon the finalization of the allocation of the purchase price of NTU, $7,554 was reclassed to other intangible assets from Laureate Online Education goodwill.

The following table summarizes intangible assets as of December 31, 2004:

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Subject to amortization:			
Student rosters	$ 18,617	$ (7,905)	$ 10,712
Non-compete agreements	1,370	(852)	518
Other	818	(601)	217
Not subject to amortization:			
Tradenames and accreditations	174,694		174,694
Total	$ 195,499	$ (9,358)	$ 186,141

The following table summarizes intangible assets as of December 31, 2003:

	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Subject to amortization:			
Student rosters	$ 11,787	$ (3,403)	$ 8,384
Non-compete agreements	954	(647)	307
Other	623	(469)	154
Not subject to amortization:			
Tradenames and accreditations	79,789		79,789
Total	$ 93,153	$ (4,519)	$ 88,634

Amortization expense for intangible assets subject to amortization was $4,428 in 2004, $2,247 in 2003, and $1,596 in 2002. The estimated future amortization expense for intangible assets for each of the five years subsequent to December 31, 2004 is as follows: 2005 - $4,587; 2006 - $4,136; 2007 - $2,482; 2008 - $242; 2009 and beyond - $0.

As of December 31, 2004, the weighted average amortization period of total intangible assets subject to amortization is 2.6 years. The weighted average amortization period of the student roster, non-compete agreements, and other intangibles is 2.6 years, 3.9 years, and 2.7 years, respectively.

Note 8 Investments

Ventures

During the first quarter of 2003, the Company acquired the remaining membership interests in the Ventures business not owned by the Company or Apollo for consideration of 581 shares of common stock, which is restricted from sale for three years. These membership interests had been held by investment companies, some of which are partially owned by certain executive management of the Company. Additionally, all membership profit interests in the Ventures business have been eliminated. Upon completion of these acquisitions and the sale of the Principal K-12 Disposal Group discussed in Note 3, the Company owned all of the membership interests of Sylvan Ventures LLC. On June 30, 2003, the Company sold several portfolio investments held by Ventures, which were considered non-strategic assets, for contingent consideration. For the year ended December 31, 2003, the Company recorded a loss on Ventures assets held for sale of $8,394, primarily representing the book value of cost basis investments in iLearning ($298) and ClubMom ($7,596). Ventures also wrote-off the balance of its equity method investment in Chancery Software Limited (Chancery) through a $6,637 charge to equity in net loss of affiliates.

Investment in Affiliates (Equity Method Investments):

The table below includes summarized financial data of those other affiliates in which Ventures had an interest at December 31, 2002, and includes results of operations data of the affiliate for the entire year.

	iLearning	Chancery
Net sales	$ 5,052	$ 16,258
Gross profit	$ 3,673	$ 10,018
Net loss	$ (4,183)	$ (1,890)

The Company disposed of its investments in iLearning and Chancery in the first quarter of 2003. The results of iLearning and Chancery from January 1, 2003 to the disposal dates were not significant.

Realized Investment Income and Losses

The Company recognized a net realized investment loss of $0 in 2004, $8,394 in 2003, and $10,561 in 2002. The most significant transactions giving rise to these gains and losses are described below.

In 2003, the Company recorded a loss on Ventures assets held for sale of $8,394, primarily representing the book value of a cost basis investment in ClubMom ($7,596).

In 2002, the Company recorded a loss of $7,359 related to the write-off of its investment in and advances to the Frontline Group. This investment write-off was recognized due to management s assessment that the investment was permanently impaired as a result of challenges facing the corporate training industry in general and Frontline Group specifically. The Company originally accepted shares of common stock in Frontline Group in 1999, as consideration for the sale of the PACE business unit.

Note 9 - Long-Term Debt

Long-term debt consists of the following at December 31:

	2004	2003
Mortgage notes payable bearing interest at variable rates ranging from 3.25% to 8.5%	$ 42,045	$ 46,731
Notes payable secured by fixed assets, bearing interest at rates ranging from 3.80% to 6.46%	18,303	12,160
Long-term credit lines bearing interest at rates ranging from 3.62% to 14.40%		169
Capital lease obligations bearing interest at rates ranging from 4.99% to 8.64%	16,189	3,525
Government loans bearing interest rates ranging from 3.00% to 4.69%		3,901
Various notes payable bearing interest at fixed rates ranging from 0.00% to 8.09%	25,429	26,696
Various notes payable bearing interest at variable rates ranging from 5.25% to 22.68%	14,669	832
Various unsecured lines of credit bearing interest at variable rates ranging from 2.52% to 10.67%	16,980	2,740
	133,615	96,754
Less: current portion of long-term debt	47,010	21,654
Total long-term debt, net of current portion	$ 86,605	$ 75,100

On June 30, 2000, the Company issued $100,000 of ten-year convertible subordinated debentures. The debentures bore interest at a fixed rate of 5.00%, payable semi-annually, and were convertible at any time into the Company s common stock at $15.735 per share. The debentures were redeemable by the Company, subsequent to June 30, 2003, providing certain conditions were achieved including the average share price exceeding 150% of the conversion price. The debentures matured on June 30, 2010. In the first quarter of 2002, $5,000 of the debentures were converted into 318 shares of the Company s stock. On June 30, 2003, as partial consideration for the purchase of the Company s Principal K-12 Disposal Group, Apollo tendered to the Company a portion of their convertible debentures with a face value of $50,569. In July 2003, Apollo Management L.P converted their remaining portion of the Company s convertible debentures with a face value of $29,431, into 1,870 shares of the Company s stock at the $15.735 per share conversion price provided for in the debenture agreement. In December 2003, the remaining convertible debentures, with a face value of $15,000, were converted into 953 shares of the Company s stock at the $15.735 per share conversion price provided for in the debenture agreement. Subsequent to these conversions, there are no remaining convertible debentures outstanding.

The Company s long-term debt is secured by assets with a carrying value of $178,510 at December 31, 2004. Aggregate maturities of Company s borrowings are as follows: 2005 - $47,010; 2006 - $15,020; 2007 - $12,999; 2008 - $8,867; 2009 - $6,028 and thereafter $43,691.

Effective June 30, 2003, the Company entered into an unsecured line of credit agreement of $30,000, with a $5,000 sub-limit for standby letters of credit, which is intended for working capital purposes. The line of credit expires August 2005. The outstanding balance on the line of credit was $1,019 at December 31, 2004. Individual units within campus-based operations have unsecured lines of credit, which total $24,974 million, primarily for working capital purposes. The aggregate outstanding balance on the campus-based segments lines of credit was $15,961 million at December 31, 2004, which is included in the current portion of long-term debt

The weighted average short term borrowing rate was 8.1% and 5.8% at December 31, 2004 and December 31, 2003, respectively.

Note 10 - Due to Shareholders of Acquired Companies

Due to shareholders of acquired companies consists of the following amounts payable in cash at December 31:

	2004	2003
Amounts payable to former shareholders of UNAB	$ 27,773	$ 25,441
Amounts payable to former shareholders of Les Roches		1,939
Amounts payable to former shareholders of Glion		2,308
Amounts payable to former shareholders of IEDE	1,357	
Amounts payable to former shareholders of UI	4,800	5,000
Amounts payable to former shareholders of ULACIT	100	
Amounts payable to former shareholders of UPC Peru	2,984	
Amounts payable to former shareholders of Walden	19,249	
	56,263	34,688
Less: current portion of due to shareholders	26,861	4,747
	$ 29,402	$ 29,941

56

In September 2004, the Company entered into an agreement with the prior owners of Walden to finance a portion of the purchase of the final 49% ownership interest in Walden. Principal of $19,000 plus interest at 4.5% was paid in January 2005.

In May 2003, the Company entered into an agreement with the prior owners of UNAB to finance a portion of the initial purchase price of UNAB. Principal payments are due in three annual installments commencing in June 2005. The note bears interest at 6.5% Chilean Inflation-Indexed (UF) with interest payments due quarterly commencing in August 2003.

In October 2003, the Company entered into an agreement with the prior owners of Universidad Interamericana (UI) to finance a portion of the initial purchase price of UI in the amount of $5,000. A principal payment of $500 is due in October 2005, and the balance is due in October 2006. The note bears interest at 6% with interest payments due quarterly commencing in January 2004.

Note 11 Leases and Related Party Transactions

The Company conducts significant operations from leased facilities. These facilities include the Company s corporate headquarters and other office locations, warehouse space, and several of the Company s higher education facilities. The terms of substantially all of these leases are ten years or less, and generally contain renewal options. The Company also leases certain equipment under non-cancelable operating leases, the majority of which are for terms of 60 months or less. Future minimum lease payments at December 31, 2004, by year and in the aggregate, for continuing and discontinued operations, under all non-cancelable operating leases are as follows:

	Continuing Operations	Discontinued Operations	Total
Years ending December 31:			
2005	$ 29,288	$ 2,744	$ 32,032
2006	28,314	1,827	30,141
2007	28,129	1,353	29,482
2008	25,562	1,171	26,733
2009	23,939	773	24,712
Thereafter	110,849	308	111,157
	$ 246,081	$ 8,176	$ 254,257

The Company has entered into sublease agreements for leased office space approximating 231,421 square feet, for an annual rental of $6,056, adjusted annually for increases in gross operating rent and related expenses. The sublease agreements have various expiration dates through 2011.

The Company entered into lease agreements for its university campuses in Mexico with certain officers and minority owners of the Company s Mexican university subsidiary. The leases have an initial term of ten years with an additional two-year extension available at the Company s option. During 2002, this lease was amended to include an additional three-year extension available at the Company s option, for a total term of up to 15 years. The amended lease also contains a provision for the Company, at its option, to purchase the real estate for fair market value of the property, less the Company s investment in leasehold improvements, at the end of the lease term. Fixed monthly rents are adjusted annually for inflation. The Company recognized approximately $5,645, $5,112 and $4,534 of rent expense under these leases for the years ended December 31, 2004, 2003, and 2002, respectively.

These officers and minority shareholders also provided staffing services to UVM for one of its campuses in 2004 and four of its campuses in 2003. UVM incurred approximately $244 and $3,035 of expenses for 2004 and 2003, respectively, in connection with this contract.

During 2003, the Company entered into a lease agreement for Universidad Interamericana campuses located in Costa Rica and Panama with certain former owners, and in 2004 entered into another lease agreement for the ULACIT campus. Both leases have initial terms of fifteen years, with additional five-year extensions available at the Company s option. The leases also contain provisions for the Company, at its option, to purchase the real estate for its fair market value at any time. Under the UI lease, monthly rental payments are based on eight percent of net campus revenues for the first two years and ten percent of net campus revenues in the third year. Subsequent rental payments will be adjusted for inflation. The Company recognized approximately $842 and $147 of rent expense under this lease for the year ended December 31, 2004 and the period from October 15, 2003 through December 31, 2003, respectively. The ULACIT lease has fixed monthly rental payments. The Company recognized approximately $87 of rent expense under this lease for the period from October 25, 2004 through December 31, 2004.

In connection with the sale of the Company s Principal K-12 Disposal Group to Educate, the Company entered into a three-year management service agreement with Educate, which will expire on June 30, 2006. Under the terms of the agreement, Educate will provide certain support services, including, but not limited to, specified accounting, benefits, IT, human resources, purchasing and payroll services to Laureate. Conversely, Laureate will provide certain support services, primarily in the areas of facilities, tax and treasury, to Educate. The agreement requires the Company to pay a fixed fee, adjusted as appropriate based on increases to predetermined service volumes. The net fee due to Educate on an annual basis is approximately $3,000.

Rent expense, net of sub-lease income, included in income from continuing operations for all cancelable and non-cancelable leases was approximately $27,767, $21,120, and $14,247 for the years ended December 31, 2004, 2003 and 2002, respectively. Rent expense, net of sub-lease income, included in income from discontinued operations for all cancelable and non-cancelable leases was approximately $6,135, $13,232, and $18,041 for the years ended December 31, 2004, 2003 and 2002, respectively.

Note 12 Commitments and Contingencies

Purchase Obligations

As part of the acquisition of ECE, the Company committed to purchase the remaining 30% ownership from the sellers on December 31, 2008 for approximately $9,500. The purchase obligation is denominated in Euros, and is subject to foreign currency exchange rate risk on the dates of payment.

As part of the acquisition of IFG, the Company committed to additional capital contributions, which will increase the Company s share of ownership. The agreement provides that, no later than July 31, 2006 and July 31, 2007, the Company shall contribute approximately $1,700 and $2,500 resulting in an increase in ownership share of 16% and 23%, respectively. In addition, during the period October through November 2008, the sellers may exercise a put option requiring the Company to purchase the remaining 10% ownership for approximately $1,100. The purchase obligation is denominated in Euros, and is subject to foreign currency exchange rate risk on the dates of payment.

Loss Contingencies

The Company is subject to legal actions arising in the ordinary course of its business. In management s opinion, the Company has adequate legal defenses and/or insurance coverage with respect to the eventuality of such actions and does not believe any settlement would materially affect the Company s financial position.

Guarantees

Subsequent to the divestiture of the Principal K-12 Disposal Group, all leases related to Sylvan Learning Centers were renegotiated or assigned in the name of Educate during the third quarter of 2003. Leases with remaining payments of $8,234 through December 2008 are guaranteed by the Company. Under the terms of Asset Purchase Agreement with Educate, the Company is indemnified against any losses suffered as a result of these lease guarantees. On December 10, 2004, Laureate entered into an agreement to guarantee lease payments owed by Kendall College to Key Equipment Finance. Leases with remaining payments of $5,073 through December 2011 are guaranteed by the Company.

Standby Letters of Credit

The Company has $3,028 outstanding in standby letters of credit. The Company is self-insured for workers compensation and other insurable risks up to predetermined amounts above which third party insurance applies. The Company is contingently liable to insurance carriers under certain of these policies and has provided a letter of credit in favor of the insurance carriers for $1,258. The Company has also issued a standby letter of credit in the amount of $1,400 assuring the collectibility of a $1,522 line of credit at AIEP, which is being used for working capital purposes. The outstanding balance on the line of credit was $409 at December 31, 2004.

Contingent Payments

In connection with certain acquisitions, variable amounts of contingent consideration are payable to the seller based upon specified terms. All existing contingent consideration agreements are predicated upon improved operating profitability of the acquired entities and utilize multiples consistent with those used to calculate the initial purchase price. The Company will record the contingent consideration when the contingencies are resolved and the additional consideration is payable.

Additional amounts of contingent consideration are due the sellers of UDLA based on operating results for the three years ended December 31, 2006. No later than March 31, 2006, the Company is obligated to the sellers for an amount equal to 60% of six times (i) average EBIT for 2004 and 2005, less (ii) 2000 EBIT; this result is reduced by (iii) 42% of certain specified debt. Assuming EBIT remains at 2004 levels for 2005, the Company would be obligated to the sellers for approximately $60,866. No later than March 31, 2007, the Company is obligated to the sellers for an amount equal to 20% of four times (i) average EBIT for 2005 and 2006; this result is reduced by (ii) 20% of certain specified debt and (iii), $6.5 million. Assuming EBIT remains at 2004 levels for 2005 and 2006, the Company would be obligated to the sellers for approximately $12,559. The Company has pledged its shares of Decon, the holding company that controls and operates UDLA, to satisfy its payment obligations to the sellers. The Company cannot dispose of, lien or encumber the shares without the prior approval of the sellers.

Effective April 1, 2008 the minority owners of UDLA have the right to require the Company to purchase their remaining 20% interest in Decon for a variable purchase price based on average EBIT for certain specified periods. Effective April 1, 2009 the Company has a call right to acquire the remaining 20% interest under a similar methodology for certain specified periods.

Effective April 1, 2009 the minority owners of UNAB and AIEP have the right to require the Company to purchase their 20% interest for a variable purchase price based on average EBIT for certain specified periods. Effective April 1, 2009 the Company has a call right to acquire this 20% interest under a similar methodology for certain specified periods.

Additional amounts of contingent consideration, not to exceed $10,000, are due the sellers of KIT eLearning BV equal to four times the average of the audited earnings before interest, income taxes, depreciation and amortization for the calendar years ending December 31, 2006 and 2007. KIT eLearning BV was acquired on March 31, 2004 and is operated as Laureate Online Education BV.

Note 13 Benefit Plans

Stock Options Plans

The Board of Directors may grant options under five stock option plans to selected employees, officers and directors of the Company to purchase shares of the Company s common stock at a price not less than the fair market value of the stock at the date of the grant. The 1998 Stock Incentive Plan (1998 Plan) is the only plan with significant stock option awards available for grant. The 1998 Plan allows for the grant of up to 3,750 shares of common stock in the form of incentive and non-qualified stock options, stock appreciation rights, stock awards, phantom stock awards, convertible securities and performance awards that expire six or ten years after the date of grant. Options outstanding under all five of the Company s stock option plans have been granted at prices which are equal to or exceed the market value of the stock on the date of grant and vest ratably over periods not exceeding six years.

The following table summarizes the stock option activity of the Company for the years ended December 31:

	2004		2003		2002	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of year	7,992	$ 14.80	7,317	$ 18.53	8,231	$ 17.85
Granted	414	24.43	2,792	8.15	694	20.97
Exercised	(1,658)	16.13	(953)	15.32	(1,106)	12.99
Forfeited	(105)	15.79	(1,164)	21.87	(502)	22.35
Outstanding at end of year	6,643	$ 15.06	7,992	$ 14.80	7,317	$ 18.53
Exercisable at end of year	5,457	$ 14.33	6,500	$ 14.69	4,969	$ 17.51

The following table summarizes information about stock options outstanding at December 31, 2004:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Shares	Weighted Average Exercise Prices	Weighted Average Remaining Contractual Life (Years)	Number of Shares	Weighted Average Exercise Prices
$3.33-$6.08	1,836	$ 3.72	4.9	1,722	$ 3.71
$6.78-$13.11	624	$ 10.71	3.8	456	$ 10.14
$13.55-$19.77	2,177	$ 15.11	3.9	1,554	$ 14.23
$20.03-$42.74	2,006	$ 26.72	4.2	1,725	$ 26.13
	6,643			5,457	

Defined Contribution Retirement Plan

The Company sponsors a defined contribution retirement plan under section 401(k) of the Internal Revenue Code. The provisions of this plan allow for voluntary employee contributions of up to 20% of an employee s salary, subject to certain annual limitations. The Company may at its discretion make matching contributions, which are allocated to eligible participants. All employees are eligible after meeting certain service requirements. The Company made discretionary contributions to this plan of $328, $979, and $833 during the years ended December 31, 2004, 2003 and 2002, respectively.

Employee Stock Purchase Plan

The Company sponsors an employee stock purchase plan that allows eligible employees to purchase shares of common stock at a 15% discount to the lower of the fair market value on the first day or the last day of the annual offering period (March 1 through February 28). Employees may authorize the Company to withhold up to 10% of their compensation during any offering period, subject to certain limitations. During 2004, 2003, and 2002, shares totaling 14, 40, and 24 were issued under the plan at an average price of $10.60, $10.55, and $16.12, respectively.

The Company terminated the Employee Stock Purchase Plan, effective December 31, 2004, and subsequently refunded contributions for the current plan year to participants, due to an insufficient number of authorized shares to accomplish the Plan year-end stock purchase.

Shares Reserved For Future Issuance

As of December 31, 2004, the Company has reserved 6,806 shares of common stock for future issuance upon the exercise of all outstanding stock options.

Replenishment Plan Implementation Change

During the quarter ended June 30, 2004, certain current and former employees were inadvertently permitted to exercise 203 stock options on a net share basis, whereby shares equal in value to the option strike price and the employee s minimum tax withholding obligation were withheld by the Company (also known as a cashless exercise). Under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees,* the use of in the money options to cover the strike price resulted in a new measurement date and, as a result, the Company recognized $1,049 of additional compensation expense in continuing operations and $1,436 of additional compensation in discontinued operations for the difference between the exercise price and the market value of the shares on date of exercise. When the situation was discovered by management in May 2004, the Company discontinued this practice and, therefore, expects no further compensation charges from the exercise of employee stock options.

Stock Option Modification in the Second Quarter of 2003

In periods prior to 2003, certain members of executive management and employees of the Company were granted options under the 1998 Plan to acquire common stock of the subsidiary serving as the holding company for the campus-based segments. Due to the restructuring of the Company s operations resulting from the sale of the Principal K-12 Disposal Group and non-strategic Ventures assets, on April 1, 2003 the Company negotiated an agreement with employees holding stock options to acquire common stock of the subsidiary that provided for the exchange of these stock options for stock options to acquire common stock of the Company. The result of the exchange of options did not increase the aggregate intrinsic value of the options or reduce the ratio of the exercise price per share of the options to the per share fair value of common stock on the date of exchange, as determined by independent members of the Board of Directors advised by independent valuation experts. The exchange was accounted for as a modification of granted stock options that established a new measurement date for the purpose of determining stock compensation expense. The Company recorded non-cash compensation expense of $1,898 and $21,901 in the years ended December 31, 2004 and 2003, respectively, and expects to record estimated aggregate additional compensation expense $197 in 2005 and 2006.

In connection with the completed sale of the Principal K-12 Disposal Group discussed more fully in Note 3, each unexpired and unexercised outstanding option to purchase shares of the Company s common stock held by employees who were employed by Educate was modified to partially accelerate vesting and allow for exercise for up to twenty-four months following the closing. This was accounted for as a modification of granted stock options, resulting in a new measurement date for the purpose of determining stock compensation expense. The modification resulted in estimated non-cash compensation expense of $4,066, which is equal to the intrinsic value of such options at June 30, 2003, the closing date of the sale of the Principal K-12 Disposal Group. This expense was included in the Company s results from discontinued operations for the year ended December 31, 2003 in the consolidated statements of operations.

Non-vested Stock Awards

During the years ended December 31, 2004 and 2003, certain executives were granted non-vested shares of common stock with related compensation measured at the fair market value of the stock at the date of grant. Non-cash compensation is being recognized pro-rata over the vesting periods of the shares, which do not exceed six years. During the years ended December 31, 2004 and 2003, 191 shares were granted at a weighted average value of $31.78 per share, and 255 shares were granted at a weighted average grant date value of $17.75 per share, respectively. Non-cash compensation expense related to the granted shares of $2,771 and $975 was recorded 2004 and 2003, respectively. The Company estimates that it will incur additional compensation expense related to these 2003 and 2004 grants of $2,016 in 2005, $2,016 in 2006, and an aggregate amount of $2,823 from 2007 through 2009.

Note 14- Income Taxes

Significant components of the provision for income taxes on earnings from continuing operations for the years ended December 31 are as follows:

	2004	2003	2002
Current:			
Federal	$ 5,187	$ 13,390	$ 3,266
Foreign	(13,585)	(13,745)	(10,468)
State	(2,494)	1,844	1,751
	(10,892)	1,489	(5,451)
Deferred:			
Federal	2,976	(805)	9,117
Foreign	3,460	1,813	2,445
State	(2,342)	433	2,678
	4,094	1,441	14,240
Total benefit (expense)	$ (6,798)	$ 2,930	$ 8,789

For the years ended December 31, 2004, 2003 and 2002, foreign income from continuing operations before income taxes was $108,150, $71,185, and $47,409, respectively.

The Company uses the liability method to account for income taxes. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company s deferred tax assets and liabilities arising from continuing operations are as follows as of December 31:

	2004	2003
Deferred tax assets:		
Net operating loss carryforwards	$ 23,363	$ 14,000
Deferred revenue	2,128	1,006
Allowance for doubtful accounts	886	1,073
Deferred compensation	9,550	10,378
Equity in net losses of affiliates	27,444	37,437
Non-deductible reserves	3,738	615
Tax credit carryforwards	4,860	3,400
Other	28	558
Total deferred tax assets	71,997	68,467
Deferred tax liabilities:		
Advertising costs		1,216
Prepaid expenses	720	679
Depreciation	6,455	3,937
Amortization of intangible assets	53,984	8,153
Deferred income	12,021	11,221
Other		202
Total deferred tax liabilities	73,180	25,408
Net future income tax benefits (liabilities)	(1,183)	43,059
Valuation allowance for net deferred tax assets	(14,054)	(13,503)
Net deferred tax assets (liabilities)	$ (15,237)	$ 29,556

At December 31, 2004, undistributed earnings from continuing operations of non-U.S. subsidiaries totaled approximately $373,400. Deferred tax liabilities have not been recognized for these undistributed earnings because it is management s intention to reinvest such undistributed earnings outside of the U.S. If all undistributed earnings were remitted to the U.S., the amount of incremental U.S. federal income taxes, net of foreign tax credits, would be approximately $87,800.

At December 31, 2004, undistributed gains on the sale of non-domestic discontinued operations totaled approximately $238,400. Deferred tax liabilities have not been recognized for these undistributed gains because it is management s intention to reinvest such undistributed gains outside of the United States. If all undistributed gains were remitted to the United States, the amount of incremental United States federal income taxes, net of foreign tax credits, would be approximately $83,400.

The net operating loss carryforwards at December 31, 2004 are related to subsidiaries of the Company, and are available only to offset future taxable income of those subsidiaries. These net operating loss carryforwards will begin to expire in 2007. The tax credit carryfowards consist of foreign tax credits that begin to expire in 2006.

The valuation allowance relates to the uncertainty surrounding the realization of the tax benefits attributable to the net operating losses of subsidiaries of the Company that are available only to offset future taxable income of those subsidiaries.

In June of 2004, the Internal Revenue Service (IRS) completed their field examination of the Company s 1998 and 1999 federal income tax returns. In connection with this examination, the Company received notice of certain adjustments proposed by the IRS, primarily related to transfer pricing and the timing of certain deductions.

The Company vigorously disagrees with the proposed adjustments and intends to aggressively contest the proposed adjustments through applicable IRS and judicial procedures, as appropriate. Although the final resolution of the proposed adjustments is uncertain, based on current information, in the opinion of the management, the ultimate disposition of these matters will not have a material adverse effect on the Company s consolidated financial position, liquidity or results of operations.

The reconciliation of the reported income tax expense to the amount that would result by applying the U.S. federal statutory tax rate of 35% to income from continuing operations before income taxes for the years ended December 31 is as follows:

		2004		2003		2002
Tax (expense) benefit at U.S. statutory rate	$	(38,780)	$	(8,216)	$	(1,068)
Permanent differences		(6,229)		(1,111)		(1,897)
State income tax benefit, net of federal tax effect		(121)		2,890		2,664
Tax effect of foreign income taxed at lower rate		30,867		13,227		8,462
Change in valuation allowance		7,465		(3,882)		(462)
Utilized tax credits						1,108
Other				22		(18)
Total tax benefit (expense)	$	(6,798)	$	2,930	$	8,789

Note 15 - Earnings (Loss) Per Share

The following table summarizes the computations of basic and diluted earnings per share for the years ended December 31:

		2004		2003 (as restated- Note 3)		2002
Numerator used in basic and diluted earnings (loss) per common share:						
Income from continuing operations, before cumulative effect of change in accounting principle	$	82,658	$	9,685	$	3,600
Loss from discontinued operations, net of tax		(6,323)		(5,480)		(4,266)
Gain (loss) on disposal of discontinued operations, net of tax		(13,324)		41,930		(16,643)
Cumulative effect of change in accounting principle, net of tax						(78,634)
Net income (loss)	$	63,011	$	46,135	$	(95,943)
Denominator for basic earnings (loss) per share weighted-average common shares outstanding		46,356		41,980		40,053
Net effect of dilutive stock options based on treasury stock method		2,660		1,798		
Denominator for diluted earnings (loss) per share weighted average common shares outstanding and assumed conversions		49,016		43,778		40,053
Earnings (loss) per common share, basic:						
Income from continuing operations, before cumulative effect of change in accounting principle	$	1.78	$	0.23	$	0.09
Loss from discontinued operations, net of tax		(0.14)		(0.13)		(0.11)
Gain (loss) on disposal of discontinued operations, net of tax		(0.29)		1.00		(0.42)

Cumulative effect of change in accounting principle, net of tax						(1.96)
Earnings (loss) per common share	$	1.36	$	1.10	$	(2.40)
Earnings (loss) per common share, diluted:						
Income from continuing operations, before cumulative effect of change in accounting principle	$	1.69	$	0.22	$	0.09
Loss from discontinued operations, net of tax		(0.13)		(0.13)		(0.11)
Gain (loss) on disposal of discontinued operations, net of tax		(0.27)		0.96		(0.42)
Cumulative effect of change in accounting principle, net of tax						(1.96)
Earnings (loss) per common share	$	1.29	$	1.05	$	(2.40)

Outstanding stock options and convertible debentures were not included in the computation of earnings (loss) per share for the year ended December 31, 2002 because they were anti-dilutive. The number of shares of common stock issuable upon the exercise of stock options and the conversion of debentures was 969 and 6,037, respectively, as of December 31, 2002.

Note 16 - Business and Geographic Segment Information

The Company is focused exclusively on providing a superior higher education experience to over 159,000 students through a leading global network of accredited campus-based and online higher education institutions. The Company s educational services are offered through three reportable segments: Latin America, Europe and Laureate Online Education.

The accounting policies of the segments are the same as those described in the significant accounting policies. The Company evaluates performance based on profit or loss from operations before income taxes, corporate general and administrative expenses, non-cash stock compensation expense and campus-based overhead expenses.

The Latin America segment consists of five separately accredited universities and one professional institute, and has operations in Mexico, Chile, Peru, Ecuador, Panama, and Costa Rica. Latin America higher education institutions currently enroll approximately 123,000 full-time students and offer more than 100 degree programs through 34 campuses. The schools primarily serve 18- to 24-year-old students and offer an education that emphasizes career-oriented fields of study with undergraduate and graduate degrees in a wide range of disciplines, including international business, law, health sciences, information technology and engineering.

The Europe segment consists of one accredited university and several other accredited post-secondary institutions, and has operations in Spain, Switzerland, and France. Europe higher education institutions currently enroll approximately 15,000 full-time students and offer more than 75 degree programs through 8 campuses. The schools primarily serve 18- to 24-year-old students and offer an education that emphasizes career-oriented fields of study with undergraduate and graduate degrees in a wide range of disciplines, including international business, hotel management, health sciences, architecture and engineering.

The Company believes that all of its campus based higher education institutions benefit from strong academic reputations and brand awareness, and established operating histories. Each school also has flexible, non-tenured, teaching-focused faculty and is led by an experienced local management team.

The Laureate Online Education segment offers undergraduate and graduate degree programs to working professionals through distance learning. Laureate Online Education consists of Walden, Canter, NTU, and Laureate Online Education BV, which collectively offer degree programs including education, psychology, health and human services, management, engineering, and information technology. Laureate Online Education institutions currently enroll approximately 21,000 students.

Other represents results from the Ventures business, which was disbanded in 2003.

These reportable segments are business units that offer distinct services and are managed separately. The campus-based reportable segments of Latin America and Europe are not aggregated with Laureate Online Education as Laureate Online Education offers services to a different class of customer, through a different delivery system, and with different economic characteristics. The Latin America and Europe segments are managed separately and have certain differences in classes of customer and economic characteristics, and thus are not aggregated together.

Prior to 2004, the Company s reportable segments consisted of campus-based and online higher education. All historical segment information has been reclassified to conform to the current year presentation.

The following table sets forth information on the Company s reportable segments for the years ended December 31:

2004	**Latin America**	**Europe**	**Laureate Online Education**	**Other**
Revenues	$ 360,485	$ 152,400	$ 135,134	$
Segment profit	85,458	23,784	21,143	
Segment assets	626,682	415,682	383,707	1,574
Long-lived assets	220,796	248,100	10,115	
Depreciation and amortization	17,831	10,621	11,424	

64

2003	Latin America	Europe	Laureate Online Education	Other
Revenues	$ 249,533	$ 126,555	$ 95,815	$ 903
Segment profit (loss)	57,626	19,934	13,288	(2,975)
Segment assets	446,244	293,744	213,214	3,828
Long-lived assets	135,558	214,242	8,483	
Depreciation and amortization	11,466	9,132	5,223	228

2002	Latin America	Europe	Laureate Online Education	Other
Revenues	$ 169,411	$ 91,854	$ 74,343	$ 395
Segment profit (loss)	30,993	16,679	9,053	(7,001)
Segment assets	186,418	247,638	181,790	23,914
Long-lived assets	70,805	183,629	7,309	418
Depreciation and amortization	6,811	6,200	3,806	43

The following tables reconcile the reported information on segment profit and assets to income from continuing operations before income taxes. Minority interest, equity in net income (loss) of affiliates and cumulative effect of change in accounting principle, and total assets reported in the statements of operations and balance sheets for the years ended December 31:

	2004	2003	2002
Total profit for reportable segments	$ 130,385	$ 87,873	$ 49,724
Campus-based segments overhead	(12,040)	(11,995)	(12,736)
Core operating general and administrative expense	(21,380)	(17,774)	(21,318)
Non-cash compensation expense	(5,718)	(23,050)	(1,046)
Net non-operating income (expenses)	19,553	(9,978)	(11,271)
Income from continuing operations before income taxes, minority interest, equity in net income (loss) of affiliates and cumulative effect of change in accounting principle	$ 110,800	$ 25,076	$ 3,353

	2004	2003	2002
Total assets for reportable segments	$ 1,427,645	$ 957,030	$ 639,760
Campus-based segments corporate long- lived assets	6,581	4,070	3,327
Unallocated corporate assets	49,443	116,900	95,795
Assets of discontinued operations, net	47,041	71,914	228,929
Total assets	$ 1,530,710	$ 1,149,914	$ 967,811

	2004	2003	2002
Total long-lived assets for reportable segments	$ 479,011	$ 358,283	$ 262,161
Campus-based segments corporate assets	732	984	1,088
Unallocated corporate long-lived assets	5,849	6,583	9,987
Total long-lived assets	$ 485,592	$ 365,850	$ 273,236

	2004	2003	2002
Total depreciation and amortization for reportable segments	39,876	$ 26,049	$ 16,860
Campus-based segments corporate depreciation and amortization	437	264	115
Corporate depreciation and amortization	1,245	1,626	3,329
Depreciation and amortization of discontinued operations		2,982	10,733
Total depreciation and amortization	$ 41,558	$ 30,921	$ 31,037

65

Revenue and long-lived assets information of continuing operations by geographic area for the years ended December 31 is as follows:

	2004	2003	2002
Revenues			
Mexico	$ 182,214	$ 150,121	$ 133,577
Chile	148,141	97,585	35,834
United States	128,330	96,718	74,738
Spain	90,684	76,831	60,328
Other foreign countries	98,650	51,551	31,526
Consolidated total	$ 648,019	$ 472,806	$ 336,003
Long-Lived Assets			
Mexico	$ 121,809	$ 76,628	$ 45,618
Spain	121,628	111,161	93,048
Switzerland	110,160	102,295	90,231
Chile	79,446	57,774	25,187
United States	16,112	16,050	18,802
Other foreign countries	36,437	1,942	350
Consolidated total	$ 485,592	$ 365,850	$ 273,236

Revenues are attributed to countries based on the location of the customer.

Note 17 - Supplemental Cash Flow Information

Cash flow information for the Company reflects the total cash flows including continuing operations and discontinued operations.

Interest payments were approximately $5,963, $8,201, and $7,395 for the years ended December 31, 2004, 2003 and 2002, respectively. Income tax payments were $24,596, $49,065, and $4,277 for the years ended December 31, 2004, 2003, and 2002, respectively.

Note 18 - Quarterly Financial Data (Unaudited)

The following financial information reflects all normal recurring adjustments, which are, in the opinion of management, necessary for a fair statement of the results of the interim periods. All periods results have been restated to separately disclose discontinued operations. Summarized operating data is as follows:

	Quarter Ended			
2004	**March 31**	**June 30**	**September 30**	**December 31**

Revenues	$	132,156	$	158,251	$	146,110	$	211,502
Direct costs		128,564		136,090		128,404		163,714
Operating income		3,592		22,161		17,706		47,788
Income from continuing operations before cumulative effect of change in accounting principle		2,507		23,837		9,303		47,011
Income (loss) from discontinued operations, net of tax		(2,891)		(3,027)		31		(436)
Loss on disposal of discontinued operations, net of tax								(13,324)
Net income (loss)	$	(384)	$	20,810	$	9,334	$	33,251
Income (loss) per common share, basic:								
Income from continuing operations before cumulative effect of change in accounting principle	$	0.06	$	0.53	$	0.20	$	0.97
Income (loss) from discontinued operations		(0.06)		(0.07)		0.00		(0.01)
Loss on disposal of discontinued operations		0.00		0.00		0.00		(0.27)
Net income (loss)	$	(0.01)	$	0.46	$	0.20	$	0.68
Income (loss) per common share, diluted:								
Income from continuing operations before cumulative effect of change in accounting principle	$	0.05	$	0.50	$	0.19	$	0.92
Income (loss) from discontinued operations		(0.06)		(0.06)		0.00		(0.01)
Loss on disposal of discontinued operations		0.00		0.00		0.00		(0.26)
Net income (loss)	$	(0.01)	$	0.43	$	0.19	$	0.65
Shares used in computation, basic:		44,925		45,344		46,524		48,624
Shares used in computation, diluted:		47,484		48,131		49,124		51,310

On April 27, 2004, the Company received payment in full on one of its notes receivable from Educate, originally recorded net of a $13,448 discount. The early retirement of the Educate note resulted in an accelerated recognition of the remaining unamortized original issue discount in the amount of $12,722, which has been included in investment and other income.

As more fully described in Note 13, during the quarter ended June 30, 2004, certain current and former employees were inadvertently permitted to exercise stock options on a net share basis, whereby shares equal in value to the option strike price and the employee s minimum tax withholding obligation were withheld by the Company (also known as a cashless exercise). As a result, the Company recognized $1,049 of additional compensation expense in continuing operations and $1,436 of additional compensation in discontinued operations for the difference between the exercise price and the market value of the shares on date of exercise.

As more fully described in Note 3, on December 31, 2004, the Company entered into an agreement to sell the WSI business. As a result, the Company recorded a loss of $13,389, net of income tax expense of $3,202. In connection with the transaction, the Company recognized a net tax benefit of approximately $12,038.

	Quarter Ended			
2003	**March 31**	**June 30**	**September 30**	**December 31**
Revenues	$ 95,324	$ 116,242	$ 106,327	$ 154,913
Direct costs	97,013	127,139	95,048	118,552
Operating income (loss)	(1,689)	(10,897)	11,279	36,361
Income (loss) from continuing operations before cumulative effect of change in accounting principle	(12,831)	(13,013)	6,124	29,405
Income (loss) from discontinued operations, net of tax	2,082	(776)	(699)	(6,087)
Gain (loss) on disposal of discontinued operations, net of tax	(5,217)	44,640		2,507
Net income (loss)	$ (15,966)	$ 30,851	$ 5,425	$ 25,825
Income (loss) per common share, basic:				
Income (loss) from continuing operations before cumulative effect of change in accounting principle	$ (0.32)	$ (0.32)	$ 0.14	$ 0.67
Income (loss) from discontinued operations	0.05	(0.02)	(0.02)	(0.14)
Gain (loss) on disposal of discontinued operations	(0.13)	1.08	0.00	0.06
Net income (loss)	$ (0.39)	$ 0.75	$ 0.13	$ 0.59
Income (loss) per common share, diluted:				
Income (loss) from continuing operations before cumulative effect of change in accounting principle	$ (0.32)	$ (0.32)	$ 0.13	$ 0.62
Income (loss) from discontinued operations	0.05	(0.02)	(0.01)	(0.13)
Gain (loss) on disposal of discontinued operations	(0.13)	1.08	0.00	0.05
Net income (loss)	$ (0.39)	$ 0.75	$ 0.12	$ 0.54
Shares used in computation, basic:	40,477	41,164	42,637	43,785
Shares used in computation, diluted:	40,477	41,164	46,635	47,130

On June 30, 2003, the Company sold the its K-12 Disposal Group and sold certain investments in the Ventures business that were not strategic to its post-secondary education business in a transaction more fully described in Note 3 to the consolidated financial statements. In addition, during the second quarter of 2003, management committed to a plan to dispose of its WSI business. In the first quarter of 2004, due to the unfavorable regulatory climate for private educational enterprises in India, the Company decided to terminate its current programs there, including cessation of the educational activities of South Asia International Institute. The operations of the Company s disposal group comprising its WSI operations, including the Spanish operations of WSI, which were sold in July 2002, are classified as discontinued operations. The quarterly financial data has been presented to reflect the sale of the K-12 and WSI segments and termination of the Company s programs in India as discontinued operations for all periods presented.

During 2003, the Company recorded a non-cash stock compensation expense of $21,901. In periods prior to 2003, certain members of executive management and employees of the Company were granted options under the 1998 plan to acquire common stock of the subsidiary serving as the holding company for the campus-based segments. Due to the restructuring of the Company s operations resulting from the sale of the Principal K-12 Disposal Group and non-strategic Ventures assets, on April 1, 2003 the Company negotiated an agreement with employees holding stock options to acquire common stock of the subsidiary that provided for the exchange of these stock options for stock options to acquire common stock of the Company. The result of the exchange of options did not increase the aggregate intrinsic value of the options or reduce the ratio of the exercise price per share of the options to the per share fair value of common stock on the date of exchange, as determined by independent members of the Board of Directors advised by independent valuation experts. The exchange was accounted for as a modification of granted stock options that established a new measurement date for the purpose of determining stock compensation expense.

During the quarter ended March 31, 2003, the Company recorded a loss of $7,158 related to the write-off of its equity basis investment in Chancery. During the quarter ended June 30, 2003, the Company recorded a gain on the sale of its K-12 segment of $71,752, net of tax expense of $39,194; a loss of $8,273, net of tax benefit of $4,425, related to the write-off of the United Kingdom and France net assets; and a loss of $20,777, net of tax benefit of $1,698, related to the write-down of WSI net assets in anticipation of the sale. In addition, the Company s cost basis investment in ClubMom was sold on June 30, 2003 for contingent consideration, for a loss of $7,596.

The projected effective tax rate for the year changed each quarter throughout fiscal year 2003 due to changes in the mix of earnings and losses between different tax jurisdictions, the establishment of valuation allowances against net operating losses of certain subsidiaries, the effect of non-cash compensation expense, and the mid-year reclassification of WSI to discontinued operations.

Earnings per share are computed independently for each of the quarters presented. Therefore, the sum of the quarterly net earnings per share will not necessarily equal the total for the year.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

There were no changes in accountants, disagreements, or other events requiring disclosure under this Item.

Item 9A. Controls and Procedures

Evaluation of Disclosure 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 management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures. Based upon that evaluation, the Company s Chief Executive Officer and Chief Financial Officer have concluded that the Company s disclosure controls and procedures are effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

There were no changes in internal control over financial reporting during the quarter ended December 31, 2004 that materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

Management s Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Under the supervision and with the participation of management, including the Chief Executive Officer and Chief Financial Officer, the Company conducted an evaluation of the effectiveness of internal control over financial reporting as of December 31, 2004 based on the framework in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on that evaluation, management concluded that internal control over financial reporting was effective as of December 31, 2004.

Management s assessment of the effectiveness of internal control over financial reporting as of December 31, 2004 has been audited by Ernst & Young LLP, an independent registered public accounting firm, as stated in their report which is included elsewhere herein.

/s/ Douglas L. Becker
Douglas L. Becker

Chairman and CEO
Laureate Education, Inc.

/s/ Sean R. Creamer
Sean R. Creamer
Senior Vice President & CFO
Laureate Education, Inc.

69

Report of Independent Registered Public Accounting Firm
On Internal Control Over Financial Reporting

Board of Directors and Stockholders

Laureate Education, Inc.

We have audited management s assessment, included in the accompanying Management s Report on Internal Control over Financial Reporting, that Laureate Education, Inc. maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Laureate Education, Inc. s management is

responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that Laureate Education, Inc. maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Laureate Education, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on the COSO criteria**.**

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Laureate Education, Inc. (formerly Sylvan Learning Systems, Inc.) and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, stockholders equity, and cash flows for each of the three years in the period ended December 31, 2004 and our report dated March 10, 2005 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Baltimore, Maryland
March 10, 2005

Item 9B. Other Information

Douglas L. Becker Employment Agreement

On March 10, 2005, an Employment Agreement was entered into between Laureate Education, Inc. and Douglas L. Becker. The agreement extended the agreement which expired June 30, 2004 and provides that Douglas Becker will be employed as the Chief Executive Officer of the Company and shall also serve as Chairman of the Company Board. Compensation for this position shall be $500,000 base salary and bonus target of 100% of base salary upto satisfaction of all stated criteria, which shall be established each year by the Compensation Committee of the Board. This Agreement is effective until June 30, 2007.

Douglas L. Becker Restricted Stock Agreement

Douglas L. Becker was granted 166,000 shares of restricted stock on February 28, 2004 and entered into a restricted stock agreement with the Company in the fourth quarter of 2004. The plan provides for monthly vesting over a six year period, but provides accelerated vesting upon the achievement of certain performance thresholds which could provide that all shares are vested over a three year period.

PART III.

Item 10. Directors and Executive Officers of Laureate Education, Inc.

Information required by this item is incorporated by reference to the information to be set forth under the caption Election of Laureate Directors in the Proxy Statement relating to the 2005 Annual Meeting of Stockholders, which will be filed on or before April 30, 2005.

The Company has adopted a Code of Business Conduct and Ethics for Directors and Employees (Code of Ethics), including the principal executive officer, principal financial officer, principal accounting officer and persons performing similar functions. Copies of the Code of Ethics are available free of charge by writing to Investor Relations at 1001 Fleet Street, Baltimore, Maryland 21202. Any waivers of the Code of Ethics must be approved, in advance, by the full Board of Directors. Any amendments to, or waivers from the Code of Ethics must be approved, in advance, by the full Board of Directors. Any amendments to, or waivers from the Code of Ethics that apply to executive officers and directors will be posted on the Corporate Governance section of the Internet website located at www.laureate-inc.com.

Item 11. Executive Compensation

Information required by this item is incorporated by reference to the information to be set forth under the caption Compensation of Executive Officers and Directors in the Proxy Statement relating to the 2005 Annual Meeting of Stockholders.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information required by this item is incorporated by reference to the information to be set forth under the caption Stock Ownership of Certain Beneficial Owners, Directors and Management in the Proxy Statement relating to the 2005 Annual Meeting of Stockholders.

Item 13. Certain Relationships and Related Transactions

Information required by this item is incorporated by reference to the information to be set forth under the caption Certain Relationships and Related Transactions in the Proxy Statement relating to the 2005 Annual Meeting of Stockholders.

Item 14. Principal Accountant Fees and Services

Information required by this item is incorporated by reference to the information to be set forth under the caption Principal Accountant Fees and Services in the Proxy Statement relating to the 2005 Annual Meeting of Stockholders.

PART IV.

Item 15. Exhibits, Financial Statement Schedules

(a) The following documents are filed as a part of this report:

1. Financial Statements

The response to this portion of Item 15 is contained in a separate section of this Report.

2. Financial Statement Schedules

The following consolidated financial statement schedule of Laureate Education, Inc. and subsidiaries are included in Item 15(a):

Schedule II Valuation and qualifying accounts.

All other schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and, therefore, have been omitted.

3. Exhibits

(a) Exhibits filed with this report:

Exhibit Number	Description
10.01	Performance Shares Grant Agreement with Douglas L. Becker
10.02	Employment Agreement with Douglas L. Becker
23.01	Consent of Ernst & Young LLP with respect to Consolidated Financial Statements of Laureate Education, Inc.
23.02	Consent of PricewaterhouseCoopers LLP with respect to Consolidated Financial Statements of Chancery Software Ltd.
31.01	Certification of Douglas L. Becker pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.02	Certification of Sean R. Creamer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.01	Certification of Douglas L. Becker pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.02	Certification of Sean R. Creamer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
99.01	Consolidated Financial Statements of Chancery Software Ltd.

SIGNATURES

Pursuant to the requirements of Section 13 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 on March 11, 2005.

LAUREATE EDUCATION, INC.
(Registrant)

By: /s/Douglas L. Becker
Douglas L. Becker
Chairman of the Board

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated and on March 11, 2005.

Signature	Capacity
/s/Douglas L. Becker Douglas L. Becker	Director, Chairman of the Board and Chief Executive Officer
/s/Sean R. Creamer Sean R. Creamer	Senior Vice President and Chief Financial Officer
/s/ R. Christopher Hoehn-Saric R. Christopher Hoehn-Saric	Director
/s/James H. McGuire James H. McGuire	Director
/s/Isabel Aguilera Isabel Aguilera	Director
/s/Richard W. Riley Richard W. Riley	Director
/s/David A. Wilson David A. Wilson	Director
/s/John A. Miller John A. Miller	Director
/s/Wolf H. Hengst Wolf H. Hengst	Director
/s/R. William Pollock R. William Pollock	Director

Schedule II

Laureate Education, Inc.

Valuation and Qualifying Accounts

(in thousands)

		Additions			
Description	**Balance at Beginning of Period**	**Charges to Costs and Expenses**	**Charges to Other Accounts (1)**	**Deductions**	**Balance at End of Period**
Year Ended December 31, 2002					
Allowance for doubtful accounts	$ 3,543	3,461	598	(1,663)	$ 5,939
Deferred tax asset valuation account	$	1,122			$ 1,122
Year Ended December 31, 2003					
Allowance for doubtful accounts	$ 5,939	8,233	7,477	(3,941)	$ 17,708
Deferred tax asset valuation account	$ 1,122	4,218	9,158	(994)	$ 13,504
Year Ended December 31, 2004					
Allowance for doubtful accounts	$ 17,708	14,019	4,120	(4,787)	$ 31,060
Deferred tax asset valuation account	$ 13,504	550			$ 14,054

(1) For the year ended December 31, 2003, other charges consist of reserves acquired through purchase acquisitions of $5,823 and foreign currency translation of $1,654. For the year ended December 31, 2004, other charges consist of reserves acquired through purchase acquisition of $2,898 and foreign currency translation of $1,222.