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VITAL SIGNS INC
Form 10-Q
February 09, 2005

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-Q

(Mark one)

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

FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2004

OR

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

COMMISSION FILE NUMBER: 0-18793

VITAL SIGNS, INC.

(Exact name of registrant as specified in its charter)

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

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

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports
required to be filed by Section 13 or 15(d) of the Securities Exchange Act of
1934 during the preceding 12 months (or for such shorter period that the
registrant was required to file such reports) and (2) has been subject to such
filing requirements for the past 90 days.
Yes No

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

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

At February 4, 2005 there were 12,605,704 shares of Common Stock, no par value, outstanding.

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VITAL SIGNS, INC.

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PART I.

FINANCIAL INFORMATION

Item 1. Financial Statements

Certain information and footnote disclosures required under generally accepted accounting principles have been condensed or omitted from the following consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission. Vital Signs, Inc. (the "registrant", the "Company", "Vital Signs", "we", "us", or "our") believes that the disclosures are adequate to assure that the information presented is not misleading in any material respect. It is suggested that the following consolidated financial statements be read in conjunction with the year-end consolidated financial statements and notes thereto included in the registrant's Annual Report on Form 10-K for the year ended September 30, 2004.

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

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors
VITAL SIGNS, INC.

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

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the consolidated financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of Vital Signs, Inc. and Subsidiaries as of September 30, 2004 and the related consolidated statements of income, stockholders' equity and cash flows for the year then ended (not presented herein); and in our report dated November 12, 2004 we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying

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consolidated balance sheet as of September 30, 2004 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

GOLDSTEIN GOLUB KESSLER LLP

New York, New York
February 1, 2005

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VITAL SIGNS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

| | December 31, 2004 | September 30, 2004 |
|---|---------------------------|-----------------------|
| | ----- | ----- |
| | (In thousands of dollars) | |
| | (Unaudited) | |
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | 79,883 | \$ 76,468 |
| Accounts receivable, less allowances for rebates and doubtful accounts of \$7,375 and \$8,725, respectively .. | 31,548 | 31,876 |
| Inventory | 17,750 | 16,766 |
| Prepaid expenses | 3,103 | 2,816 |
| Other current assets | 1,549 | 1,596 |
| | ----- | ----- |
| Total Current Assets | 133,833 | 129,522 |
| Property, plant and equipment--net | 30,154 | 29,900 |
| Goodwill | 69,506 | 69,506 |
| Deferred income taxes | 430 | 796 |
| Other assets | 7,092 | 5,952 |
| | ----- | ----- |
| Total Assets | 241,015 | \$235,676 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | 5,289 | \$ 5,114 |
| Accrued expenses | 7,594 | 7,780 |
| Accrued income taxes | 4,463 | 3,387 |
| | ----- | ----- |
| Total Current Liabilities | 17,346 | 16,281 |
| | ----- | ----- |
| Minority interest in subsidiary | 3,456 | 3,172 |
| | ----- | ----- |
| Commitments and contingencies | | |
| Stockholders' Equity | | |
| Common stock--no par value; authorized 40,000,000 | | |

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| | | |
|--|---------|-----------|
| shares, issued and outstanding 12,630,974 and 12,715,566 shares, respectively | 21,179 | 24,279 |
| Accumulated other comprehensive income | 5,183 | 3,059 |
| Retained earnings | 193,851 | 188,885 |
| | ----- | ----- |
| Stockholders' equity | 220,213 | 216,223 |
| | ----- | ----- |
| Total Liabilities and Stockholders' Equity | 241,015 | \$235,676 |
| | ===== | ===== |

(See Notes to Consolidated Financial Statements)

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

| | For Mon Dec |
|--|-------------------|
| | 2004 |
| | (In tho per s |
| Net Revenues: | |
| Net sales | \$37,25 |
| Service revenue | 8,44 |
| | ----- |
| | 45,69 |
| Cost of goods sold and services performed: | |
| Cost of goods sold | 18,51 |
| Cost of services performed | 4,47 |
| | ----- |
| | 22,98 |
| Gross profit | 22,70 |
| Operating expenses: | |
| Selling, general and administrative | 12,00 |
| Research and development | 1,78 |
| Restructuring expense | 5 |
| Other expense--net | 3 |
| | ----- |
| Total operating expenses | 13,88 |
| Operating Income | 8,82 |
| Other (income) expense | |
| Interest (income) | (25 |

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| | |
|--|----------|
| Interest expense | - |
| Total other (income) | (25) |
| Income from continuing operations before provision for income taxes and minority interest in income of consolidated subsidiary | 9,08 |
| Provision for income taxes | 3,15 |
| Income from continuing operations before minority interest in income of consolidated subsidiary | 5,93 |
| Minority interest in income of consolidated subsidiary | 10 |
| Income from continuing operations | 5,82 |
| Discontinued Operations: | |
| Loss from operations of Vital Pharma, net of income taxes benefit of (\$47) and (\$83) .. | 9 |
| Net income | \$ 5,73 |
| Earnings (loss) per Common Share: | |
| Basic | |
| Income per share from continuing operations | \$ 0.4 |
| Loss per share from discontinued operations | \$ (0.0) |
| Net earnings per share | \$ 0.4 |
| Diluted | |
| Income per share from continuing operations | \$ 0.4 |
| Loss per share from discontinued operations | \$ (0.0) |
| Net earnings per share | \$ 0.4 |
| Basic weighted average number of shares outstanding | 12,61 |
| Diluted weighted average number of shares outstanding | 12,77 |
| Dividends paid per share | \$ 0.0 |

(See Notes to Consolidated Financial Statements)

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

| | For the Three Ended Decem |
|---------------------------------------|------------------------------|
| | 2004 |
| | (In thousa dollar |
| Cash Flows from Operating Activities: | |
| Net income | \$ 5,733 |

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| | | |
|--|----------|-------|
| Add loss from discontinued operations | 90 | ----- |
| Income from continuing operations | 5,823 | |
| Adjustments to reconcile income from continuing operations to net cash provided by continuing operations | | |
| Depreciation and amortization | 1,168 | |
| Deferred income taxes | 366 | |
| Minority interest in income of consolidated subsidiary | 284 | |
| Tax benefit on stock options | -- | |
| Changes in operating assets and liabilities: | | |
| Decrease in accounts receivable | 1,003 | |
| (Increase) decrease in inventory | (429) | |
| (Increase) decrease in prepaid expenses and other current assets | (17) | |
| (Increase) decrease in other assets | (488) | |
| Decrease in accounts payable | (1,361) | |
| (Decrease) in accrued expenses | (532) | |
| Increase (decrease) in accrued income taxes | 1,076 | |
| Increase (decrease) in other liabilities | 311 | |
| | | ----- |
| Net cash provided by continuing operations | 7,204 | |
| Net cash used in discontinued operations | (90) | |
| | | ----- |
| Net cash provided by operating activities | 7,114 | |
| Cash flows from investing activities: | | |
| Net proceeds from sales of assets of Vital Pharma | -- | |
| Net proceeds from sale of Vital Pharma real estate | -- | |
| Acquisition of property, plant and equipment | (338) | |
| Capitalized software costs | (741) | |
| Capitalized patent costs | (52) | |
| | | ----- |
| Net cash used in investing activities | (1,131) | |
| Cash flows from financing activities: | | |
| Dividends paid | (767) | |
| Proceeds from exercise of stock options | 775 | |
| Purchase of common stock | (3,974) | |
| Principal payments on long-term debt and notes payable | -- | |
| | | ----- |
| Net cash used in financing activities | (3,966) | |
| Effect of foreign currency translation | 1,398 | |
| | | ----- |
| Net increase in cash and cash equivalents | 3,415 | |
| Cash and cash equivalents at beginning of period | 76,468 | |
| | | ----- |
| Cash and cash equivalents at end of period | \$79,883 | |
| | | ===== |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the nine months for: | | |
| Interest | \$ -- | \$ |
| Income taxes | \$ 1,418 | \$ |

(See Notes to Consolidated Financial Statements)

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. The consolidated balance sheet as of December 31, 2004, the consolidated statements of income for the three months ended December 31, 2004 and 2003, and the consolidated statements of cash flows for the three months ended December 31, 2004 and 2003, have been prepared by Vital Signs, Inc. (the "registrant", the "Company", "Vital Signs", "we", "us", or "our") and are unaudited. In the opinion of management, all adjustments necessary to present fairly the financial position at December 31, 2004 and the results of operations for the three months ended December 31, 2004 and 2003, and the cash flows for the three months ended December 31, 2004 and 2003, have been made.

2. See the Company's Annual Report on Form 10-K for the year ended September 30, 2004 (the "Form 10-K") for additional disclosures relating to the Company's consolidated financial statements.

3. At December 31, 2004, the Company's inventory was comprised of raw materials of \$11,552,000 and finished goods of \$6,198,000. At September 30, 2004, the Company's inventory was comprised of raw materials of \$10,563,000 and finished goods of \$6,203,000.

4. Net revenues consist of product sales and service revenues. For all product sales, revenue is recognized when title to the product passes to the customer. For substantially all product sales, title passes upon shipment of the product by the Company, although for certain sales, title passes when the product is received by the customer. For service revenue, revenue is recorded when the service is performed. A component of product sales is a deduction for rebates due on sales to distributors. A reconciliation of gross to net sales is provided below:

| | Three Months Ended December 31, | |
|--------------------------|------------------------------------|-----------|
| | 2004 | 2003 |
| Gross sales | \$ 51,380 | \$ 48,084 |
| Rebates | (13,241) | (11,085) |
| Other deductions | (882) | (1,104) |
| | 37,257 | 35,895 |
| Net sales | 8,441 | 7,953 |
| Service revenues | \$ 45,698 | \$ 43,848 |
| Total net revenues | ===== | ===== |

Other deductions consist of discounts, returns and allowances for credits.

5. The Company has aggregated its business units into four reportable segments, Anesthesia, Respiratory/Critical Care, Sleep and Pharmaceutical Technology Services. There are no material intersegment sales. Anesthesia and Respiratory/Critical Care share certain manufacturing, sales and administration costs; therefore the operating profit, total assets, and capital expenditures are not specifically identifiable. However the Company has allocated these shared costs on a net sales basis to arrive at operating profit for the anesthesia and respiratory/critical care segments. Total assets and capital expenditures for anesthesia and respiratory/critical care have also been allocated on a net sales basis. Management evaluates performance on the basis of

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the gross profits and operating results of the four business segments. Summarized financial information concerning the Company's reportable segments is shown in the following table:

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

| | Anesthesia ----- | Respiratory Critical Care ----- | Sleep ----- | Pharmaceutical Technology Services ----- | Consolidate ----- |
|-------------------------------|---------------------|--|----------------|---|----------------------|
| For the Three Months Ended | | | | | |
| December 31, 2004 | | | | | |
| Net revenues | \$ 20,127 | \$10,148 | \$10,752 | \$ 4,671 | \$ 45,698 |
| Gross profit | 10,255 | 5,744 | 4,707 | 2,001 | 22,707 |
| Gross profit percentage | 51.0% | 56.6% | 43.8% | 42.8% | 49.7% |
| Operating income (loss) | 5,297 | 2,670 | (36) | 893 | 8,824 |
| Total assets | 121,073 | 61,045 | 38,707 | 20,190 | 241,015 |
| Capital expenditures | 401 | 202 | 361 | 167 | 1,131 |
| 2003 | | | | | |
| Net revenues | \$ 18,496 | \$10,667 | \$10,956 | \$ 3,729 | \$ 43,848 |
| Gross profit | 9,332 | 6,080 | 5,026 | 1,576 | 22,014 |
| Gross profit percentage | 50.5% | 56.7% | 45.8% | 42.3% | 50.2% |
| Operating income | 4,279 | 2,467 | 962 | 384 | 8,092 |
| Total assets | 107,424 | 61,954 | 36,194 | 18,916 | 224,488 |
| Capital expenditures | 388 | 223 | 373 | 175 | 1,159 |

6. Other comprehensive income for the three months ended December 31, 2004 and 2003 consisted of:

| | Three Months Ended December 31, ----- | |
|------------------------------------|---|------------------|
| | 2004 ----- | 2003 ----- |
| Net income | \$5,733 | \$5,070 |
| Foreign currency translation | 2,124 | 1,612 |
| Comprehensive income | \$7,857 ===== | \$6,682 ===== |

7. In December 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 148, "Accounting for Stock-Based Compensation--Transition and Disclosure, an amendment of SFAS No. 123". SFAS No. 148 provides alternative methods of transition for a

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voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 "Accounting for Stock-Based Compensation", to require prominent disclosures in annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect in measuring compensation expense. The disclosure requirements of SFAS No. 148 are effective for periods beginning after December 15, 2002.

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

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

| | Three Month Period Ended December 31, | |
|--|--|---------|
| | 2004 | 2003 |
| | ----- | ----- |
| Net income--as reported | \$5,733 | \$5,070 |
| Net income--Pro forma | 5,490 | 4,883 |
| Basic net income per common share--as reported | .45 | .39 |
| Diluted net income per common share--as reported | .45 | .39 |
| Basic net income per common share--Pro forma | .44 | .38 |
| Diluted net income per common share--Pro forma | .43 | .38 |

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for the three months ended December 31, 2004 and 2003, respectively: expected volatility of 33% and 50%, respectively, risk-free interest rate of 5.0% and 3.7%, respectively, dividend yield rate of .6% and .7%, respectively, and all options have expected lives of between five and ten years.

8. In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share Based Payment" ("SFAS 123(R)"). SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. SFAS 123(R) is effective for the Company beginning in the fourth quarter of this fiscal year. The new standard allows for two transition alternatives, either the modified-prospective method or the modified-retrospective method. The Company has not completed its evaluation of SFAS 123(R) and therefore has not selected a transition method or

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determined the impact that adopting SFAS 123(R) will have on its results of operations.

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

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Item 2. Management's Discussion and Analysis of Results of Operations and Financial Condition

Forward Looking Statements

This Quarterly Report on Form 10-Q contains, and from time to time we expect to make, certain forward-looking statements regarding our business, financial condition and results of operations. The forward-looking statements are typically identified by the words "anticipates", "believes", "expects", "intends", "forecasts", "plans", "future", "strategy", or words of similar import. In connection with the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), we intend to caution investors that there are important factors that could cause our actual results to differ materially from those projected in our forward-looking statements, whether written or oral, made herein or that may be made from time to time by or on behalf of us. Investors are cautioned that such forward-looking statements are only predictions and that actual events or results could differ materially from such statements. We undertake no obligation to publicly release the results of any revisions to our forward-looking statements to reflect subsequent events or circumstances or to reflect the occurrence of unanticipated events.

We wish to ensure that any forward-looking statements are accompanied by meaningful cautionary statements in order to comply with the terms of the safe harbor provided by the Reform Act. Accordingly, we have set forth in Exhibit 99.1 to our Annual Report on Form 10-K for the year ended September 30, 2004 a list of important factors, certain of which are outside of management's control, that could cause our actual results to differ materially from those expressed in forward-looking statements or predictions made herein and from time to time by us. Reference is made to such Exhibit 99.1 for a list of such risk factors.

Results of Operations

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

Increase from
Prior Period
Three Months
Ended
December 31, 2004
Compared with
Three Months
Ended

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December 31, 2003

Consolidated Statement of Operations Data:

| | |
|--|--------|
| Net revenues..... | 4.2% |
| Gross profit..... | 3.2% |
| Research And Development..... | 18.5% |
| Total operating expenses..... | (0.3)% |
| Income from continuing operations..... | 11.5% |
| Net income..... | 13.1% |

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

Net Revenue. Net revenues for the three months ended December 31, 2004 increased by 4.2% (an increase of 2.8% excluding the favorable effect of foreign exchange) to \$45.7 million as compared to \$43.8 million in the comparable period last year. Of our total revenues, \$33.5 million, or 73.3%, were derived from domestic sales and \$12.2 million, or 26.7%, were derived from international sales. The following are the net revenues by business segment for the three months ended December 31, 2004 compared to the three months ended December 31, 2003:

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REVENUE BY BUSINESS SEGMENT

| | For the Quarter Ended December 31, | | Percent Change |
|--|---------------------------------------|----------|-------------------|
| | 2004 | 2003 | |
| | ----- | ----- | ----- |
| | (Dollars in thousands) | | |
| Anesthesia | \$20,127 | \$18,496 | 8.8% |
| Respiratory/Critical Care | 10,148 | 10,667 | (4.9%) |
| Sleep | 10,752 | 10,956 | (1.9%) |
| Pharmaceutical Technology Services | 4,671 | 3,729 | 25.3% |
| | ----- | ----- | ----- |
| | \$45,698 | \$43,848 | 4.2% |
| | ===== | ===== | ===== |

Sales of anesthesia products increased 8.8% from \$18.5 million for the three months ended December 31, 2003 to \$20.1 million for the three months ended December 31, 2004. The increase is due to a 61.2% increase in sales of Limb-O(TM), our patented anesthesia circuit, to \$2,602,000 and an 8.2% increase in sales of traditional anesthesia circuits to \$6,158,000. Domestic sales of anesthesia products increased 6.2%, from \$17,096,000 for the three months ended December 31, 2003 to \$18,154,000 for the three months ended December 31, 2004. International sales of anesthesia products increased 40.9%, from \$1,400,000 for the three months ended December 31, 2003 to \$1,973,000 for the three months ended December 31, 2004.

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Sales of respiratory/critical care products decreased 4.9%, from \$10.7 million for the three months ended December 31, 2003 to \$10.1 million for the three months ended December 31, 2004. The most significant factor was a decline of 39.0% in international sales of our ABG product principally related to international OEM customers. The remaining products in the Respiratory/Critical Care segments had an overall increase of 2.6%.

Net revenues in the Sleep segment decreased 1.9% (a decrease of 6.9% excluding foreign exchange) from \$11.0 million for the three months ended December 31, 2003 to \$10.8 million for the three months ended December 31, 2004. The Net revenues at Sleep Services of America (SSA), the Company's domestic sleep disorder diagnostic business, decreased 10.7% resulting from the effect of closing certain less profitable sleep labs between the second and fourth quarters of fiscal 2004. SSA has experienced a 13.8% sales increase, during the three months ended December 31, 2004, in the continuing sleep centers over the same period as last year. Also in this segment, revenues for Breas, our European manufacturer of personal ventilators and CPAP devices, increased 3.7% primarily from favorable foreign exchange. This was partially offset by declines resulting from increased competition in our ventilator product line and the discontinuing certain OEM products as a result of the increased focus on our own manufactured products.

Service revenues in the Pharmaceutical Technology Services segment increased 25.3%, from \$3.7 million for the three months ended December 31, 2003 to \$4.7 million for the three months ended December 31, 2004, resulting primarily from the impact of several significant sales of the company's ComplianceBuilder software to pharmaceutical clients.

Cost of Goods Sold and Services Performed. Cost of goods sold and services performed increased 5.5% from \$21.8 million for the three months ended December 31, 2003 to \$23.0 million for the three months ended December 31, 2004.

Cost of goods sold increased \$1.0 million, or 5.4%, from \$17.5 million for the three months ended December 31, 2003 to \$18.5 million for the three months ended December 31, 2004 resulting from volume increases of approximately \$674,000 and foreign exchange increases of approximately \$334,000. Cost of services performed increased 4.7%, from \$4.3 million for the three months ended December 31, 2003 to \$4.5 million for the three months ended December 31, 2004 resulting primarily from volume increases.

Gross Profit. Our gross profit increased 3.2%; from \$22.0 million for the three months ended December 31, 2003 to \$22.7 million for the three months ended December 31, 2004. Our overall gross profit margin was 49.7% for the three months ended December 31, 2004; a decrease from the 50.2% achieved in the three months ended December 31, 2003, resulting from decreased margins at our European subsidiary, Breas, and increased rebate

expense in both the Anesthesia and Respiratory/Critical Care segments. For gross profit information related to our four segments, refer to Footnote 6 of the Notes to Consolidated Financial Statements.

Operating Expenses

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Selling, General and Administrative Expenses. Selling, general and administrative expenses decreased 2.7%; from \$12.3 million for the three months ended December 31, 2003 to \$12.0 million for the three months ended December 31, 2004. The \$300,000 decrease consists primarily of reduced legal expenses of \$265,000 (primarily related to the audit committee investigation during the first quarter of fiscal 2004), \$156,000 for net cost reductions at our Breas subsidiaries and \$113,000 for net cost reductions within the Vital Signs core business. These savings were offset in part by an increase from foreign exchange at Breas of approximately \$210,000.

Research and Development Expenses. Research and development expenses increased by approximately \$278,000, or 18.5%, from \$1.5 million for the three months ended December 31, 2003 to \$1.9 million for the three months ended December 31, 2004 as the Company invests in the development of the new Breas family of Sleep CPAP and ventilation equipment, patient interfaces, and single use products for anesthesia, respiratory and critical care.

Restructuring Expense. Restructuring expense for the three months ended December 31, 2004, included costs of \$55,000 related to the closing of our California manufacturing plant.

Other (Income) Expense--Net. Other expense included in operating expenses, decreased by \$32,000 from \$70,000 for the three months ended December 31, 2003 to \$38,000 for the three months ended December 31, 2004.

Other Items

Interest Income and Expense. Interest income increased \$76,000, or 41.5%, from \$183,000 for the three months ended December 31, 2003 to \$259,000 during the three months ended December 31, 2004, resulting from the increase in available cash and cash equivalents. Interest expense decreased 100% from \$24,000 for the three months ended December 31, 2003, as the Company paid down its Industrial Revenue Bond in December 2003 in its entirety.

Provision for Income Taxes. The provision for income tax expense for the three months ended December 31, 2004 and 2003 was \$3.2 million and \$2.9 million, respectively, reflecting effective tax rates of 34.7% and 35.0% for these periods, respectively.

Discontinued Operations. The net loss (after applying the taxes) from discontinued operation was approximately \$90,000 for the three months ended December 31, 2004 and approximately \$154,000 for the three months ended December 31, 2003.

Liquidity and Capital Resources

Historically, our primary liquidity requirements have been to finance business acquisitions and to support operations. We have funded these requirements principally through internally generated cash flow. At December 31, 2004, we had cash and cash equivalents of approximately \$79.9 million and we had no long-term debt. We have a \$20 million line of credit with JP Morgan Chase Bank. There were no amounts outstanding on the JP Morgan Chase Bank line of credit at December 31, 2004.

Vital Signs continues to generate cash flows from its operations. During the three-months ended December 31, 2004, cash and cash equivalents increased by \$3.4 million. Operating activities provided \$7.1 million net cash, of which \$7.2 million was provided from continuing operations and \$90,000 was used by our discontinued operation at Vital Pharma. Investing activities used \$1.1 million for capital additions. Financing activities used \$4.0 million, consisting of \$4.0 million for the repurchase of common stock, and \$767,000 paid for dividends, which were offset by \$775,000 of cash received from the exercise of

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stock options.

Cash and cash equivalents were \$79.9 million at December 31, 2004 as compared to \$76.5 million at September 30, 2004. At December 31, 2004 our working capital was \$116.5 million as compared to \$113.2 million at September 30, 2004. At December 31, 2004 the current ratio was 7.7 to 1, as compared to 8.0 to 1 at September 30, 2004.

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Capital additions for the three month period ended December 31, 2004 were approximately \$1.1 million, and included expenditures for equipment at our New Jersey facility (\$105,000), Thomas Medical Products facility (\$118,000), new laboratory equipment (\$43,000) for the sleep labs at SSA, computer hardware and software to upgrade MIS systems (\$72,000) and the capitalized costs of software development (\$741,000) and patents (\$52,000). We expect that our total capital expenditures for fiscal 2005 should not exceed our total capital spending of \$5.3 million in fiscal 2004. This statement represents a forward-looking statement under the Reform Act. Actual results could differ materially from this statement for a number of reasons, including the possibility that the Company may determine that its business requires new equipment in order to meet competitive and/or technological challenges.

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

Our Board of Directors has authorized the expenditure of up to \$20 million for the repurchase of Vital Signs' stock. From fiscal 2003 through the three-month period ended December 31, 2004, we had repurchased 488,100 shares for \$14.7 million, at an average price of \$30.11. Any purchases under Vital Signs' stock repurchase program may be made from time-to-time in the open market, through block trades or otherwise. Depending on market conditions and other factors, these purchases may be commenced or suspended at any time or from time-to-time without prior notice.

Our Board of Directors has approved and paid \$767,000 in dividends (amounting to \$.06 per share) in the current fiscal year.

Critical Accounting Principles and Estimates

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

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different assumptions or conditions.

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

- o Through September 30, 2001, we amortized goodwill and intangibles on a straight-line basis over their estimated lives. Upon our adoption of SFAS No. 142 on October 1, 2001, we ceased amortizing goodwill and we perform an annual impairment analysis based upon discounted cash flows to assess the recoverability of the goodwill, in accordance with the provisions of SFAS No. 142. On an annual basis we conduct an impairment test of our goodwill and intangible assets. We completed this impairment test during the three-month period ended March 31, 2004 and found no impairment. If we are required to record impairment charges in the future, it would have an adverse impact on our results of operations and financial condition.
- o We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments, which results in bad debt expense. Our allowance for doubtful accounts was \$534,000 at December 31, 2004 and \$563,000 at September 30, 2004. We determine the adequacy of this allowance by evaluating individual customer receivables, considering the customer's financial condition and credit history and analyzing current economic conditions. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.
- o The Company's sales to distributors in the domestic anesthesia and respiratory/critical care business segments, which represented 25.1% of the Company's net sales during the three-month period ended December 31, 2004, are made at the Company's established distributor price. Since the end-user (i.e., a

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hospital) is typically entitled, on a case by case basis, to a price lower than our established price, the distributor is due a rebate (the difference between the established price and the lower price to which the end-user is entitled) when shipment is made to the end user. In order to properly reflect our sales to distributors, the Company records the gross sale (at our established price), less the amount of expected rebate to arrive at net sales. The allowance for rebates was \$6,841,000 and \$8,162,000 at December 31, 2004 and September 30, 2003, respectively. Rebate expense for the three-month period ended December 31, 2004 and 2003 was \$13,241,000 and \$11,085,000, respectively.

- o We have established an allowance for inventory obsolescence. The allowance was determined by performing an aging analysis of the inventory; based upon this review, inventory is stated at the lower of cost (first in, first out method) or its net realizable value. Our inventory allowance for obsolescence was \$979,000 at December 31, 2004 and \$1,150,000 at September 30, 2004.
- o We are subject to various claims and legal actions in the ordinary

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

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

Our international net revenue represents approximately 26.7% of our total net revenues. Our Breas subsidiary, located in Sweden, represents 57.0% of our total international net revenues. We do not enter into any derivative transactions, including foreign currency transactions, for speculative purposes. The Company has not entered into any derivative instrument transactions (i.e. foreign exchange forward or option contracts) as of December 31, 2004.

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

Item 4. Controls and Procedures

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

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

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Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information about purchases made by the Company of its common stock during the quarter ended December 31, 2004:

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid Per Share | (c) (1) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) (1) Maximum Dollar Amount That May Yet be Purchased Under the Plans or Programs |
|---------------------------|--|---|---|---|
| ----- | ----- | ----- | ----- | ----- |
| 10/1/2004-10/31/2004..... | 72,700 | \$33.99 | 72,700 | \$6,788,300 |
| 11/1/2004-11/30/2004..... | 28,000 | \$36.33 | 28,000 | \$5,769,850 |
| 12/1/2004-12/31/2004..... | 12,500 | \$38.88 | 12,500 | \$5,283,350 |
| | ----- | ----- | ----- | ----- |
| Total..... | 113,200 | \$35.11 | 113,200 | \$5,283,350 |
| | ===== | ===== | ===== | ===== |

(1) In May 2003, our Board of Directors authorized the expenditure of up to \$20 million for the repurchase of Vital Signs' stock. Any purchases under Vital Signs' stock repurchase program may be made from time-to-time in the open market, through block trades or otherwise. Depending on market conditions and other factors, these purchases may be commenced or suspended at any time or from time-to-time without prior notice. On February 8, 2005 our Board of Directors authorized the expenditure of an additional \$15 million for the repurchase of Vital Signs stock.

Item 6. Exhibits

Exhibits

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- 31.1 Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
 - 31.2 Certification of the Interim Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
 - 32.1 Certification of the Chief Executive Officer Pursuant to PARA 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
 - 32.2 Certification of the Interim Chief Financial Officer Pursuant to PARA 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

VITAL SIGNS, INC.

By: /s/ RICHARD T. FEIGEL

Richard T. Feigel
Corporate Controller and
Interim Chief Financial Officer

Date: February 9, 2005

EXHIBIT INDEX

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